CHAPTER I

INTRODUCTION
The capital structure has an important role to play in connexion with the affairs of joint stock companies. It goes without saying that the nature of operations undertaken by a company plays a definite role in the shaping of this capital structure. The said operational activities are however moulded by current economic conditions on the one hand and the managerial decisions made in respect of them on the other. Nevertheless, the historical background under which the companies are formed is also not without its effect in the matter.

As the capital structure is affected by the nature of operations, besides other factors as mentioned above, so it is equally true to say that the nature of operations is also affected by the capital structure. Accordingly, the capital structure, which is the result of the action and reaction of so many factors, changes over time. This change may be studied either with reference to the companies of different types, but, all of a particular industry, or to those of different industries but all of a particular type. Investigations about these changes in the capital structure of companies makes, naturally, an important study.

So far as the study of the change of capital structure of a particular industry is concerned a reference may be made, say, to the jute industry of India from the year 1959 to 1968.

The findings of the said study have been that the capital structure of the jute industry did not remain static since its inception. It rather had changes in it over different periods of time. The changes that occurred in the capital structure of jute industry between 1959-1968 were, to put briefly thus:

The percentage of equities and retained profits to total capital came down, while that of borrowings reached a soaring height. In terms of figures, so far as the twenty-nine companies that were under study in the work referred to are concerned, the percentage to total finance came down from 27.3% to 16.9% in case of equity share capital and from 28.9% to 22.1% in case of retained profits. The percentage to the same of borrowings, however, went up from 31.5% to 54.8%. Among borrowings again, bank loan was exceedingly high in proportion. As a result of these changes creditorship capital surpassed ownership capital. But external capital, which was already above internal, went further above it. The trend was gradual and smooth except intervention of a break about the year 1963. In that year there was practically a visible reverse order in the movement of the major components of the capital structure.

Similarly, in case of the cotton textile industry, the capital structure changed so that the proportion of equity share capital to total finance fell, though not uniformly, from 26.9% in 1959 to 19.4% in 1968. At the same time, the proportion of preference share capital met with continuous fall all over the period from 5.2% in 1959 to 3.3% in 1968.

Thus, the proportion of equity share capital and preference share capital moved always downward more or less in unison with each other. Borrowed capital, on the other hand, moved in the opposite direction in its percentage to total capital. It stood at 42.6% in 1959 to 58.9% in 1968. Therefore the rise of the proportion of external capital was caused by borrowed capital alone.

A survey of the trend in the combination of the ownership and creditorship capitals in the cotton textile industry over the same period revealed that, the percentage of creditorship capital to total showed an increasing trend though not at a uniform rate. This percentage went up from 42.6% in 1959 to 58.9% in 1968. Naturally, the proportion of ownership capital registered a declining trend from 57.4% to 41.1% over the period. Here preference share capital is considered a part of ownership capital. If preference share capital is considered a part of the creditorship capital, the trend of rise of the proportion of creditorship capital, which was 47.8% in 1959, continued till 1968 when it was 62.2% though this rise was not uniform all through. Similarly, the proportion of ownership capital recorded a fall from 62.2% in 1959 to 37.8% in 1968. In consequence, the ratio of the ownership capital to creditorship capital recorded a fall from 1.3% in 1959 to 0.7% in 1968, if preference shares were considered a part of ownership capital. It would, however, work at 1.1% in 1959 to 0.6% in 1968, if preference shares were considered a part of creditorship capital.

The nature of the change in the capital structure was slightly different in the case of the tea industry. The tea industry had a highly equipped equity base. As such an increasing trend, though not at a uniform rate, of the percentage of external capital to total capital was noticed in the case of the capital structure of this industry. The percentage of external capital went up from 56.7% in 1859 to 68.2% in 1968. Naturally the internal capital had a declining trend. And its share came down from 43.3% in 1959 to 31.8% in 1968. This, in turn, brought a rise in the ratio of external capital to internal capital by 0.8% i.e., in terms of percentage of total capital from 1.3% in 1959 to 2.1% in 1968.

