UNIT III

Subject Name	Subject Code	Semester	Prepared By
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Meaning of Capital Structure

Capital structure refers to the mix of sources from where the long term fund required in a firm may be raised i.e, what should be the proportions of share capital, preference share capital, internal sources, debentures and other sources of funds in the total amount of capital which a firm may raise for establishing its business.

Definition of Capital Structure

The term capital structure has been defined by several authors differently, Some of the definitions are :

(i) IM. Pandey: Capital structure refers to the composition of long term sources of funds such as debentures, long term debt, preference share capital and ordinary share capital including reserves and surpluses (retained earnings).

(ii) John J. Hampton: Capital structure is the combination of debt and equity securities that comprise a firm's financing of its assets.

We can thus, define capital structure as the overall mix of components of capitalisation. It is a composite function and includes the following decisions:

(i) **Type of securities to be used or issued**: e.g.

(a) Shares: Equity shares, Preference shares.

(b) Debt: Debentures, bonds, public deposits, loans from banks and financial institutions. (ii) **Ratio or proportion of securities**: The ratio or proportion of securities in any capital structure is an important decision. The decision of capital mix is called capital gearing.The capital gearing may be high, low or even. When the proportion of equity share capital is high in comparison with other securities in the total capitalization, it is low geared and in the opposite case, it is high geared and at the same time, if equity share capital is equal to the other securities, it is called evenly geared.

Patterns of Capital Structure

There may be four fundamental patterns of capital structure as follows:
(i) Equity share capital only (including Reserves & surplus).

(ii) Equity share capital and preference share capital.

(iii) Equity, preference share capital and long term debt. i.e. Debentures, bonds and loans from financial institutions etc.

(iv) Equity share capital and long term debt.

Difference between Capital Structure and Financial Structure

The term capital structure differs from financial structure. Financial structure refers to the composition or make up of the entire liabilities side of the balance sheet of a firm. It shows the way in which the firm's assets are financed. It includes long term as well as short term sources of finance. Capital structure is the permanent financing of the firm represented primarily by long term debt and shareholders funds but excluding all short term credit. Thus, a firm's capital structure is only a part of its financial structure.

Optimum Capital Structure

The capital structure is said to be optimum capital structure when the firm has selected such a combination of equity and debt so that the wealth of firm is maximum. At this capital structure, the cost of capital is minimum and market price per share is maximum. It is, however, difficult to find out optimum debt and equity mix where the capital structure would be optimum because it is difficult to measure a fall in the market value of an equity share on account of increase in risk due to high debt content in the capital structure.

Features of an Appropriate Capital Structure

(i) **Minimum cost**: An appropriate capital structure should attempt to establish the mix of securities in such a way as to raise the requisite funds at the lowest possible cost. As the cost of various sources of capital is not equal in all circumstances, it should be ascertained on the basis of weighted average cost of capital. The management should aim at keeping the issue expenses and fixed annual payments at a minimum in order to maximize the return to equity shareholders.

(ii) **Maximum return**: An appropriate capital structure should be devised in such a way so as to maximize the profit of the firm. In order to maximize profit, the firm should follow a proper policy of trading on equity so as to minimize the cost of capital.

(iii) **Minimum risk**: An appropriate capital structure should possess the quality of minimum risk. Risk,such as increase in taxes, rates of interest,costs etc. and decrease in prices and value of shares as well as natural calamities adversely affects the firm's earnings. Therefore, the capital structure should be devised in such a way as to enable it to afford the burden of these risks easily.

(iv) **Maximum control**: An appropriate capital structure has also the quality of retaining control of the existing equity shareholders on the affairs of the firm. Generally, the ultimate control of the firm rests with the equity shareholders who have the right to elect directors. The firm should, therefore, issue preference shares or debentures to the public instead of equity shares because preference shares carry limited voting rights and debentures do not have any voting rights. Thus the capital structure of a firm should not be changed in such a way which would adversely affect the voting structure of the existing shareholders, dilute their control on the firm's affairs.

(v) **Flexibility**: An appropriate capital structure should have the quality of flexibility in it. A flexible capital structure enables the firm to make the necessary changes in it according to the changing conditions. In other words, under flexible capital structure, a firm can procure more capital whenever required or redeem the surplus capital.

