

A Review of Capital Structure Theories

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Capital structure is still a puzzle among finance scholars. So far, researchers have not yet reached a consensus on the optimal capital structure of firms by simultaneously dealing with the agency problem. Purpose of this study is to review various capital structure theories that have been proposed in the finance literature to provide clarification for the firms' capital structure decision. Starting from the capital structure irrelevance theory of Modigliani and Miller (1958) this review examine the several theories that have been put forward to explain the capital structure.

Three major theories of capital structure emerged over the years following the assumption of the perfect capital market of capital structure irrelevance model. Trade off theory of capital structure assumes that firms have one optimal debt ratio and firm trade off the benefit and cost of debt and equity financing. Pecking order theory (Myers, 1984, Myers and Majluf, 1984) assumes that firms follow a financing hierarchy whereby minimize the problem of information asymmetry. But neither of these two theories provide a complete description why some firms prefer debt and others prefer equity finance under different circumstances.

Another theory of capital structure has introduced recently by, Baker and Wurgler (2002), market timing theory of capital structure. This theory explains the current capital structure as the cumulative outcome of past attempts to time the equity market which implies that firms issue new shares when they perceive they are overvalued and that firms repurchase own shares when they consider these to be undervalued. Market timing issuing behaviour has been well established empirically by others already, but Baker and Wurgler (2002) show that the influence of market timing on capital structure is regular and continuous. So the predictions of these theories sometimes acted in a contradictory manner and Myers (1984) 30 years old question "How do firms choose their capital structure?" still remains.

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