An examination of the trend in the changes of the composition of external capital in the capital structure of tea industry revealed that the percentage of equity share capital to total finance fell, though not at a uniform rate, from 40.5% in 1959 to 39.2% in 1968. Like equity, preference share capital had a similar trend in the tea industry and its percentage to total finance came down from 4.2% in 1959 to 2.4% in 1968. So far as the proportion of the borrowed capital is concerned it moved in the opposite direction and its percentage went up from 12% in 1959 to 26.6% in 1968. Thus, it will be observed that the rise in the percentage of external capital in the capital structure of tea industry was caused by borrowed capital alone.

From the examination of the trend in ownership and creditorship capital it was found that in this industry the percentage of creditorship capital to total showed an increasing
trend though not at a uniform rate. Its percentage went up from 12% in 1959 to 26.6% in 1968. In the circumstances, the ownership capital had a downward trend from 88% in 1959 to 73.4% in 1968. Here preference share capital was a part of ownership capital. If preference share capital was considered a component of creditorship capital, the trend of rise of the proportion of creditorship capital had been from 16.2% in 1959 to 29% in 1968. This rise in the proportion of creditorship capital was not however at a uniform rate all through. In the same way the ownership capital recorded a fall from 83.8% in 1959 to 71% in 1968. As a result there had been a fall in the ratio of ownership capital to creditorship capital from 7.3% in 1959 to 2.6% in 1968, if preference shares were a part of ownership. It would have been 5.2% in 1959 to 2.4% in 1968, if preference shares were considered part of creditorship capital.

As against the findings in respect of the changes of capital structure of the above mentioned jute, cotton textile and tea industries in India, the trend of change of capital structure in the medium and large companies, covering all industries in India in the private sector, (Private and Public limited companies taken together)*, over the period between 1960-61 and 1969-70 as revealed by the Reserve Bank study has been (i) decline in the proportion of share capital due to decline in the percentage of both equity and preference capital; (ii) increase in the proportion of borrowed capital the major bulk of which came from bank; and (iii) decline in the proportion of retention after its rise in the initial few

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* It refers to companies in general which are not owned partially or wholly and controlled by the Government. Nevertheless, a detailed discussion about the difference between public sector and private sector companies and also that between private and public limited companies will be made in the next chapter.
years. Share capital accounted for 35.5% of the total capital in these companies in the year 1960-61. But its proportion to the total capital of these companies at the end of 1969-70 was found to be 29.2%. Thus, over a period of ten years the proportion of share capital fell by 17.7%. As against this the proportion of borrowed capital which had been 42.1% of the total capital in the year 1960-61 increased to 49.8% at the end of 1969-70. The proportion of retention increased from 22.4% in the year 1960-61 to 26.3% at the end of 1964-65. Thereafter its proportion registered a decline till 1967-68 when its percentage came down to 19.7%. From the year 1968-69 again a rising trend was noticeable in the case of the proportion of retained profit in the total capital of these companies. And its share increased from 19.3% at the end of 1967-68 to 21% at the end of 1969-70. As a result of these changes creditorship capital surpassed ownership capital from the year 1967-68 and external sources which were higher than the internal sources from the year 1960-61 maintained the same feature, though at a declining rate, till 1965-66. In the year 1966-67 there was a reversal trend and external sources registered an increase by 6.7% in that year. But from the year 1967-68 again the proportion of external sources began to decline. At the end of 1969-70 its share was 71.7% of the total capital. These various aspects of the trend in the changes in the capital structure of medium and large companies covering all industries in India (Private Limited and Public Limited companies taken together) in the private sector have been shown in Tables 1, 2 and 3 of the present study.

It will be observed that the trend of changes in the capital structure of jute, cotton textile and tea industries which was in short found to be (i) a rise in the proportion of borrowings; and (ii) fall in the proportion of equity and retention, has been found to be more or less the same as revealed in case of that of the medium and large companies covering all industries in India in the private sector. As against these,
the world trend as a whole may be mentioned here for the purpose of comparison. The same may be studied with reference to the two periods viz., 1900-1947 and 1947-1966.  

In the period between 1900-1947 the world wide trend in the change of the capital structure covering all industries had been (i) relative increase in the share of internal finance specially of depreciation; (ii) relative decline in external financing specially of the equities in relation to debt. And (iii) within the sub category of debt rise in short term debt in relation to the long term debt. 

