Section - 1

Ans 4 Elements of a Capital structure

capital structure means combination of owner's Fund and Borrowed fund. Each has its own benefits and drawbacks and management attempts to find the perfect capital structure in term of risk/reward payoff for shareholder

A Owner's Fund

It includes

1. share capital
2. Reserve and surplus

1. Share Capital :- This refers to money put up and owned by the shareholders This is the money that was originally invested in the business in exchange for shares of stock or ownership. This is also called ownership securities.

Ownership securities consist of share issued and allotted in the profit and management of the company. The capital raised this way is known as owned capital risk capital or venture capital

A company can be broadly classified into two typ

(i) Equity shares (ii) Preference share

Equity share - are those ownership securities which do not carry special or preferential rights in respect of annual dividend or the return of capital in the events of the ~~wed~~ winding up of the company. Equity shareholders have overall right of sharing dividends voting at the general meeting and to the distribution of assets.

Debenture holders and preference shareholders have a prior claim on the profit of the company and on the assets of the company, in event of its liquidation.

Retained Earning - which represent

profits from past years that have been kept by the company and used to strengthen the balance sheet or funds growth, acquisition or expansion.

Many expects consider Equity capital to the most expensive type of capital that a company can utilized because its "cost" is the return the firm must earn to attract investment.

B. Borrowed Fund :-

Borrowed Fund (creditorship securities) consists of various types of debentures which are acknowledgement of corporate debts to the respective (debenture) holders wit a right to receive interest at specified rate and refund of the principal sum after the expiry of the agreed term. Capital raised through creditorship securities is known as borrowed capital or debt capital.

Generally, long-term bonds is considered the safest one because the company repays these debt within few year with the principal while paying interest only in the meantime. The includes-

1. Debentures
2. Long term loans form financial institutions.

so the capital structure of a firm can have following pattern

1. Acquiring the funds only by issuing ordinary shares.

2. Acquiring the funds by issuing equity shares and preference shares.

3. Acquiring the funds by issuing equity shares, preference shares and debentures.

~~with~~ which capital structure is more suitable to the firm depends on various internal and external factors.

Net income approach

This approach is given by Durand Davi's According to this approach the capital structure decision is relevant to the valuation of the firm. As such a change in the structure causes an overall change in the cost of capital and also in the total value of the firm A higher debt content in the capital structure means a high financial leverage and this results in decline in the overall or weighted average cost of capital. This results is increase in the value of the firm and also increases in the value of equity shares

On the other hand, a decreases in the use of debt in capital structure will lead to an increase in the overall value of equity shares

Assumptions of NI approach

There are usually three basic assumption of this approach

1. The risk perception of investors is not changed by the use of debt

2. The cost of debt is less than the cost of equity debts capitalisation rate is less than the equity capitalisation rate.

3. corporate taxes do not exist

According to NI approach the value of the firm can be determin as follow

value of firm (V) = Market value of equity (S) + Market value of Debt (B)

V = Total market of the Firm
S = Total market value of equity
B = Total market value of debts.

$$S = \frac{NI}{Ke}$$

NI = earning available to equality share holders

Ke = equity capitalization.