

# Role of Capital Structure in Financial Performance of a Company

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## ABSTRACT

The main objective of the firms is to maximize its profits and in the same time minimize its costs, when companies search about resources to finance its investments they take this objective in consideration. The main sources that firms could use to provide the necessary finance are the internal finance which is equity, and the external finance which is debt. Most of companies use a mix between equity and debt which form the capital structure. Capital structure is most significant discipline of company's operations. This study constitutes an attempt to identify the impact between Capital Structure and Companies Performance, taking into consideration the level of Companies Financial Performance. Capital structure is a financial tool that helps to determine 'how do firms choose their capital structure?' a firm's capital structure is then the composition or structure of its liabilities. The term capital structure should not be confused with financial structure. While financial structure consists of short-term debt, long-term debt and share holders' fund i.e., the entire left hand side of the company's Balance Sheet. But capital structure consists of long-term debt and shareholders' fund. So, it may be concluded that the capital structure of a firm is a part of its financial structure. Capital structure refers to the proportion of long-term debt and equity in the total capital of a company. On the other hand, financial structure refers to the net worth or owners' equity and all liabilities (long-term as well as short-term).

**Keywords:** *Capital Structure; Financial Structure, Financial Performance; Capital Adequacy*

## Article Publication

Published Online: 14-Feb-2021

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## 1. Introduction

Capital structure refers to the permanent financing of the company, represented by owned capital and loan/debt capital (i.e. Preferred Stock, Equity Stock, Reserves and Long-term Debts). In other words, it includes all long-term funds invested in the business in the form of Long-term Loans, Preference Shares and Debentures, including Equity Capital and Reserves. Capital structure is a part of the financial structure and refers to the proportion of the various long-term sources of financing. The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets. It is concerned with making the array of the sources of the funds in a proper manner, which is in relative magnitude and proportion. Each component of capital structure has a different cost to the firm. In case of companies, it is financed from various sources. In proprietary concerns, usually, the capital employed, is wholly contributed by its owners. In this context, capital refers to the total of funds supplied by both—owners and long-term creditors. Since, it is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So it relates to the arrangement of capital and excludes short-term borrowings. The question arises: What should be the appropriate proportion between owned and debt capital? It depends on the financial policy of individual firms. In one company debt capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company.

### Few definitions of capital structure given by some financial experts:

In the words of **Gerstenberg**, “Capital structure of a company refers to the make-up of its capitalisation and it includes all long-term capital resources viz., loans, reserves, shares and bonds.”

“Capital structure is the combination of debt and equity securities that comprise a firm’s financing of its assets.”—**John J. Hampton**.

“Capital structure refers to the mix of long-term sources of funds, such as, debentures, long-term debts, preference share capital and equity share capital including reserves and surplus.”—**I. M. Pandey**.

In the words of **P. Chandra**, “Capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations toward debt capital and a residual component that belongs to equity shareholders”.

## 2. Capital Structure and Financial Structure

Business people use the term **structure** in quite a few different ways. Two other similar terms describe the nature of the company's financial position: Financial structure and capital structure.

Both structures concern the "Liabilities + Equities" side of the Balance sheet equation:

Assets = Liabilities + Equities.

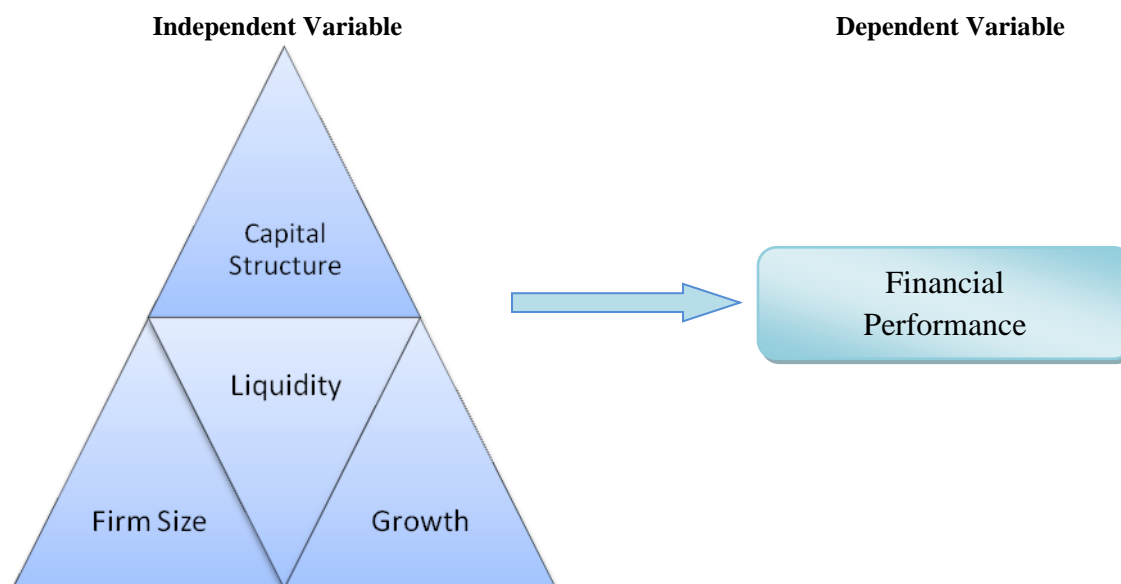
- Financial structure refers to the balance between all of the company's liabilities and its equities. It thus considers the entire "Liabilities+Equities" side of the Balance sheet.
- Capital structure, by contrast, refers to the balance between equities and long-term liabilities. Short-term liabilities do not contribute to capital structure.