In the period between 1947-1966 this trend in the capital structure had not only been maintained but was further reinforced. In consequence, internal finance as a percentage of total finance went upto 68% for all corporations taken together between 1957-66. This swelling in the proportion of internal finance has been particularly due to the increasing share of depreciation allowance. But, if depreciation was not taken into consideration the share of retained earnings would be found to have a declining trend as a source of fund for expansion. And in fact the share of retention of all companies taken together came down over the period from 1/3rd. to 1/5th.

In consonance with the trend in the previous period, the period between 1947 and 1966, the trend in the change of capital structure was marked by the declining share of the external sources in the capital structures of all corporations. Accordingly, the share of external sources came down from 44% of total finance at the end of 1947-51 to 31% at the end of 1957-66. The decline in the external source was evidently the outcome of the declining share of equities among external sources. In fact, in the period between 1962-66 new issues provided barely 1% of the total sources.

The aim of the work is however not to study the capital structure of a particular industry. On the contrary, the aim is to study the constitution and change of the capital structure over a given period of time of a particular type of companies. The type of companies that has been chosen for this study is captioned as 'Central government companies'. The period concerned is from the year 1960-61 to 1969-70. The terminology 'Central government companies' has practically been derived from that of 'Government companies' as used in Section 617 of the Companies Act, 1956 of India. A detailed study of what is meant by Government Companies in general and Central government companies in particular and their position in relation to other companies will be made in the next chapter. The projected study, as contemplated for this work, will evidently consist of an identification and analysis of the Capital structure of the said Central government companies in relation to other companies and a comparative estimation of the trend of its changes within the period fixed for study. An attempt would be made to find out the motive forces acting behind the two and suggest the improvement that may be brought about in future. The period of study of the Indian Companies whether Central government companies or Private sector companies, it will be observed is more or less the same. Though the period of study of the world industries is a bit different, the peculiarities of the capital structure are not expected to differ much because the fluctuations of the economic conditions over a long period of time, are expected to be smoothed out to fall into a trend which is expected to be more or less similar. But before all these studies are actually taken up it is necessary that some ideas about the capital and capital structure of companies in general are considered here. Thereafter the specific study will ensue and it will depend, for its information, mainly on the following sources: (i) Reserve Bank Publications, (ii) Published reports by the Bureau of Public Enterprises,
(iii) Annual Reports of individual companies, (iv) Different Committee reports and circulars issued by the govt., (v) the various other official and non-official documents that will be found relevant for the purpose.

MEANING AND DIMENSION OF CAPITAL

The term capital has received different interpretations in different hands. To an individual capital is synonymous with cash, irrespective of the same being used as a medium of exchange or held in the coffer. Economists' interpretation of capital has been on functional basis. To them capital is the stock of goods that are used for further production of goods and service. A businessman takes capital as his total investment for a return in physical properties and valuable intangibles.6 Whereas, to an accountant, capital is equivalent to net worth. Net worth may be taken in the sense of what the business is, on the whole, worth for, or what are its net promises in favour of proprietorship at any particular moment. In the eye of law capital is the contraction of the word capital stock, and is understood in the narrow sense of par value or, frequently, the amount which is paid in for stock.7 In view of this multiplicity of interpretations, it has even been suggested that the word capital should not be used in any serious discussion.8 But, this is, rather a negative approach amounting to an attempt to evade the problem instead of solving it. It is, therefore, better to concentrate to evolve a clear idea about the term capital in the perspective

of its relation with business undertakings.

Really speaking there may be two possible approaches to the concept of capital. One of these is the 'Fund' concept and the other the 'Asset' concept of Capital. Fund concept implies that the capital of a business is the sum total of funds that have been employed for the running of the business. It corresponds to the idea of total capital as developed by Marple. It may also be described as Financial Capital. In as much as cash representing Fund cannot by itself constitute capital till it is committed to asset. Another nomenclature of Financial capital may be 'Passive' capital. Needless to point out that Fund concept recognises the separate entity of business and considers capital from liability side.

Once it has been said that Funds committed to assets represent capital, it remains to be identified which part of the fund constitute capital of an enterprise particularly when a business has various alternative sources of finance. As already mentioned, to an accountant capital in the sense of claim of or promise to proprietors, is synonymous with proprietorship.


