

The Relationship Between Capital Structure Composition and Financial Performance of Listed Firms: A Critical Review of Literature

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1.0 ABSTRACT

Capital structure is important in the business affairs of any going concern entity as its the overall source of finance used by a company in financing its operations and has been considered as one of the most important factors in firm financing policy due to its crucial role in corporate performance. The characterization of the relationship signs as positive or negative and the direction weather capital structure impacts on Financial performance of Firms both manufacturing and non-manufacturing are questions that authors have tried to answer for a long time. Financial performance is the blue print of the financial affairs of a concern and it reveals the organizations ability to translate its financial resources into mission related activities. The literature has laid down the inconsistencies as a result of different multi-sector samples and the multiplicity of financial performance of the Firms. Since these factors are apparently the originating causes of this inconsistency, there is need to address them particularly in the review of the literature that is available, this will allow the reflection of new trends in research and to highlight ways of enriching this research tradition. Decision about capital structure still remains one of the most challenging and most difficult issues facing companies, at the same time the most critical decision about the continued survival of companies. To study the relationship between capital structure composition and financial performance of Firms will help us know the potential problems in financial performance and capital structure.

2.0 INTRODUCTION

The main objective of the firms is to maximize its profits and at the same time minimize cost, when companies search about resources to finance its investments they take this objective into consideration. The main sources that firms could use to provide the necessary finance are the internal finance which is equity, and the external finance which is debt. Most companies use a mix between equity and debt which form the capital structure. (Nassar S.,2016). A firm basic resource is the stream of cashflows produced by its assets .When the firm is financed entirely by common stock, all the cashflows belong to the stock holders and when it issues both debt and equity securities, it undertakes to split up the cash flows into two streams ,a

relatively safe stream that goes to the debt holders and a more risky one that goes to the stakeholders(Erasmus,2008).According to Pandey(2005).

One of the most important issues in corporate finance is responding “how do firms choose their capital structure?” Locating the optimal capital structure composition for a long time has been the focus of attention in many academic and financial institutions that probes into this area. This is comprehensible as there is a lot of money to be made by advising firms on how to improve their capital structure. Defining optimal capital structure is acritical decision. This decision is important not only because of the impact but such a decision has an organizations ability to deal with its competitive environment (Borigham and Gapenski,1996).

Capital structure refers to the way in which an organization is financed, a combination of long-term capital (Ordinary shares and reserves, preference shares, debentures, bank loans, convertible loans stock and so on) and short-term liabilities such as bank overdraft and trade creditors. Equity finance is that finance provided by the owners of the business and it’s the risk bearing finance. Equity finance holders own a portion of the firm denominated in shares and they are entitled to a part of the profit of a business, referred to as dividend. It is however not mandatory to pay a dividend all the time as the company may retain the profits for financing expansion of its operations. Equity owners also share in the risk of the business and are the last to benefit when a business is wound up after debt holders have been paid.

Debt finance, on the other hand, is finance generated through borrowing from external sources such as banks or from issues of bonds, all of which attract a fixed return. Debt may be short term, repayable over periods shorter than one year, or long term, repayable over periods longer than one year. The lender does not gain control of the business, but is paid specific cost for the use of funds known us interest. the borrower has a contractual obligation

to pay the interest and to repay the principal when due, regardless of the performance or profitability of the business. (Brockington,1990)

Capital structure composition shows the degree to which a business enterprise utilizes borrowed money and equity financing (Deesomsaket *al.*, 2004). Consequently, as noted by Van Horne and Wachowicz (2005), listed companies that are highly financially leveraged may be at risk of bankruptcy if they are unable to make payments on their debt and as result, they may be unable to find new lenders in the future (Deesomsaket *al.*, 2004).The decision on the capital structure is fundamental for any listed firm due to the need to maximize returns to the various stakeholders and also because of the fact that such a decision has great impact on the listed firm's ability to deal with competitive financial environment (Deesomsaket *al.*, 2004).According to Erasmus (2008), Financial performance is a subjective measure of how well a listed firm can use assets from its primary mode of business and generate revenue. This term is also used as a general measure of a firms overall financial health over a given period of time , and can be used to compare similar firms across the same industry or sectors in aggregation .Financing decisions is one of the important areas in financial management increase shareholder's wealth. To determine the extend managers achieve this object; we can relate it to the financial performance measurement of company. The decision is important not only because of the need to maximize returns to various organizational constituencies, but also because of the impact such a decision has on enlisted firm's ability to deal with its competitive environment.