For comparing the firm's debt to its equities, financial structure is, therefore, more sensitive than the capital structure to short-term liabilities. "Financial structure" reflects the status of working capital and cash flow, salaries payable, accounts payable, and taxes payable. The Capital structure does not.

Capital structure, on the other hand, refers to the makeup of the company's underlying value. Here, capital structure focuses on the balance between funding from equities and financing from long-term debt. The presumption is that firms use funds from both sources to acquire income-producing assets. Capital structure is also known as capitalization.

Thus, a company’s capital structure is only a part of its financial structure.

## 3. Conceptual Model



## 4. Patterns of Capital Structure

When a company is analyzing what capital structure to adopt it can opt for any of the following pattern.

- a) Capital structure with equity shares only
- b) Capital structure with equity and preference shares
- c) Capital structure with equity shares and debentures
- d) Capital structure with equity, preference shares and debentures

But the best method of choosing the composition of capital structure depends on a number of factors such as the nature of Company's business, regularity of earnings, conditions of the money market, attitude of the investor, etc. but the most significant is to choose the alternative which gives the highest EPS or rates of return on equity capital.

Debt is a liability on which interest has to be paid irrespective of the company's profits. While equity consists of shareholders, or owners, funds on which payment of dividend depends upon the company's profit. A high proportion of the debt content in the capital structure increase the risk and may lead to financial insolvency of the company in adverse times. However, raising fund through debt is cheaper than to raise funds through equity due to tax factor as interest on debenture is an allowable deduction. On the other hand, payment of dividend is an appropriation of profit, hence, the same is not allowed as deduction for computation of taxable income.

In short, if a company having 50% tax bracket pays debenture interest @ 10% the ultimate effective cost comes to 5%. That is not applicable also in case of preference shares.

If a firm raises its funds by the issue of 10% preference shares, the dividend so paid to the preference shareholders is also not allowed as deduction for income tax purposes i.e., the cost of raising funds would be @ 10%. So it can safely be stated that to raise fund by the issue of debt capital or borrowings is cheaper which result in a higher profit available to the equity shareholders that, in other words, increase the EPS.

## 5. Capital Structure Theories

The capital structure theories explore the relationship between your company's use of debt and equity financing and the value of the firm. We will discuss these theories one by one. The capital structure theories use the following assumptions for simplicity:

1. The firm uses only two sources of funds: debt and equity.
2. The effects of taxes are ignored.
3. There is no change in investment decisions or in the firm's total assets.
4. No income is retained.
5. Business risk is unaffected by the financing mix.

### I. Net Income Approach:

According to this approach, a firm can minimise the weighted average cost of capital and increase the value of the firm as well as market price of equity shares by using debt financing to the maximum possible extent. The theory propounds that a company can increase its value and decrease the overall cost of capital by increasing the proportion of debt in its capital structure.

#### This approach is based upon the following assumptions:

- (i) The cost of debt is less than the cost of equity.
- (ii) There are no taxes.
- (iii) The risk perception of investors is not changed by the use of debt.

The line of argument in favour of net income approach is that as the proportion of debt financing in capital structure increase, the proportion of a less expensive source of funds increases. This results in the decrease in overall (weighted average) cost of capital leading to an increase in the value of the firm. On the other hand, if the proportion of debt financing in the capital structure is reduced or say when the financial leverage is reduced, the weighted average cost of capital of the firm will increase and the total value of the firm will decrease.