Therefore while tracing out capital with reference to fund employed, an accountant takes only fund originally brought by the proprietors together with fund that have been subsequently ploughed back into the business out of retained profits. Funds contributed by the creditors are excluded by them from the composition of capital on the ground that such funds represent claim by parties external to the business and are devoid of certain rights and privileges enjoyed by the proprietors. In case of loss business is under compulsion to provide for the fixed rate of earnings of creditors out of funds either borrowed for the purpose or already contributed by the owners. Moreover, in case of liquidation of the business, these creditors enjoy priority over the owners with respect to return of these funds and may be required to be repaid out of the proprietors' funds. Therefore, how funds contributed by creditors, who have to seek remedy out of the funds contributed by the owners in case both of receiving payment of income or repayment of principal be treated at par in the composition of capital? As such accountants reject outright the idea of including creditors' funds in the composition of capital.

Against this argument of accountants, it may be pointed out that a business being a separate entity, funds contributed by owners also represent claim against the business. May be that this is an internal claim. But the purpose with which a business collects funds from its external and internal claimants are identical viz., for commitment to assets. Therefore when the purpose is identical there cannot be any justification
for the exclusion of funds contributed by creditors from the composition of capital, simply because they enjoy priority over the owners regarding realisation of the fund or deriving income out of it. After all the basic character of all the funds, whether contributed by the owners or creditors, is to generate business income. So the objection raised against the treatment of creditors' fund as capital cannot be justified at least in case of long term borrowings.

Accountant's objection to the inclusion of short term credit in the composition of capital fund lies in the fact that such funds may go out of the business at any time for which a part of the assets has always to be kept in a liquid form. Such funds, it is argued, are extremely transitory in character and, therefore, not worthy of being included in the composition of capital. This sort of reasoning however ignores the fact that the possibility of an amount going out of the business is also associated with the possibility of getting new credit. As such short term credit also assumes, at least to the extent of a minimum limit below which the amount of creditors never falls the character of long term funds through the continuity of the flows of such funds into the business. Accountants therefore should not have any objection in including the funds contributed by the short term creditors in the composition of capital of a business upto that minimum limit. Modern tendency is also to regard all

liabilities as a form of capital. Fixed liabilities are designated as loan capital and current liabilities as circulating capital.

When capital of a business is assessed with reference to assets employed, a very pertinent question that arises is whether in the assessment of capital all categories of assets viz., tangibles, intangibles including fictitious assets, will be counted upon. To an accountant assets, as capitalised expenditure, represent claim to services. It need not always be associated with material object having a tangible existence. Further, according to them, though assets in general should possess value, all assets may not have value in exchange. It suffices if they have money value equal to capitalised cost. In as much as the intangible assets satisfy these criteria there is no constraint on the part of the accountants in including intangibles among assets. That is how the attitude of accountants in the assessment of capital of a business with reference to assets employed may be interpreted. Moreover, when we proceed to measure the

13. Rowland - (Revised by Holmes) Principles of Accountancy. Cassel and Company. 6th. edition 1960, p.153. Rowland's proposition can be taken as true only when current assets in total are considered circulating or working capital, otherwise, current liabilities are only negative component of circulating or working capital.


15. Ibid. p.20.
consumption of capital of a business within a given period of time, we not only take into account capital investment in fixed assets but also capital locked up in current assets. In both the cases the asset may be comprising either tangibles or intangibles. The total capital 'Y' employed in a business is always equal to R+W, where 'R' represents investment in fixed assets and 'W' represents investment in current assets. Therefore, it will be erroneous to ignore even the current assets which are intangible, in any approach to the assessment of capital.

Among assets, Trade-debtors, Bills Receivables etc are considered current assets because of their convertibility or affinity for a change into other forms. According to Dr. Canning, intangible assets like prepaid expenses constitute current assets in as much as these may be taken to represent possible release by each of services due to be received by the business in future from an individual or institution. But they may become service potentials like 'preliminary expenses' etc when they become a source of benefit even after receipt of specific services from an individual or institution is over. At that time such intangibles become nominal or fictitious assets like preliminary expenses, goodwill etc. However, outstanding income is considered an item of

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current asset because of liquidity or quick convertability into cash. Once we accept these arguments the intangibles merge themselves into the current assets. Current assets, it has already been established, form an important limb of capital.