(vi) **Proper liquidity**: An appropriate capital structure has to maintain proper liquidity which is essential for the solvency of the firm. In order to achieve proper liquidity, all debts which threaten the solvency of the firm should be avoided and a proper balance between fixed assets and current assets should be maintained according to the nature and size of business.

(vii) **Conservatism**: A firm has to follow the policy of conservatism in devising the capital structure. This would help in maintaining the debt capacity of the firm even in unfavourable circumstances.

(viii) **Full utilisation**: An appropriate capital structure is needed for optimum utilization of financial resources of a firm. Both under capitalization and over capitalization are injurious to the financial interest of a firm. Thus there should be a proper co-ordination between the optimum of capital and the financial needs of a firm. A fair capitalization enables to make full utilization of the available capital at minimum cost.

(ix) **Balanced leverage**: An appropriate capital structure should attempt to secure a balanced leverage by issuing both types of securities ie, ownership securities and creditorship securities. Generally, shares are issued when the rate of capitalization is high, and debentures are issued when rate of interest is low.

(x) **Simplicity**: An appropriate capital structure should be easy to understand and easy to operate. For this purpose, the number and type of securities issued should be limited.

Factors determining Capital Structure

The following factors must be considered while determining the capital structure of a firm:

(i) **Trading on equity**: The concept of trading on equity is based on the concept of taking advantage of equity i.e. owner funds to earn additional profits, In case, where the rate of return of firm is higher than the cost of borrowed funds i.e. preference shares or debentures or public deposits or debts, the firm shall prefer to arrange more funds from these sources, so that it earns additional profits after paying fixed rate on these sources.

(ii) **Stability on sales**: An established firm which has a growing market and high sales does not have any difficulty in meeting its fixed commitments. Interest on debentures has to be paid regardless of profits. If sales are on the rise, interest payments can be met and therefore, a firm is able to employ more debt in its capital structure. If sales are fluctuating and unstable, then the firm will not be able to pay interest charges as and when they become due. Therefore, it is better not to employ too much debt in its capital structure.

(iii**) Exercise control**: The control of a firm is entrusted to the board of directors elected by the equity shareholders. If the board of directors and shareholders of a firm wish to retain control over the firm in their hands, they should not allow further issue of equity shares to the public. In such a case, more funds can be raised by issuing preference shares and debentures.

(iv) **Cost of capital**: Cost of capital, is the payment made by firm to obtain capital. Thus interest is the cost of debentures or loans and the dividend paid by the firm is the cost of preference and equity capitals. The rate of dividend on preference capital is fixed which is generally lower than that of equity capital. The cost of debentures is generally lower and tax deductible. Therefore, a firm may prefer as much debt as it possibly can subject to its earning capacity so as to enable the firm to keep on paying its interest obligation.

(v) **Statutory requirements**: The structure of capital of a firm is also influenced by the requirements of the statutes applicable to it. For example, banking companies have been prohibited by the Banking Regulation Act from issuing any type of securities except equity shares.

(vi) **Capital market conditions**: The conditions prevailing in the capital market also influences the determination of the securities to be issued. For instance, during depression, people do not like to take risk and so are not interested in equity shares. But during boom, investors are ready to take risk and invest in equity shares. Therefore, debentures and preference shares which carry fixed rates of return may be marketed during depression easily.

(vii) **Corporate taxation**: Under the Income tax laws, dividend on share is not deductible while interest paid on borrowed capital is allowed by deduction. Owing to these provisions, corporate taxation plays an important role in determining the choice between, sources of financing.

(viii) **Government policies**: Government policies are a major factor in determining capital structure. For example, a change in the lending policies eg of financial institutions may mean a complete change in the finance pattern to be followed in the firms. Similarly, the Rules and Regulations framed by SEBI considerably affect the capital issue policy of various firms. Monetary and fiscal policies of the Government also affect the Capital structure decision.

(ix) **Flexibility**: It denotes the capacity of the business and its management to adjust to expected and unexpected changes in the business environment. The capital structure should provide maximum freedom to changes at all times.