Financial performance measurement is one of the tools which indicate the financial strengths, weaknesses, opportunities and threats (SWOT). The financial metrics used include: return on investment (ROI), residual income (RI), earning per share (EPS), dividend yield, price earnings ratio, growth in sales, market capitalization among others (Barbosa & Louri, 2005). Much of the theory in corporate sector assumes that the goal of firm should be to maximize

the wealth of its current shareholders. One of the major cornerstones of determining this goal is financial ratio. Financial ratios are commonly used to measure listed firms' financial performance. Generally, listed corporations include them in their annual reports to stakeholders. Investment analysts provide them for investors who are considering the purchase of a listed firm's securities. Financial ratios represent an attempt to standardize financial information to facilitate meaningful comparisons. It provides the basis for answering some very important questions concerning the financial wellbeing of the listed firm. Its objectives are to determine the listed firm's financial strengths and to identify its weaknesses.

On the general trend in published literature the available empirical literature on the relationship between capital structure composition and financial performance of listed firms varies with the nature of specific search done. Mostly being positively and negatively related (Brigham *et al*, 2001, Pandey, 2006). It recognizes that capital structure is like a 'double - edged sword' because it can either magnify the listed firm's potential gains or losses (Pandey, 2006). On the contrary, Brigham *et al*, 2001 asserts that capital structure composition decisions may influence financial performance of a listed firm negatively and its worth in the market. For example, Mule and Mukras (2013) observe that for the period 2006-2011, listed companies' in Kenya debt levels oscillated between 22.64 % and 76.2 % implying that capital structure composition of listed firms in Kenya vary greatly.

On the other hand, equity financing is an aspect of distribution of companies' stock among the entity's owners, that is, shareholders and can be investigated from two perspectives (Jiang, 2004). One perspective is the identities of ownership and the other perspective is ownership concentration (Jiang, 2004) which has been defined by Demsetz and Villalonga (2001) as the shares owned by a certain number of individuals, institutions or families. According to La Porta *et al*. (1998) ownership concentration and institutional differences are

caused by the degree of legal protection of minority shareholders in each country, a viewpoint contrasted by Roe (2003) who asserts that political factors can explain the differences in ownership concentration across countries.

Theoretical literature link equity financing and financial performance both positively and negatively (Januszki *et al.*, 2002 and Nickel *et al.*, 1997). It recognizes that firm performance is positively related to the majority shareholder. This is because listed firm's financial performance and majority shareholder are substitutable (Nickel *et al.*, 1997). This is contrary to Januszki *et al.* (2002) who posit that a majority of shareholder has a negative influence on firm's financial performance. Their reasons being that such firms have single ultimate owner, which operate under strong ownership, experience higher productivity growth.

Empirical evidence (Maniagi *et al.*, 2013, Mule and Mukras, 2013, Gicheha, 2012, San and Heng, 2011, Onaolapo and Kajola, 2010) show mixed relationships between debt financing and financial performance of listed firms leading to theory building stagnation. San and Heng (2011) use correlational research design and judgmental sampling to study the association between capital structure composition and financial performance of the listed firms in the construction industry in the aftermath of financial crises of 2007-08. On the other hand, Maniagi *et al.* (2013), Onaolapo and Kajola (2010) and Gicheha (2012) use convenient sampling and time series data in comparing capital structure and performance of non-financial listed firms, however all the listed firms are not studied and the cross-sectional aspects of the data are not considered. On the contrary, Mule and Mukras (2013) used panel methodology to study the effect of financial leverage on financial performance of listed firms in Kenya and found that financial leverage was a significant negative predictor of financial performance measured in terms of ROA, $\beta = -.0438$ ($p = .0350$) and Tobin's Q, $\beta = -.5144$ ($p = .0124$) meaning a unit change in financial leverage leads to a significant decrease in ROA

and Tobin's Q of .0438 and 0.5144, respectively, all else being equal. Given importance of debt financing in the capital structure composition decisions, causes of mixed results have not been established.

On the other hand, empirical findings of investigations into the relationship between equity financing and financial performance of listed firms have also yielded mixed results leading theory stagnation (Ndwiga, 2012, Uadiale, 2010, Isik and Soykan, 2013, Mandaci and Gumus, 2010, Ongore, 2011). Uadiale (2010) elevates outside directorship role in financial performance of firms in Nigeria using correlation analysis and accounting measures of performance, all firms instead of listed firms are considered. On the contrary, Ongore (2011) use descriptive research design, cross-sectional data, logistic regression and step wise regression to investigate the relationship between ownership structure and performance, however, he only considers cross-sectional aspects of listed firms as opposed to panel which encompasses both time and cross-sectional aspects.