Another line of reasoning in favour of including the intangible assets in the estimation of capital has been that the expenses recorded by these accounts lend to the tangible assets of the enterprise, a particular set up of employment under which these assets are able to render comparatively a greater amount of services in future. As a result the business as a whole, as made of all such tangible assets taken together, acquires an ability for earning additional profit, that imparts each individual item of such assets a value higher than that at which it appears in the financial statement. Thus, according to this line of reasoning, intangibles assets represent nothing but an aggregate of the unrecorded part values of other assets appearing in the balance sheet. On the strength of this argument intangibles such as goodwill, preliminary expenses, pre-paid insurance, patents etc. may rightly deserve even to be included in fixed assets. But as at least some of them are often found to raise unduly the nominal value of capital stock they are deducted from capital fund in spite of their


asset making character. Fictitious assets, such as, debit balance of Profit and Loss Account, balance of Share or Debenture Discount Accounts are, however to be treated more as deduction from relevant liabilities, than assets by themselves.

**Sources of Capital and the Perimeter of Capital Structure**

Once the meaning of capital has been analysed and its dimension gauged, it becomes imperative to trace the meaning of capital structure and determine its perimeter. Along with that the relation that capital bears to the said capital structure has also to be known. The word structure is a term of the science of Engineering which connotes the arrangements of the various parts of a building or some other construction. Corporate enterprises, as we know, raise their capital from diverse sources such as issue of shares and debentures and retained earnings. Initially issue of shares dominate the field. Borrowing and retained earnings, particularly the latter, serve as source only at the later stage of company development. Again, whatever may be the sources from which capital fund is collected the latter is invested in assets which are also of diverse character. This means that although the capital of corporate enterprises deserves to be considered something 'whole', it has different segments in its composition irrespective of whether capital is approached from 'Fund' concept or 'Asset' concept. It has been stated that in case of the construction of a building and other constructions there are some standard proportions
in which various elements are integrated together. They naturally depend on the size and nature of what is built.

Similarly, in the matter of procurement of capital by corporate enterprises from diverse sources, as also in the subsequent commitment of the said capital to various assets, certain proportions of combinations of various elements are to be maintained. A combination of different elements of capital, as stated above, in some given proportions may affect the realisation of the goals of minimisation of the cost of capital and maximisation of return on it in a particular way. Thus the said combination should work without impairing flexibility of the structure for the achievement of those desired results. This arrangement of capital goes by the name of capital structure. In this connection it should be noted that there is no such thing as the model capital structure for all business undertakings. Capital structure of each enterprise is the result of a conglomeration of several factors; some external some internal. But though there is no such thing as the model capital structure, there are however some basic principles which guide the planning of the capital structure of corporate enterprises so that the desired objectives of having an ideal capital structure may be attained. Further, empirical studies of the capital


structure of different industries reveal that there are however some common characteristics which typify each industry. For instance, while capital structure is considered from fund approach, there is a high ratio of creditorship securities or fixed charge securities in the capital structure of public utility undertakings, whereas in the case of basic and manufacturing industries it is the equity shares which predominate. But, it was observed previously that remaining bound within the general framework the capital structure of each industry based on sources of fund may undergo a change over time. Again different industries may have their inherent peculiarities as to the ratios between fixed and working capital as a whole and those between the different components of working capital. These peculiarities are, also, likewise subject to change over time.

In the early discussions there appears to exist a considerable amount of looseness in the matter of ascertaining the relation that capital bears to the capital structure. There are financial experts who even believe that there is no difference between capital and capital structure. Walker and Baughn, for example, are of the view that capital structure is synonymous with total capital except that this term refers to the make up of the credit side of the balance-sheet or the division of claims among trade creditors, bank creditors, bond holders, stock holders etc. Thus it seems

that capital structure refers more to the quality aspect of capital. It goes without saying that capital, on all accounts, refers to a quantity. Therefore, it appears to be more reasonable to understand structure with reference mainly to the quality of capital as it does not put capital and capital structure within the same parenthesis.