(x) **Timing** : Closely related to flexibility is the timing for issue of securities. Proper timing of a security issue often brings substantial savings because of the dynamic nature of the capital market. Intelligent Management tries to anticipate the climate in capital market with a view to minimize the cost of raising funds and also to minimize the dilution resulting from an issue of new equity shares.

(xi) **Size of the firm**: Small firms rely heavily on owner’s funds, while large and widely held firms are generally considered to be less risky by the investors. Such large firms can issue different types of debt instruments or securities.

(xii)**Purpose of financing**: In case funds are required for productive purposes like manufacturing etc., the firm may raise funds through long term sources, On the other hand, if the funds are required for productive purposes, like welfare facilities to employees such as hospitals, etc,, the firm may rely only on internal resources.

(xiii) **Period of finance**: Funds required for medium and long term periods say pay 8 to 10 years, may be raised by way of borrowings. But if the funds are for permanent requirement, it will be appropriate to raise them by issue of equity shares.

(xiv) **Maneuverability**: It means having many possible alternatives at the time of expanding or contracting the requirement of funds. It enables use of proper type of funds available at a given time and also enhances the bargaining power while dealing with prospective suppliers of funds

(xv) **Flotation costs**: These costs are incurred at the time of issue of shares, debentures etc. These costs should be taken into account while raising long term funds. The cost of raising debt is less than the cost of issuing equity shares. Further, issue expenses as a percentage of total funds decrease with the increase in the size of the issue.
(xvi) **Requirement of investors**: Different of types of securities are issued to different classes of investors according to their requirements. Sometimes the investor may be motivated by the options and advantages available with a security e.g. double options, convertibility, security of principal and interest, etc.

(xvii) **Provision for future growth**: Future growth consideration and future requirements of capital should also be considered while planning the capital structure.

DIVIDEND

Meaning of Dividend

The term dividend refers to that part of the profit (after tax) which is distributed among the owners/ shareholders of the firm. In other words, it is a taxable payment declared by a firm's board of directors and given to its shareholders out of the firm's current or retained earnings usually quarterly. Dividends are usually given as cash (cash dividend), but they can also take the form of stock (stock dividend) or other property. Dividends provide an incentive to own stock in stable firms even if they are not experiencing much growth. Firms are not required to pay dividends. The firms that offer dividends are most often firms that have progressed beyond the growth phase and no longer benefit sufficiently by reinvesting their profits. So they usually choose to pay them out to their shareholders, also called payout.

Types of Dividends

Following are the different types of dividends offered to the shareholders of the firm:
(i**) Regular Dividend**: It is paid annually, proposed by the board of directors and approved by the shareholders in general meeting. It is also known as final dividend because it is usually paid after the finalisation of accounts. It is generally paid in cash as a percentage of paid up capital, say 10% or 15% of the capital. Sometimes it is paid per share.

(ii) **Interim Dividend**: If Articles so permit, the directors may decide to pay dividend at any time between the two Annual General Meetings before finalising the accounts. It is generally declared and paid when firm has earned heavy profits or abnormal profits during the year and directors wish to pay the profits to Shareholders. Such payment of dividend in between the two Annual General meetings before finalisation of accounts is called Interim Dividend.
(iii) **Stock Dividend**: Stock dividend is in the form of issue of bonus share, the equity shareholders in lieu or addition to the cash dividend. Stock dividends usually are expressed as a percentage of the number shares outstanding.

(iv) **Bond Dividend**: In rare instances, dividends are paid in the form bonds for a long term period. The firm generally pays interest on these bonds and repay the bonds on maturity. Bond dividend enables the firm to postpone payment of cash.
(v) **Property Dividend**: Sometimes, dividend is paid in the form of assets instead of payment of dividend in cash. The distribution of dividend is made when the asset is no longer required in the business such as investment or stock finished goods.
But it is however important to note that in India, distribution of divided permissible in the form of cash or bonus shares only. Distribution of dividend any other form is not allowed.
Meaning of Dividend Policy

Dividend Policy refers to the policy chalked out by firms regarding the amount they would pay to their shareholders as dividend. Once firms make profits have to decide on what to do with these profits. The firms have two options:

They can retain these profits within the firm or they can pay these profits in the form of dividends to their shareholders.

