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Commentary

Capital structure contains optimal and component structures in financial management

Robert Livingston*

Department of Finance, New York University, New York, NY 10003, USA.

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DESCRIPTION

Capital Structure or Capital Frame work of a company comprises of long term capital funds raised by it from different sources for the conduct of its business. Various components of the 'Capital Structure' are raised from time to time meet the needs of the company and generally consist of: Equity shares, Preference shares, Debt funds, Funds borrow on long-term basis, retained earnings.

Thus we can say that it is the decision about the proportion of different sources of long-term funds, required for running the firm.

The mix of firm's permanent long-term financing respected by the debt, preferred stock, and common stock equity. The composition of a firms financing consists of equity, preference, and debt.

Capital structure of a company refers to the component or make-up of tis capitalisation and it includes all long-term capital resources.

Cost of capital companies having high risk perception and higher leverage may probably have to pay a higher cost of capital.

Valuation of a company is influenced by its capital frame work. Companies with high risk perception and high leverage are likely to have a lower valuation, whereas the companies with low risk perception and low leverage are likely to have a higher valuation.

Capital structure of a company may be considered as Optimal or Balanced capital structure. If its financial plane as an appropriate debt-equity mix, which result is enhancing the company's value to the maximum level it is possible only when the weighted average cost of the company is minimum. If the optimal status of the capital structure of a company is achieved though external borrowings, the borrowed funds need to be given credit, as they facilitated to the improvement to the market value of the company's share. However, if the borrowed fund is lead to erosion in the market value of the company shares, it may be concluded that because of borrowed funds the company's capital structure has lost its way.

Maximisation of the market value of a company's shares needs to be the objective of an 'Optimal Capital Planning'. This maximisation is possible when each source of capital will have the same marginal cost. The above concept is however, more simplistic and theoretical in nature. In practice, the establishment of an 'Optical Capital Structure is a challenging task and significant variations amongst inter industry and intra industry companies with regards to 'Capital Structure' decision of a company with a view to have an optical framework is impacted by numerous elements.

An 'Optical Capital Structure' which a company would prefer to have may exhibit different characteristics.

Components of 'Capital funds' of a company may be classified on the basis of their sources. Accordingly, they are put into two categories they are owner's capital and borrowed capital.

Equity shares are the element sources of raising funds for an entrepreneur to start a business. Amongst all the components of 'Capital Structure' of a company, equity capital are true owners of a company, they have highest level of risk. The balance of net profit after payment to all other claimants is distributed amongst all the shareholders of a company as divided.

Capital borrowed when the funds are raised through mode, a company enters into a contract with the subscribers of the instrument regarding acknowledgement of the debt and payment of interest and principal. Debentures have fix interest rate payment and are repayable on a fixed maturity date.

*Corresponding author. Robert Livingston, E-mail: robertston@ilstu.edu.