Traditionally, capital structure is used to cover the total combined investment of bond holders including any long term debt such as mortgages and long term loans as well as stock holders' investment, including retained earnings as well as original investment. This formulation of capital structure seems to have been based on the theory that funds from short term borrowings do not form a part of capital. It merely facilitates the use of capital. But it has already been pointed out that short term credit also assumes, at least to the extent of a minimum limit below which the amount of such credit never falls, the character of long term funds through the continuity of the flow of such funds into the business. And to that extent short term credit may be said to form a part of capital. Moreover, based on the separate entity concept we know that, every business enterprise has to incur cost for the use of capital. This cost not only comprises cost for the use of share holders' funds including retained earnings and the funds collected from long term borrowing, but also net cost for the use of funds acquired by short term borrowing. The term 'net cost' is used here.

for in any calculation of the cost of short term borrowing, the income from short term lending of the enterprise has also to be reckoned with. In any case, if the funds from short term credit are kept beyond the coverage of capital structure, no correct estimation of the cost of capital will be possible.

Based on these reasonings Lindsay and Sametz commented that 'given the great importance of bank credit and trade credit, it seems artificial to omit short term or informal debt from capital structure problems especially for small firms where current liabilities comprise a large part of the sources of funds.' It is a fact that sometimes short term debts may occupy a very important position in the finance of a firm. There may be even extreme cases where current liabilities can not only be equal to the whole of current assets but exceed them by representing a part of fixed assets also. Hence it may not be quite unjustified to include in the capital structure analysis at least the minimum balance below which the short term credits are never found to fall.

Various Facets of Capital Structure

It has already been indicated in our foregoing discussions that corporate enterprises acquire their capital by tapping diverse sources and keep the acquired capital

Invested in different types of assets. Capital structure being the qualitative aspect of capital, it has, accordingly, a double edged manifestation. One edge is the 'finance structure' depending on source and the other edge is the 'asset structure' depending on the nature of utilisation or investment. These two edges of capital structure are not however independent. Rather they are interdependent. It can not, possibly, be said that the mix of sources of finance available can influence to a great extent the nature of assets that an enterprise can afford to acquire. The latter will evidently be determined by the need of the business. Similarly, the nature of assets necessary for an enterprise does not seem to exert a great influence on the source-mix to be tapped for the procurement of capital. That will logically depend on the least cost factor. In the light of this discussion it is quite justified to say that 'capital structure is entirely an effect of the decisions to invest. Nevertheless, a correlation between source-mix of capital and its investment-composition, however remote, may not possibly be undetectable under some given circumstances. For instance, capital assets are usually financed out of permanent or fixed capital. Again there is a long-standing practice among the Indian businessmen to finance working capital out of bank overdraft. But for that, the conclusion cannot at once be drawn that, what should be the nature and composition of

investment are themselves determined by the nature of finance available. After all, acquisition of capital proceeds investment and not the latter the former. In any case, the problems relating to the capital structure of corporate enterprises, therefore, can be studied either with reference to the composition of the sources of finance or with reference to its counterpart, viz., composition of assets. In our present study of the nature and changes of the capital structure of central government companies we have looked at the problem with reference more to the sources-mix than to the asset or investment composition. Therefore, hence-forward the term 'capital structure' will be used only in the former sense.

There have been various classifications of capital structure on different basis even when it is identified as different kinds of financing or sources-mix of capital. One of such classification seems to have been based on the various streams of the flow-in of capital. A capital structure is deemed to have a 'simple' structure when it comprises a single source e.g., equity shares. Simple nature of capital structure is believed to remain unimpaired even when the sources of capital are more than one provided they are of allied nature. For example when capital structure comprises equity shares and retained earnings, it is still considered simple. But as soon as a corporate enterprise derives its capital from more than one source not of identical or allied

nature, e.g. equity shares and preference shares, or equity shares and debentures, the nature of its capital structure is said to be different. It then assumes the character of a 'complex' structure.

Another interesting point to note in this connection is that a capital structure may be classified into 'simple' and 'complex' only when it is considered from the fund approach. A similar classification is not possible in case of asset approach as the existence of any enterprise with only one type of asset is a rarity. Another factor which must not be lost sight of is that, as soon as we bring short term credit within the campus of capital structure, simple structure becomes a nulity. Even if we assume that a corporate enterprise starts with 'simple' capital structure, the same cannot be sustained for a long time for a number of reasons. A sustained simple structure presupposes the fulfilment of two basic conditions by the Corporation namely (1) all future expansions, in addition to normal growth, are financed externally by equity issues only and (II) that when the enterprise concerned has been earning enough profit to be capable of leaving sizeable surplus after meeting all obligations including payment of dividends to share holders and supporting maintenance of original level of activities and normal growth, equity is forborne to that extent.