Definition of Dividend Policy

The term dividend policy has been defined as given below:
(i) Weston and Brigham: Dividend policy determines the division of earnings between payments to shareholders and retained earnings.

(ii) Gitman: The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made.

Nature of Dividend Policy The nature of dividend policy are as follows:

(i) **Tied up with retained earnings**: A dividend policy is tied up with the retained earnings policy. It has the effect of dividing net earnings of the firm into two parts: retained earnings and dividend.

(ii) **Influence on financing decision**: Dividend policy has an influence on the financing decision of the business. Distribution of dividends reduces the cash funds of the business and to that extent it has to depend upon external sources of finance. The cost of funds raised from external sources is relatively higher than the cost of retained earnings. The management will decide to pay dividend when the firm does not have profitable investment opportunities.
(iii) **Impact on shares:** Dividend policy of the firm has far reaching consequences in the share prices, growth rate of the business and the wealth of shareholders, Due to market imperfections and uncertainty, shareholders give a higher weightage to the current dividends rather than future dividends and capital gains. Thus the payment of dividends influences the market price of shares. Higher the rate of dividends, greater the price of shares and vice versa. Higher market price of shares and bigger current dividends enhance the wealth of shareholders.
(iv)Optimal dividend policy: As dividend is an active decision variable, it has to be intelligently managed by the finance manager who should endeavour to formulate an optimal dividend policy i.e., a policy with few or no dividends payment fluctuations, over a long period of time, having & favourable impact on the wealth of shareholders.
Objectives of Divided Policy

The following are the are the objectives of dividend policy of' a firm:

(i) Providing sufficient financing (ii) Return to shareholders (iii) Wealth Maximisation.

Factors determining Dividend Policy

Following ate the factors which influence the dividend policy of a firm:
(i) **Stability of earnings**: Industrial units have stable earnings and they follow a consistent dividend policy than those having uneven flow. Firms dealing in necessities have stable earnings.
(ii) **Age of firm**: Age of the firm counts much in deciding the dividend policy. A newly established firm may require much of its earnings for expansion and plant improvement and may adopt a rigid dividend policy. While, on the other hand, an older company can formulate a more consistent policy regarding dividend.

(iii) **Regularity and stability in dividend payment**: Dividend should be paid regularly because each investor is interested in the regular payment of dividend, The management should, in spite of regular payment of dividend, the rate of dividend should be constant. For the purpose, sometimes firms maintain dividend equalisation fund.

(iv) **Time for payment of dividend**: When should the dividend be paid should be considered. Payment of dividend means outflow of cash. It is desirable to distribute dividend at a time when cash is least needed by the firm because there are peak times as well as lean period of expenditure. Wise management should plan the payment of in such a manner that there is no cash outflow at a time when firm is already in need of funds.

(v) **Liquidity of funds**: Availability of cash and sound financial position is also an important factor in dividend decision. A dividend represents a cash outflow and the greater the fund and the liquidity of the firm, the better the ability to pay dividend. The liquidity of a firm depends very much on the investment and finance decisions of the firm which in turn determine the rate of expansion and the manner of financing. If cash position is weak, stock dividend can be distributed and if cash position is good, the firm can distribute the cash dividend.
(vi) **Policy of control**: If the directors want to have control on firm, they would not like to add new shareholders and therefore, declare dividend at low rate. Because by adding new shareholders, they fear dilution of control and diversion of policies and programmes of the existing management. So they prefer to meet the need for funds through retained earnings. If the directors do not bother about the control of affairs, they will follow a liberal dividend policy.

(vii) **Repayment of loan**: Firms having loan indebtedness are vowed to a high rate of retention earnings, unless some other arrangements are made for the redemption of debt on maturity. It will naturally lower down the rate of dividend. Sometimes, the lenders (mostly institutional lenders) put restrictions on the dividend distribution till such time their loan is outstanding.

(viii) **Government policies**: The earning capacity of the firm is widely affected by the change in fiscal, industrial, labour, control and other government policies. Sometimes government restricts the distribution of dividend beyond a certain percentage in a particular industry or in all spheres of business activity as was done in emergency. The dividend policy has to be modified or formulated by firms according to such restrictions.