After Modigliani and Miller, Jensen and Meckling discussed the agency cost theory which refers to the potential conflict between managers and shareholders in one side and between shareholders and debtors in another side and later Jensen and Meckling's (1976) argument on the relationship between capital structure and firm performance, many researchers have begun to study the relationship between capital structure and firm performance. To date the results of the empirical literature on the relationship between capital structure and performance are contradictory which justifies further research. Moreover, many of the reported studies on the relationship between financial structure and performance have been conducted in developed countries where capital markets are well developed. The Kenyan capital market is relatively under developed and therefore the traditional capital structure theories that have their origin in the developed countries needed to be tested in the Kenyan context. One of the research gaps brought about this study is linking the performance of listed

companies to capital structure composition since there is variation of companies in terms of their capital structure composition and studies have shown that there is no optimal capital structure composition of equity and debt (Ross,2002).

From these there is need to further the studies by showing whether capital structure composition has an impact on the financial performance of the listed companies. Theoretical and empirical studies try to define the determinants of capital structure but research investigating the relationship between capital structure and firms' level of performance are limited. Therefore, taking into consideration meta-analysis of existing literature above, this study Seek to establish the relationship between capital structure composition and financial performance of listed companies at Nairobi Securities Exchange (NSE).

2.1 Identification and definition of general Topic

To understand how Companies, finance their operations, it is necessary to examine the determinants of their financing and the capital structure decisions. Capital financing decisions involves a wide range of policy issues. At various companies, such decisions affect capital structure, corporate governance and company development (Green, Murinde and Suppakitjarak, 2002). Capital structure refers to a mixture of a variety of long term sources of funds and equity shares including reserves and surpluses of an enterprise. The historical attempt to building theory of capital structure began with the presentation of a paper by Modigliani & miller (MM) (1958). They revealed the situations under what conditions that the Capital structure is relevant or irrelevant to the financial performance of the listed companies. Most of the decision making process related to the Capital Structure are deciding factors when determining , a number of issues e.g. cost, various taxes and rate, interest rate have been proposed to explain the variation in Financial Leverage across firms (Van Horne,1993; Hampton,1998; Titman and Wessels,1998).these issues suggested that

depending on attributes that caused the cost of various sources of capital, the firm's select Capital Structure and benefits related to debt and equity financing.

The relationship between capital structure composition and financial performance is one that received considerable attention in the finance literature. How important is the concentration of control for the company performance or the type of investors exerting that control are questions that authors have tried to answer for long time in prior studies.

The current economic crisis has put great pressure in both manufacturing and non-manufacturing firms especially underperforming firms. The supply of credit has drastically dropped, while increase in risk and cost of capital pressure firms in finding the right balance between debt and equity.(Olokoyo,2012).According to Akeem, Edwin, Kinyanjui & Kayode (2014) the corporate sector in various companies is characterized by a large number of firms operating in a largely deregulated and increasingly competitive environment.The problem of Capital structure, therefore arises from determining the quantum of each source of finance that will yield optimum return with little risk (Akintoye, 2016; Dada & Ghazali, 2106; Gambo et al..2016). According to the above, it is apparent that the exact effect of capital structure composition on financial performance is yet to be established and it is calling for further investigations.

2.1.1 Corporate Governance

Corporate governance is the system of rules, practices and processes by which a firm is directed and controlled. Corporate governance practices include the relationship among the many stakeholders involved and the goals for which corporation is governed in contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. Internal stakeholders are the board of directors, executives, and other employees. Sustained thread of discussion regarding the relationship of capital structure composition and firm

performance in listed companies, there is need for corporations to be directed in a responsible and transparent manner in the best interest of the corporations. Also, there has been renewed interest in the role of corporate governance practices on the relationship between Capital Structure and Financial performance of firms of Modern Corporations since 2001, particularly due to the highest profile collapses of a number of large corporations, most of which involved in accounting fraud. Corporate scandals of various forms have maintained public and political interest in the Moderation of Corporate governance.

