Factors Determining Capital Structure:

The following factors influence the capital structure decisions:

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.

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.