Capital Structure

Accounting & Finance

How much debt is right, and what the theory says.

Modigliani-Miller

- Without tax, structure is irrelevant
- Firm value comes from its assets
- With tax, debt adds a tax shield
- Assumes no bankruptcy costs
- A benchmark, not a prescription

In practice

- Bankruptcy costs rise with debt
- Agency costs between debt and equity
- Financial distress deters customers
- Trade-off theory: an optimum exists
- Pecking order: retained, then debt, then equity

THE DIFFERENCE THAT MATTERS

The trade-off theory says value rises with the tax shield until distress costs overtake it. That peak is the optimum.

Pecking order explains observed behaviour better: firms prefer internal funds because issuing equity signals overvaluation.