2.1.2 Capital Structure

The capital structure is how a firm finances its overall operations and growth by using different sources of funds. In other words, the capital structure of a firm is basically the way a firm finances its assets through some combination of debt and equity that firms deem as appropriate to enhance its operations (Stewart,2011). The theory of the capital structure is an important reference theory in enterprise's financing policy. It refers to the firm's financial framework. It's a financial term that means the way a firm finances their assets through the combination of equity, debt, or hybrid securities (Saad, 2010). In short, capital structure is a mixture of a company's debts (long-term and short-term), common equity and preferred equity. i.e. it's essential on how a firm finances its overall operations and growth by using different sources of funds. Whether or not an optimal capital structure exists is one of the most important and complex issues in cooperate finance.

Modigliani-Miller (MM) theorem (1958) is the broadly accepted capital structure theory because it is the origin theory of capital structure theory which had been used by many researchers. The prediction of the Modigliani and Miller model that in a perfect capital market the value of the firm is independent of its capital structure, and hence debt and equity are perfect substitutes for each other, is widely accepted. However, once the assumption of perfect capital markets is relaxed, the choice of capital structure becomes an important value-determining factor. This paved the way for the development of alternative theories of capital

structure decision and their empirical analysis. Although it is now recognized that the choice between debt and equity depends on firm-specific characteristics, the empirical evidence is mixed and often difficult to interpret.

2.1.3 Financial performance

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenue. Financing decisions is one of the important areas in financial management increase shareholder's wealth. To determine the extend managers achieve this object; we can relate it to the financial performance measurement of company. The decision is important not only because of the need to maximize returns to various organizational constituencies, but also because of the impact such a decision has on an organization's ability to deal with its competitive environment. Financial managers are difficult to exactly determine the optimal capital structure. A firm has to issue various securities in a countless mixture to come across particular combinations that can maximize its overall value which means optimal capital structure. Although optimal capital structure is a topic that had widely done in many researches, we cannot find any formula or theory that decisively provides optimal capital structure for a firm. If irrelevant of capital structure to firm value in perfect market, then imperfections that exist in reality may cause of its relevancy. In practice, firm managers who are able to identify the optimal capital structure are rewarded by minimizing a firm's cost of finance thereby maximizing the firm's revenue. If a firm's capital structure influences a firm's performance, then it is reasonable to expect that the firm's capital structure would affect the firm's health and its likelihood of default.

Corporate performance can be measured by variables which involve productivity, profitability, growth or, even, customers' satisfaction. These measures are related among each other. Financial measurement is one of the tools which indicate the financial strengths, weaknesses, opportunities and threats (SWOT). Those measurements are return on

investment (ROI), residual income (RI), earning per share (EPS), dividend yield, price earnings ratio, growth in sales, market capitalization etc. (Barbosa & Louri, 2005). Much of the theory in corporate sector is based on the assumption that the goal of firm should be to maximize the wealth of its current shareholders. One of the major cornerstones of determining this goal is financial ratio. Financial ratios are commonly used to measure firm performance. Generally, corporations include them in their annual reports to stakeholders. Investment analysts provide them for investors who are considering the purchase of a firm's securities. Financial ratios represent an attempt to standardize financial information to facilitate meaningful comparisons. It provides the basis for answering some very important questions concerning the financial wellbeing of the firm. Its objectives are to determine the firm's financial strengths and to identify its weaknesses.

2.2 General Trends in Published literature

The literature shows that most studies on the subject of debt -equity composition of firms mostly commonly ignore the many difference among countries. The few who try to consider these conditions limits the study to generalization such as developing countries and developed countries. But do all developing countries have the same financial conditions? Is there common pattern in the choice of financing a project? According to Doku et.al. (2011) studies into relationship between financial development and choice of finance in listed firms revealed that financial market development in developing economies will expose more financial options in attempts to minimize financial constraints. The study found out that a side firm specific factors recognized in extant literature responsible in explaining financing choices of firms, financial market development also accounts for financing decisions of listed firms.

Recent research on capital structure composition and financial performance around the world has established a number of empirical regularities. Salman and Hendrawan (2012) examine

the impact of capital structure toward performance of two groups of banks, conventional and Islamic banks in Indonesia by using profit efficiency approach. Two stages procedure were employed. In the first stage, they measure profit efficiency score for each bank in Indonesia during the year 2002-2008 by using distribution free approach (DFA). In the second stage, they employed bank standard profit function model and their performance. They discover in the two approaches that there is a positive relationship between capital structure and performance.

