DETERMINANTS OF CAPITAL STRUCTURE – A REVIEW FRAMEWORK

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ABSTARCT

Financial economics has made a significant progress in explaining the incentives that make companies to choose particular financing policies. The corporate finance literature contains a host of studies examining the nature and determinants of corporate financial structure. These papers examine the determinants of capital structure from different aspects and draw conclusions on different outcomes as far as the choice of the determination of the level of financial leverage is concerned. The present study made an attempt to review a few studies on capital structure determinants.

INTRODUCTION

The capital structure of a firm is actually a mix of different securities. The firm has the option to choose among alternative capital structure. Decisions on such capital structure formation are influenced by multiple factors. These factors can be classified into internal factors such as operating leverage, financial leverage, cost of capital, desirability of control, flexibility, size of the firm, age of the firm, profitability, asset structure and non-debt tax shield and that external factors such as tax laws and regulations, capital market regulations, timing of issue, market conditions and industry conditions. However the influence of the determinants of capital structure may be different in different markets and also at different points of time. The choice of capital structure has been studied less thoroughly in developing countries as compared to developed countries. The theories of capital structure attempts to explain the mix of debt and equity securities in firms financing. Of the various theories of capital structure the important ones are Net income approach, Net Operating Income Approach, Modigliani-Miller Approach, Traditional approach, Agency Cost Theory, Pecking Order Theory, and the static trade off theory. The theories of capital structure are not designed to be general. They are conditional theories. Each emphasises certain costs and benefits of alternative financing. Besides the above theories several empirical works have been done by various researchers regarding determinants of capital structure. An attempt has been made to review such works.

Determinants of Capital Structure

Ferri & Wisley (1979) investigated the relationships between a firm's financial structure and its industrial class, size, variability of income and operative leverage. The taxonomical structure provided the basis for such investigation. Firms' leverage was found to be associated with industry class, size of the firm and operating leverage. Variation in income, measured in several ways was not found to be associated with firm's leverage.

Bhat (1980) found out that firm's financial leverage is not related to its size, growth rate and its operating leverage. A negative relationship was found to exist between firms' financial leverage and their risk, dividend payout and debt service capacity. The financial leverage of the firm and its profitability was positively related. Bhat (1980) found out that firm's financial leverage is not related to itssize, growth rate and its operating leverage. A negative relationship was found to exist between firms' financial leverage and their risk, dividend payout and debt service capacity. The financial leverage of the firm and its profitability was positively related.

Titman & Wessels (1988) used a factor–analytic technique that mitigates the measurement problems encountered when working with proxy variables. Debt levels are negatively related to the "uniqueness" of a firm's line of business whereas short-term debt ratios were negatively related to firm size. The results do not provide support for an effect on debt ratios arising from non – debt tax shields, volatility, collateral value and future growth.

Homaifar et.al., used a general auto regressive distributed lag model to estimate the long – run steady state determinants of the firm's capital structure. The results showed that leverage ratio is positively related to corporate tax rates and firm size. The relationship between leverage and the non–debt tax shelter ratio is also positive but statistically insignificant. A strong negative relationship was found between future growth opportunities and firm's leverage, as well as between leverage and stock returns.

Sander (1999) in his paper attempts to find out the financing preference and determinants affecting the choice of capital structure in Estonian. A survey was conducted in 2001 among 200 biggest Estonian non–financial companies to learn about their views and firm practices with respect to long – term financing decision. The survey results indicate that internal equity is the most preferred source of funds. The second-best financing was straight debt capital. The survey also showed that issue of new shares to existing shareholders is considered to be much better than general issue of new equity. The results revealed that those factors directly related to the project financed are very important.

The article by Rezaei (2018) investigated the determinants of capital structure of MCs and DCs listed in Tehran stock exchange. Results showed that, compared to Domestic Companies, Multinational Companies have a significantly lower leverage. In addition, Multinational Companies were significantly larger than DCs and were provided with more growth opportunities, more profitability, and have more non-debt tax shield and higher business risk. This shows that external financing will decrease when companies make more profits.

CONCLUSION

The various studies give contradicting relationships of independent variables with financial leverage. The results differ depending upon the measurement of independent variables. Among the various independent variables, the variables, found to have theoretically established relationship with the debt-equity ratio are size of the firm, business risk, profitability, asset composition, non-debt tax shield and degree of operating leverage.

Keywords: Capital Structure, Debt Equity Ratio, Agency Cost Theory

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