(ix) **Legal requirements**: In deciding on the dividend, the directors take the legal requirements too into consideration. In order to protect the interests of creditors, and outsiders, the Companies Act 1956 prescribes certain guidelines in respect of the distribution and payment of dividend.

(x) **Trade cycles**: Business cycles also exercise influence upon dividend policy. Dividend period is adjusted according to the business oscillations. During the boom, prudent management creates reserves for contingencies which follow the inflationary period. High rates of dividend can be used as a tool for marketing the securities in an otherwise depressed market.

(xi) **Need for additional capital**: Firms retain a part of their profits for strengthening their financial position. The income may be conserved for meeting the increased requirement of working capital or of future, expansion. Small companies usually find difficulties in raising finance, for their needs of increased working capital for expansion programmes They, having no other alternative, use their ploughed back profits. Thus such firms distribute dividend at low rates and retain a large part of profit,

(xii) **Ability to borrow**: Well established and large firms have better access to the capital market than the new firms and may borrow funds from the external sources if there arises any need. Such firms may have a better dividend pay-out ratio. Whereas smaller firms have to depend on their internal sources and therefore they will have to build up good reserves by reducing the dividend payout ratio for meeting any obligation requiring heavy funds.

(xiii) **Extent of share distribution**: Nature of ownership also affects the dividend decision. A closely held firm is likely to get the assent of the shareholders for the suspension of dividend

or for following a conservative dividend policy. On the other hand, a firm having a good number of shareholders widely distributed and forming low or middle income group would face great difficulty in securing such assent because they will emphasise to distribute higher dividend.
(xiv) **Past dividend rates**: While formulating the dividend policy, the directors must keep in mind the dividends paid in past years. The current rate should be around the average past rate. If it is abnormally increased the shares will be subjected to speculation. In a new concern, the firm should consider the dividend policy of the rival organisations.

(xv) **Taxation:** The tax status of the major shareholders also affects the dividend decision sometimes. For example, if a firm is owned by a few shareholders in the high income tax bracket, it would be in their interest not to receive too high an amount of dividend. Such shareholders may be interested in taking their return from the investment in the form of capital gains rather than in the form of dividends.

Types of Dividend Policy

Following are the different types of dividend policy :

(i) **Generous Dividend Policy**: Firms which adopt this dividend policy, reward shareholders generously by stepping up total dividend payment over time. Typically, these firms maintain the dividend rate at a certain level (15% to 25%) and issue bonus shares when reserves position and earnings potential permit. Such firms normally have a strong shareholders orientation.
(ii) **Erratic Dividend Policy**: Firms which follow this dividend policy, do not bother about the welfare of equity shareholders. Dividends are paid erratically whenever the management believes that it will not strain its resources.

(iii) **Stable Dividend Policy**: Firms which adopt this dividend policy pay a fixed amount of dividends regularly irrespective of fluctuations in earnings year after year. This policy attaches equal importance to the financial requirements of the firm and interest of the shareholders. The stable dividend may be in any of the following three forms.
(a) **Constant dividend per share**: Firm follows a policy of paying certain fixed amount per share as dividend.

(b) **Constant payout ratio**: Firm pays fixed percentage of earnings every year. With this policy, the amount of dividend will fluctuate in direct proportion to earnings.

(c) **Constant dividend per share plus extra dividend**: Firm usually pays a fixed dividend to the shareholders and additional dividend in a year of good earnings.

Advantages of Stable Dividend Policy

(i) This policy provides regular income to investors of the firm. (ii) It helps to maintain stability in market values of the firm's shares. (iii) Firms which follow this policy enjoy a high degree of investor confidence.(iv) Firms with stable dividend policy have always high credit standing in the market. They can raise as much funds as they like from the market because of widespread demand of their shares.

Limitation of Stable Dividend Policy

The greatest danger associated with a stable dividend policy is that once it is adopted by the firm, it cannot be changed without seriously affecting the confidence of shareholders in management and the credit worthiness of the firm. Therefore it is prudent that the dividend rate is fixed at a lower level so that it can be maintained even in years with reduced profits.