Iorpev, Luper and Kwanum (2012) examined the impact of capital structure on the performance of manufacturing Companies in Nigeria from 2005-2009. Multiple regression analysis was applied on performance indicators such as return on Assets (ROA) and profit margin (PM) as well as short-term debt to Total assets, Long term debt to total assets etc. Positive relationship was also established between leverage and profitability.

Onaolapo and Kajola (2010) examined the impact of Capital structure on firm's financial performance in anon-financial firm using the ordinary least square (OLS) method on thirty non-financial firms listed in Nigeria stock exchange and found that a firm's capital structure surrogated by Debt Ratio, has significantly negative impact on the firm's financial measures.

The legal approach to capital structure is a natural continuation of the field as it has developed over the last 60 years. Modigliani and Miller (1958) think of firms as collections of investment projects and the cash flows these projects create, and hence naturally interpret securities such as debt and equity as claims to these cash flows. They do not explain why the managers would return the cash flows to investors. Jensen and Meckling (1976) point out that the return of the cash flows from projects to investors cannot be taken for granted, and that the insiders of firms may use these resources for their own benefit. Jensen and Meckling view financial claims as contracts that give outside investors, such as shareholders and creditors, claims to the cash flows. In their model, the limitation on expropriation is the residual equity

ownership by entrepreneurs that enhances their interest in dividends relative to perquisites.

One way to think about legal protection of outside investors is that it makes the expropriation technology less efficient. At the extreme of no investor protection, the insiders can steal a firm's profits perfectly efficiently. Without a strong reputation, no rational outsider would finance such a firm. As investor protection improves, the insiders must engage in more distorted and wasteful diversion practices such as setting up intermediary companies into which they channel profits. Yet these mechanisms are still efficient enough for the insiders to choose to divert extensively. When investor protection is very good, the most the insiders can do is overpay themselves, put relatives in management, and undertake some wasteful projects. After a point, it may be better just to pay dividends. As the diversion technology becomes less efficient, the insiders expropriate less, and their private benefits of control diminish. Firms then obtain outside finance on better terms. By shaping the expropriation technology, the law also shapes the opportunities for external finance.

When investors finance firms, they typically obtain certain rights or powers that are generally protected through the enforcement of regulations and laws. Some of these rights include disclosure and accounting rules, which provide investors with the information they need to exercise other rights. Protected shareholder rights include those to receive dividends on pro-rata terms, to vote for directors, to participate in shareholders' meetings, to subscribe to new issues of securities on the same terms as the insiders, to sue directors or the majority for suspected expropriation, to call extraordinary shareholders' meetings, etc. Laws protecting creditors largely deal with bankruptcy and reorganization procedures, and include measures that enable creditors to repossess collateral, to protect their seniority, and to make it harder for firms to seek court protection in reorganization.

In different jurisdictions, rules protecting investors come from different sources, including company, security, bankruptcy, takeover, and competition laws, but also from stock exchange

regulations and accounting standards. In most corporations, laws and regulations are enforced in part by market regulators, in part by courts, and in part by market participants themselves. All outside investors be they large or small, shareholders or creditors, need to have their rights protected. Absent effectively enforced rights, the insiders would not have much of a reason to repay the creditors or to distribute profits to shareholders, and external financing mechanisms would tend to break down.

This point of view, originating in the Coase (1961) theorem, crucially relies on courts enforcing elaborate contracts. In many countries, such enforcement cannot be taken for granted. Indeed, courts are often unable or unwilling to invest the resources necessary to ascertain the facts pertaining to complicated contracts. They are also slow, subject to political pressures, and at times corrupt. When the enforcement of private contracts through the court system is costly enough, other forms of protecting property rights, such as judicially-enforced laws or even government-enforced regulations, may be more efficient. It may be better to have contracts restricted by laws and regulations that are enforced than unrestricted contracts that are not. Whether contracts, court-enforced legal rules, or government-enforced regulations are the most efficient form of protecting financial arrangements is largely an empirical question. As the next section shows, the evidence rejects the hypothesis that private contracting is sufficient. Even among countries with well-functioning judiciaries, those with laws and regulations more protective of investors have better developed capital markets.

2.3 Conflict in Theory, Methodology, Concept findings and conclusions.

2.3.1 Conflict in Theory

The reviewed literature provides insight into the theories, Methods, concepts and conclusions of each research.

