**Module Overview**

In a corporation's capital structure, there are advantages and disadvantages to having debt. Corporations receive a tax deduction from the interest paid on debt. On the other hand, dividends are not tax deductible. This helps to reduce the cost of debt since the after-tax cost of debt is used in the weighted average cost of capital and not the pre-tax cost of debt. The cost of equity is usually much higher and can be estimated through the Capital Asset Pricing Model (CAPM). If a firm is very successful, the stockholders don’t have to share the profits with debtholders since the return on debt is not a variable.

There are some problems with debt, though. As a company uses more debt in its capital structure, it increases the company’s risk. This increases the costs of equity and debt. If a company has financial problems and can’t cover its interest charges, the firm may have to go bankrupt if it can’t obtain additional financing.

Firms that have quite variable earnings and operating cash flows are better off having limited debt in their capital structures. Companies with more stable earnings and operating cash flows can utilize more debt in their capital structures.

Business risk is probably the most important factor that drives capital structure decisions. Business risk is the riskiness of a company’s operations if it doesn’t utilize debt. Financial risk is the increased shareholder risk from the use of debt in the capital structure. There’s no set optimal capital structure for all firms.

An investor’s total return consists of the capital gains yield and the dividend yield. Not all companies pay dividends; however, for those that do, it is an important component of an investor’s return, particularly for those seeking income. Individuals who are retired are usually the clientele most interested in dividends. If a stock’s price didn’t change all year, yet the company paid a healthy dividend yield, the investor would still earn a positive total return.

Successful companies typically accumulate a large amount of cash on their balance sheet. If the company has funded all the positive NPV projects that it wants to, it can look to paying a dividend or buying back stock. If it currently already pays a dividend, it can look to increase the dividend.

A company that institutes or increases a dividend provides a signal to the marketplace that it anticipates higher future cash flows, because once a company starts or increases a dividend, it rarely reduces or eliminates the dividend. On the other hand, a company that decreases its dividend or eliminates a dividend provides a signal to the marketplace that it anticipates lower future cash flows.

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