#### The total market value of a firm on the basis of Net Income Approach can be ascertained as below:

$$V = S + D$$

Where, V= Total market value of a firm

S = Market value of equity shares

= Earnings Available to Equity Shareholders (NI)/Equity Capitalisation Rate

D = Market value of debt,

and, Overall Cost of Capital or Weighted Average Cost of Capital can be calculated as:  $K_0 = EBIT/v$

## II. Net Operating Income Approach:

This theory as suggested by Durand is another extreme of the effect of leverage on the value of the firm. It is diametrically opposite to the net income approach. According to this approach, change in the capital structure of a company does not affect the market value of the firm and the overall cost of capital remains constant irrespective of the method of financing. It implies that the overall cost of capital remains the same whether the debt-equity mix is 50: 50 or 20:80 or 0:100. Thus, there is nothing as an optimal capital structure and every capital structure is the optimum capital structure.

### This theory presumes that:

- (i) The market capitalises the value of the firm as a whole;
- (ii) The business risk remains constant at every level of debt equity mix;
- (iii) There are no corporate taxes.

The reasons propounded for such assumptions are that the increased use of debt increases the financial risk of the equity shareholders and hence the cost of equity increases. On the other hand, the cost of debt remains constant with the increasing proportion of debt as the financial risk of the lenders is not affected. Thus, the advantage of using the cheaper source of funds, i.e., debt is exactly offset by the increased cost of equity.

According to the Net Operating Income (NOI) Approach, the financing mix is irrelevant and it does not affect the value of the firm.

The value of a firm on the basis of Net Operating Income Approach can be determined as below:

$$V = EBIT/K_0$$

Where, V = Value of a firm

EBIT = Net operating income or Earnings before interest and tax

K<sub>0</sub> = Overall cost of capital

The market value of equity, according to this approach is the residual value which is determined by deducting the market value of debentures from the total market value of the firm.

$$S = V - D$$

Where, S = Market value of equity shares

V = Total market value of a firm

D = Market value of debt

**The cost of equity or equity capitalisation rate can be calculated as below:**

$$\text{Cost of Equity or Equity Capitalisation Rate } (K_e) = \frac{\text{Earnings after Interest and Before Tax}}{\text{Market Value of Firm} - \text{Market Value Debt}}$$

$$= EBIT - I/V - D$$

## III. Traditional Approach:

The traditional approach, also known as Intermediate approach, is a compromise between the two extremes of net income approach and net operating income approach. According to this theory, the value of the firm can be increased initially or the cost of capital can be decreased by using more debt as the debt is a cheaper source of funds than equity.

Thus, optimum capital structure can be reached by a proper debt-equity mix. Beyond a particular point, the cost of equity increases because increased debt increases the financial risk of the equity shareholders. The advantage of cheaper debt at this point of capital structure is offset by increased cost of equity. After this there comes a stage, when the increased cost of equity cannot be offset by the advantage of low-cost debt.

Thus, overall cost of capital, according to this theory, decreases up to a certain point, remains more or less unchanged for moderate increase in debt thereafter; and increases or rises beyond a certain point. Even the cost of debt may increase at this stage due to increased financial risk.

#### IV. Modigliani and Miller Approach:

M&M hypothesis is identical with the Net Operating Income approach if taxes are ignored. However, when corporate taxes are assumed to exist, their hypothesis is similar to the Net Income Approach.

##### (a) In the absence of taxes. (Theory of Irrelevance):

The theory proves that the costs of capital is not affected by changes in the capital structure or say that the debt-equity mix is irrelevant in the determination of the total value of a firm. The reason argued is that though debt is cheaper to equity, with increased use of debt as a source of finance, the cost of equity increases.

This increase in cost of equity offsets the advantage of the low cost of debt. Thus, although the financial leverage affects the cost of equity, the overall cost of capital remains constant. The theory emphasises the fact that a firm's operating income is a determinant of its total value.

The theory further propounds that beyond a certain limit of debt, the cost of debt increases (due to increased financial risk) but the cost of equity falls thereby again balancing the two costs.

In the opinion of Modigliani & Miller, two identical firms in all respects except their capital structure cannot have different market values or cost of capital because of arbitrage process.

In case two identical firms except for their capital structure have different market values or cost of capital, arbitrage will take place and the investors will engage in 'personal leverage' (i.e. they will buy equity of the other company in preference to the company having lesser value) as against the 'corporate leverage'; and this will again render the two firms to have the same total value.