Regarding fulfilment of the first condition, it may be pointed out that, the necessary requirement is a favourable market. At least the position of the price of the shares in the capital market remains more or less, constant and it is
not disturbed by the impact of the psychology of the prospective investors to remain averse to subscribing them. Even if we assume that the market is responsive enough to absorb further issue of equity capital, the enterprise concerned may not resort to the same, as the idea of broadening its equity base may not find favour with the existing management for fear of losing control over the enterprise. Again the capital market, as we know, has different categories of investors. Some are speculative and some non-speculative in character. The speculative group make their investment in the equity shares which are classified as risk capital. But the non-speculative group attributes more importance to the security of the investment than on higher rates of yield. If the enterprise concerned is to take the advantage of savings at the disposal of the non-speculative group of investors it has to issue preference shares, a hybrid of what may be said, both debt and equity capital. Issue of these special kind of shares under such circumstances is specially true for new and growing enterprises. New or growing enterprises often find it difficult to market their equities. Or their earnings may not be sufficient to warrant the dilution necessary to float equities. But prior claim securities such as preference shares or bonds can be more easily sold by them. The issue of prior claim securities does not only help them to meet their immediate financial needs but also goes to help them, if the project is

successful, to enhance the prices of their equities in future. As soon as a corporation issues prior claim securities its capital structure assumes complex character. Moreover, there are times when it is more advantageous for a corporation to issue bonds. For example, when an economy is at its lowest ebb, a corporation can borrow from the capital market at a very low rate of interest. In such a situation it will be unwise on the part of the corporation to try to maintain the simple nature of its capital structure. Besides, acquisition and employment of capital by a corporate enterprise involves cost. Barring the process of how the cost is calculated, every enterprise is interested in minimising its average cost of capital for a given rate of income. For it is by minimising the average cost of capital that a corporation can attain its optimum capital structure. By an optimum capital structure we mean one that leads to balancing of funds from alternate sources in such a well calculated proportion that, it results into the lowest average cost of total funds employed on the one hand and produces a maximum market value for the total securities issued to produce a given amount of corporation income on the other. This least average cost capital combination is, possibly attainable when a corporation has actually a composite capital structure.

There is yet another hazard involved in corporate financing through equity shares alone. If a corporation

meets all its financial requirements by the issue of equity shares only, then a large amount of liquid cash will be required to meet its dividend commitments as and when such dividends are declared. Under competitive conditions the efficiency of the firm will depend on the net rate at which dividend may be paid after covering cost of ownership capital by its gross rate. Investors of other types of capital, are, however, entitled only to the exact cost of capital and not any amount in excess of the same. This excess payment to owners of ownership capital or share-holders may create a fresh problem of working capital for the corporation.

Turning our attention to the fulfilment of the second condition it may be pointed out that the ability of a corporation to finance itself entirely from earned profit is apparently taken to be a sign of strength. In reality, as has been pointed out by Lindsay and Sametz, it may not be so. Resorting to self-financing may be due to the fact that the firm is stagnating. Further need of fund may not simply be sufficiently promising to encourage the corporation to go outside for obtaining finance and that it can possibly do with small streams of profits earned and retained in the past. So there will be nothing wrong for a corporate enterprise that generates large sums of retained earnings to resort to external financing and thereby giving a complex shape to its capital structure, when it has enough of profitable investment opportunities. Similarly it is also

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35. Ibid.
true that the existence of a complex capital structure in a corporate enterprise does not necessarily mean that such a firm is overwhelmed with profitable investment possibilities. It may be due to the reason that its retained profits are so small in quantity that it can contribute very little towards expansion.

That a corporation may be capable of financing all its capital requirements out of retained profits is an impracticable proposition mainly for two reasons viz. (i) such a corporation will be presumed to be an entrenched monopoly in the present trend for regulated economy. As such, government regulation will be inevitable in its case, and secondly (ii) continuous earnings of excessive profit year after year may lead to the entry of competitors within the industry. Whether there is government control or competition, in either case, the profit will be lowered. Thus it is unrealistic to postulate earning of high and stable profits over a long period on the part of a corporation. For companies with irregular profits it is difficult to establish a regular pay-out policy that may be able to generate from out of retained profit spasmodically a large balance required for investment. In view of these, it will be unrealistic to assume that a corporation can finance all its future requirements of capital out of retained profit and keep its simple nature of capital structure intact for years to come.

