

Importance of Capital Structure:

The importance or significance of Capital Structure:

1. Increase in value of the firm: 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. Utilisation of available funds:

A good capital structure enables a business enterprise to utilise the available funds fully. A properly designed capital structure ensures the determination of the financial requirements of the firm and raise the funds in such proportions from various sources for their best possible utilisation. A sound capital structure protects the business enterprise from over-capitalisation and under-capitalisation.

3. Maximisation of return: 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. This can be done by the mechanism of trading on equity i.e., it refers to increase in the proportion of debt capital in the capital structure which is the cheapest source of capital. If the rate of return on capital employed (i.e., shareholders' fund + long-term borrowings) exceeds the fixed rate of interest paid to debt-holders, the company is said to be trading on equity.

4. Minimisation of cost of capital:

A sound capital structure of any business enterprise maximises shareholders' wealth through minimisation of the overall cost of capital. This can also be done by incorporating long-term debt capital in the capital structure as the cost of debt capital is lower than the cost of equity or preference share capital since the interest on debt is tax deductible.

5. Solvency or liquidity position: 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. Flexibility:

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. Undisturbed controlling: A good capital structure does not allow the equity shareholders control on business to be diluted.

8. Minimisation of financial risk: If debt component increases in the capital structure of a company, the financial risk (i.e., payment of fixed interest charges and repayment of principal amount of debt in time) will also increase. A sound capital structure protects a business enterprise from such financial risk through a judicious mix of debt and equity in the capital structure.