##### The M&M approach is based upon the following assumptions:

- (i) There are no corporate taxes.
- (ii) There is a perfect market.
- (iii) Investors act rationally.
- (iv) The expected earnings of all the firms have identical risk characteristics.
- (v) The cut-off point of investment in a firm is capitalisation rate.
- (vi) Risk to investors depends upon the random fluctuations of expected earnings and the possibility that the actual value of the variables may turn out to be different from their best estimates.
- (vii) All earnings are distributed to the shareholders.

##### (b) When the corporate taxes are assumed to exist. (Theory of Relevance):

Modigliani and Miller, in their article of 1963 have recognised that the value of the firm will increase or the cost of capital will decrease with the use of debt on account of deductibility of interest charges for tax purpose. Thus, the optimum capital structure can be achieved by maximising the debt mix in the equity of a firm.

According to the M & M approach, the value of a firm unlevered can be calculated as.

$$\text{Value of Unlevered Firm (V}_u\text{)} = \frac{\text{Earnings Before Interest \& Tax}}{\text{Overall Cost of Capital}} \text{ i.e. } \frac{\text{EBIT}}{K_o} (1-t)$$

$$\text{and, the Value of a Levered Firms is : } v_L = V_u + tD$$

Where,  $V_u$  is value of unlevered firm, and

$tD$  is the discounted present value of the tax savings resulting from the tax deductibility of the interest charges,  $t$  is the rate of tax and  $D$  the quantum of debt used in the mix.

#### 6. Importance or Significance of Capital Structure

1. A sound capital structure of a company helps to increase the market price of shares and securities which, in turn, lead to increase in the value of the firm.
2. A good capital structure enables a business enterprise to utilise the available funds fully. A sound capital structure protects the business enterprise from over-capitalisation and under-capitalisation.

3. A sound capital structure enables management to increase the profits of a company in the form of higher return to the equity shareholders i.e., increase in earnings per share.
4. A sound capital structure of any business enterprise maximises shareholders' wealth through minimisation of the overall cost of capital.
5. A sound capital structure never allows a business enterprise to go for too much raising of debt capital because, at the time of poor earning, the solvency is disturbed for compulsory payment of interest to the debt-supplier.
6. A sound capital structure provides a room for expansion or reduction of debt capital so that, according to changing conditions, adjustment of capital can be made.
7. A good capital structure does not allow the equity shareholders control on business to be diluted.
8. A sound capital structure protects a business enterprise from financial risk through a judicious mix of debt and equity in the capital structure.

## 7. Factors Determining Capital Structure

### 1. Risk of cash insolvency:

Risk of cash insolvency arises due to failure to pay fixed interest liabilities. Generally, the higher proportion of debt in capital structure compels the company to pay higher rate of interest on debt irrespective of the fact that the fund is available or not. The non-payment of interest charges and principal amount in time call for liquidation of the company. The sudden withdrawal of debt funds from the company can cause cash insolvency. This risk factor has an important bearing in determining the capital structure of a company and it can be avoided if the project is financed by issues equity share capital.

### 2. Risk in variation of earnings:

The higher the debt content in the capital structure of a company, the higher will be the risk of variation in the expected earnings available to equity shareholders. If return on investment on total capital employed (i.e., shareholders' fund plus long-term debt) exceeds the interest rate, the shareholders get a higher return.

On the other hand, if interest rate exceeds return on investment, the shareholders may not get any return at all.

### 3. Cost of capital:

Cost of capital means cost of raising the capital from different sources of funds. It is the price paid for using the capital. A business enterprise should generate enough revenue to meet its cost of capital and finance its future growth. The finance manager should consider the cost of each source of fund while designing the capital structure of a company.

### 4. Control:

The consideration of retaining control of the business is an important factor in capital structure decisions. If the existing equity shareholders do not like to dilute the control, they may prefer debt capital to equity capital, as former has no voting rights.

### 5. Trading on equity:

The use of fixed interest bearing securities along with owner's equity as sources of finance is known as trading on equity. It is an arrangement by which the company aims at increasing the return on equity shares by the use of fixed interest bearing securities (i.e., debenture, preference shares etc.). If the existing capital structure of the company consists mainly of the equity shares, the return on equity shares can be increased by using borrowed capital. This is so because the interest paid on debentures is a deductible expenditure for income tax assessment and the after-tax cost of debenture becomes very low. Any excess earnings over cost of debt will be added up to the equity shareholders. If the rate of return on total capital employed exceeds the rate of interest on debt capital or rate of dividend on preference share capital, the company is said to be trading on equity.

### 6. Government policies:

Capital structure is influenced by Government policies, rules and regulations of SEBI and lending policies of financial institutions which change the financial pattern of the company totally. Monetary and fiscal policies of the Government will also affect the capital structure decisions.