36. Ibid.

37. Ibid. p.333.
Besides classification of capital structure into 'simple' and 'complex' etc., classification of same is also possible with reference to a specific feature in the cost-behaviour of capital procured from each type of source.

For instance, the capital structure of a corporation may be composed of fixed cost capital represented by bonds and preference shares, variable cost capital represented by equity shares, and no cost capital represented presumably by retained profits, trade creditors and non-interest bearing deposits. Traditionally, within the category of variable cost capital only equity share capital would have been included. But, in view of the dimension of capital structure in which, as previously indicated, the short term loan has as well been included, the variable cost capital should comprise both the equity capital and short term loans. Further, once it was believed that financing out of retained earnings and trade creditors involves no cost. As such they constitute, what may be said, no-cost capital. But at present this idea has been rejected. Neither retained earnings, nor short term trade loans are supposed to be cost free. They too have a cost of a variable nature. Therefore a more logical classification of capital structure with reference to

40. Ibid.
cost, will exclude no-cost capital. The capital-mix would only consist of fixed and variable cost capital. And variable cost capital would comprise, besides equity capital, retained earnings and short term loans.

Another classification of the capital structure of corporations is possible with reference to the ownership of capital-mix that the structure represent. As such capital structure may be composed of ownership capital and the creditorship capital. Ownership capital is represented by stock of different categories as well as retained earnings, and the creditorship capital is represented by bonds, loans and short term credits. In the aforesaid classification of capital into ownership capital and creditorship capital, preference share capital poses a problem. There are two approaches regarding the classification of preference shares. According to one, preference share capital is considered a part of ownership capital. As such it is added to equity share capital, in order to arrive at the total ownership capital. In another approach, as preference shares enjoy a fixed rate of income and also a priority over equity both in respect of payment of income and return of capital, while the company goes into liquidation it is treated equivalent to loan capital and as such, it is added to borrowings. Both the approaches have reasons to be justified. As such, in the analysis of capital structure, preferential capital may be treated either as a part of ownership capital or as a part of creditorship capital.

The capital-mix that a capital structure represents may also be analysed with reference to the sources from where the capital has been obtained and also by studying how their proportions have changed over time. The sources of capital in a company may be external or internal. External sources comprise share capital of different types, excluding the amount derived from the capitalisation of reserve, but including the balances of share premium, forfeited shares and borrowings of different categories. Internal sources, on the other hand, comprise capital reserve, whether capitalised or not, by the issue of bonus shares and retentions in the garb of reserve and surplus including the balance of the profit and loss appropriation accounts.

The capital structure of companies may be analysed with reference to the relative contributions made by share capital, borrowed capital and retention to the total finance of a company at a point of time. The same may also be studied first by grouping the sources of capital into two broad classes, namely, ownership capital and creditorship capital. And, then by locating the relative contributions of different elements composing the aforesaid ownership and creditorship capital.

In any case the study of capital structure whether in its broad outline, or in detail, depends on their proportional or percentage contributions to the total capital of a company. At any given point of time such percentage contributions cannot be the same in companies of different types but all of a particular industry, or in those of different industries but
all of a particular type. But, by taking the totals of the absolute measure of each component of the capital structure of different companies, either of a particular industry or those of different industries but all of a particular type and then expressing them as percentages of capital or the aggregate major content of that capital of companies as described, the capital structure as a whole from a particular stand point may be worked out. But, for obvious reasons this aggregate capital structure does not remain constant. As already pointed out, it changes over time. Nevertheless, a certain trend in these changes of at least the basic character of the capital structure may be observed from period to period or over a given time. In our present study "An Analysis of the Nature and Changes of the Capital Structure of the Central Government Companies: 1960-61 - 1969-70" the investigation into the changes of the capital structure has been made in the aforesaid line. It has to be specifically mentioned that the companies selected are of a particular type from the stand point of ownership and control, though they belong to different categories of industries.