UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT
DESIGN CAPITAL STRUCTURE

Control practices

The following control objectives provide a basis for strengthening your control environment for the process of designing capital structure. When you select an objective, you will access a list of the associated business risks and control practices. That information can serve as a checklist when you begin reviewing the strength of your current process controls.

This business risk and control information can help you assess your internal control environment and assist with the design and implementation of internal controls. Please note that this information is at the generic business process level and many companies will need to go beyond generic models to address the specific business processes that support the financial and nonfinancial disclosures being made. You can combine the insight of this business risk and control information with your industry-specific knowledge and understanding of your company's environment when conducting internal control assessments and designing and implementing recommendations.

Effectiveness and efficiency of operations

A. Select the best source of capital based on the company's needs and market conditions.
B. Establish the optimal capital structure to minimize cost of capital.
C. Select the dividend policy that optimizes the company's cash flow, investor relations, capital requirements, and financial ratios.

Effectiveness and efficiency of operations

A. Select the best source of capital based on the company's needs and market conditions.

Business risks

- Excessive cost of capital.
- Dilution of ownership interests.
- Increased financial risk.

Control practices

1. Obtain the services of investment bankers to help research the optimum sources of capital.
2. Study the following factors when considering various sources of capital: anticipated market conditions, effect on financial ratios, effect on credit rating, risk (reliability of the source of funds in the future), restrictions (debt covenants), flexibility, expected inflation trends, current and expected profitability and liquidity position, stability and maturity of operations, and tax implications.
3. Consider the advantages of debt financing. (These include: tax deductible interest; no bondholder share of earnings; lower debt repayment costs during periods of inflation; no diluting effects; debt retirement prior to maturity due to call provisions; ability to sustain financial stability in markets where money is tight.)

4. Consider the disadvantages of debt financing. (These include: interest payments even when profits are low and losses incurred; debt repayment at maturity; higher debt that increases financial risk and interest costs; and indenture provisions that restrict activities.)
5. Consider the advantages of common stock issuance. (These include: no requirements to pay fixed charges such as dividends or interest or to establish repayment or sinking funds; and an improved credit rating due to stock issuance.)
6. Consider the disadvantages of common stock issuance. (These include: no tax deduction for dividends; diluted ownership interest; earnings and available dividends spread over more shares outstanding; and higher issuance costs than those for preferred stock or debt financing.)
7. Consider the advantages of preferred stock issuance. (These include: no dividend payments during difficult times; preferred stockholders cannot force bankruptcy; preferred shareholders claim no share of high earnings; growth companies earn more for owners by issuing preferred shares at higher fixed rates than by issuing common stock; no diluting effects on common stock ownership; no collateral security requirement; and better debt/equity ratio with more flexible provisions.)
8. Consider the disadvantages of preferred stock issuance. (These include: higher yield requirement than for bonds because of increased risk; no tax deduction for dividends; and higher issuance costs than for bonds.)
9. Consider the advantages of warrants. (These include: issuance of debt at lower interest rates; balanced financing between debt and equity; and generation of other fund sources when warrants are exercised.)
10. Consider the disadvantages of warrants. (These include: diluted common interests that could be exercised when the business has no need for additional capital.)
11. Consider the advantages of convertible securities. (These include: a "sweetener" in the debt offering because investors can share in the appreciation of common shares; lower interest rates than straight debt; fewer financing restrictions; equity price higher than current market prices and more appealing to investors in a tight market; call provisions that force conversion when the market price exceeds the conversion price; and lower issuance costs.)
12. Consider the disadvantages of convertible securities. (These include: conversion at lower prices instead of issuance of shares at the higher price if common share prices increase appreciably, and convertible debt repayment required if stock does not appreciate.)

B. Establish the optimal capital structure to minimize cost of capital.

Business risks

- Excessive cost of capital. (Note: Cost of capital is the cost, in terms of invested funds, that has to be paid by a company. It is the combination of the dividend and interest rates for each of the respective financing instruments. It represents what it costs a company to obtain money.)

Control practices

1. Investigate all factors relevant to evaluating the optimal capital structure. (These include: asset makeup, debt-to-equity ratios, outstanding obligations, growth rate and stability of future sales, competition, expected rate of inflation, tax laws and rates, business risks, control status of owners and managers, and lender attitudes toward the industry and the company.)
2. Utilize the weighted-average cost of capital based on the after-tax cost of capital from debt and equity to determine the cost of capital.
3. Consider low-cost foreign financing options. (These include: government grants and incentive rate loans, joint ventures with foreign companies, government incentives, and foreign subcontracting.)

C. Select the dividend policy that optimizes the company's cash flow, investor relations, capital requirements, and financial ratios.

Business risks

- If dividends are too high, fewer funds are available for operating and capital requirements.
- If dividends are too low, shareholder dissatisfaction may result.

Control practices

1. Evaluate all of the relevant factors that influence dividend policy. (These include: liquidity and cash flow, competitor policies, profitability, earnings stability, tax penalties, financial leverage, restrictive covenants, growth rate, uncertainty, ability to finance externally, and company size and maturity.)