### 7. Size of the company:

Availability of funds is greatly influenced by the size of company. A small company finds it difficult to raise debt capital. The terms of debentures and long-term loans are less favourable to such enterprises. Small companies have to depend more on the equity shares and retained earnings. On the other hand, large companies issue various types of securities despite the fact that they pay less interest because investors consider large companies less risky.

#### **8. Needs of the investors:**

While deciding capital structure the financial conditions and psychology of different types of investors will have to be kept in mind. For example, a poor or middle class investor may only be able to invest in equity or preference shares which are usually of small denominations, only a financially sound investor can afford to invest in debentures of higher denominations. A cautious investor who wants his capital to grow will prefer equity shares.

#### **9. Flexibility:**

The capital structures of a company should be such that it can raise funds as and when required. Flexibility provides room for expansion, both in terms of lower impact on cost and with no significant rise in risk profile.

#### **10. Period of finance:**

The period for which finance is needed also influences the capital structure. When funds are needed for long-term (say 10 years), it should be raised by issuing debentures or preference shares. Funds should be raised by the issue of equity shares when it is needed permanently.

#### **11. Nature of business:**

It has great influence in the capital structure of the business, companies having stable and certain earnings prefer debentures or preference shares and companies having no assured income depends on internal resources.

#### **12. Legal requirements:**

The finance manager should comply with the legal provisions while designing the capital structure of a company.

#### **13. Purpose of financing:**

Capital structure of a company is also affected by the purpose of financing. If the funds are required for manufacturing purposes, the company may procure it from the issue of long-term sources. When the funds are required for non-manufacturing purposes i.e., welfare facilities to workers, like school, hospital etc. the company may procure it from internal sources.

#### **14. Corporate taxation:**

When corporate income is subject to taxes, debt financing is favourable. This is so because the dividend payable on equity share capital and preference share capital are not deductible for tax purposes, whereas interest paid on debt is deductible from income and reduces a firm's tax liabilities. The tax saving on interest charges reduces the cost of debt funds. Moreover, a company has to pay tax on the amount distributed as dividend to the equity shareholders. Due to this, total earnings available for both debt holders and stockholders is more when debt capital is used in capital structure. Therefore, if the corporate tax rate is high enough, it is prudent to raise capital by issuing debentures or taking long-term loans from financial institutions.

#### **15. Cash inflows:**

The selection of capital structure is also affected by the capacity of the business to generate cash inflows. It analyses solvency position and the ability of the company to meet its charges.

#### **16. Provision for future:**

The provision for future requirement of capital is also to be considered while planning the capital structure of a company.

#### **17. EBIT-EPS analysis:**

If the level of EBIT is low from EPS point of view, equity is preferable to debt. If the EBIT is high from EPS point of view, debt financing is preferable to equity. If ROI is less than the interest on debt, debt financing decreases ROE. When the ROI is more than the interest on debt, debt financing increases ROE.

## 8. Effect of Capital Structure on Financial Performance

Modigliani & Miller (1958) proposed that a type of funds that a firm uses is not linked to its cost and there isn't any existence of a capital structure that is optimal, hence it is irrelevant or has no influence on the value of a firm. The trade-off theory suggests that when trying to find an optimal capital structure, firms will trade off main benefits which is tax deductibility of interest and costs which is bankruptcy cost of debt and equity financing (Myers, 1977). However, it cannot be concluded from this theory that interest tax shield has a substantial contribution to the debt ratios or the market value of a particular firm. According to pecking order theory, Myers & Majluf (1984) noted that internal finance is preferred over external finance by firms since information asymmetry creates a problem between the firm's agent and the owner. Hence, less debt capital will be used by firms that are considered to be profitable and generate better earnings as compared to those that don't generate high earnings.

## 9. Conclusion

How a company chooses to raise its capital is entirely up to the finance managers or persons tasked with that decision. But most prefer doing so internally and if that is not enough look externally starting from the safe to the riskier options. Though, we can give the best capital structure by considering factors like taxes, business risks, asset types, issuance cost, and investor attitude to security issuance when coming up with a company's structure. However, following points may be considered to increase the Company's financial performance based on capital structure. 1. Establishing the Performance standards and communicating to the investors. It will help investor in taking standard and better investment decisions. 2. Identification of investment weaknesses may result in improving the firm's financial performance, as it indicates the area for decision making. 3. Motivating the investors will help to achieve firm's financial performance. We may conclude that there is positive relationship between capital structure and financial performance and also capital structure significantly impacts the financial performance of a firm.

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