Modigliani and Miller (MM),1958 illustrate that under certain key assumptions, firms' value is unaffected by its capital structure. Capital markets is assumed to be perfect where both

insiders and outsiders have free access to information, no transaction cost, bankruptcy cost and taxation exist; equity and debt choice becomes irrelevant and internal and external funds can be perfect substitute. The MM theory (1958) argues that the value of a firm should not depend on its capital structure. It further argues that a firm should have same market value, of which capital structure levels of a company should depend on the return and risk of its operational and not on the way it finances those operations.

This theory has faced a number of criticisms from researcher's objective that there are no perfect Capital markets in reality, although later they revised their earlier theory by incorporating tax benefit and argued that under market imperfection where interest payments are tax deductible, firm value will increase with the level of financial leverage (Modigliani & Miller 1963)

Donaldson (1961). Alluded contrary to the idea of firms having a unique combination of debt and equity finance, which minimize their loss of capital. The theory says that when a firm penetrating ways of financing its long-term investments it has a very-defined order of preference with respect to the sources of finance it uses. It states that a firm first preference should be that utilization of internal funds (i.e. retained earnings) followed by, debt and equity. He further argued that the more profitable the firms become, the lesser they borrow because they would have sufficient internal project.

He further argues that it is when the internal finance is inadequate that a firm should source for external finance and most preferably bank borrowings or corporate bond.

2.3.2 Conflict in Methodology

Most of the studies reviewed used descriptive and inferential statistics analysis, cross sectional multiple regression analysis and census survey, which are good in describing how an independent variable is numerically related to the dependent variable and answers to the

questions regarding the studies but are not appropriate for correlating variables and not easily replicable.

2.3.3 Concept findings

Conceptual definition of capital structure is the combination of debt and equity to finance a firm Operations. Capital structure includes mixture of debt and equity financing (Chou and Lee, 2010). From the definition two financing options are open to financial managers debt and equity. Thus, the financial manager can increase shareholders claim or increase creditor's claim on the assets of the firm. Shareholders claim increases when shares are issued for public subscription while creditors claim increases when company borrows on a short- term or long -term basis. Therefore, the various means of financing company operations represent what is known as capital structure.

The choice of performance measures is one of the most critical challenges facing organizations. Poorly chosen performance measures routinely create the wrong signals for managers, leading to poor decisions and undesirable results. There are enormous hidden cost in misused performance measures. Shareholders pay the bill each day in the form of over investment and acquisitions that do not pay off, etc. It is not that management is poor. Simply it's the wrongly chosen performance measures, which in turn push management to take improper decisions.

According to Kayode et. al. (2014) it is a critical decision for any business organization for an appropriate capital structure, the decision is not only because of the need to maximize returns to various organizational constituencies, but also on an organizations ability to deal with its competitive environment.

2.3.4 Conclusions

The studies review has different findings on the relationship on capital structure composition and financial performance of the firm. According to Abbasali, (2012), shows that by reducing

debt ratio, management can increase the company's profitability and thus the amount of the company's financial performance measures and can also increase shareholders wealth.

Eric Atta, (2014) attest that short-term debt and total equity have a significant positive relationship with Return on Equity, Return on Assets and Return on total capital but long-term debt has significant negative relationship with return on Equity, Return on Asset and Total equity.

According to Amah, Kalu, (2016) capital structure composition are negatively related to Financial performance. They concluded that capital structure composition has no impact on financial performance, which is consistent with the pecking order theory.

Based on the reviewed literature capital structure is still a puzzling concept especially in emerging markets. Future research can be processed by comparing the capital structure and the firm performance of small and large firms.

2.4 Gaps in research/justification

Considering the literature reviewed it can be seen that there is need for more work to be done in this area of study. First, there is progress made and the new trends that have become apparent, reflects on the gaps that have been left in our knowledge and speculate on future studies that will allow us to enlarge our knowledge on the relationship on the capital structure composition and financial performance of the listed companies.

The current economic crisis has put great pressure in both manufacturing and non-manufacturing firms especially underperforming firms. The supply of credit has drastically dropped, while increase in risk and cost of capital pressure firms in finding the right balance between debt and equity. According to the above, it is apparent that the exact effect of capital structure composition on financial performance is yet to be established and it is calling for further investigations. This is the gap that this work comes to fill.

3.0 LITERATURE REVIEW

Capital structure has been defined by many authors and scholars. However, these definitions are explicit and have the same meaning. This study adopts that of Pandey which says “a company’s capital structure refers to its debt level relative to equity on the balance sheet. It is a snap shot of the amounts and types of capital that a firm has access to and what financing methods it has used to conduct growth initiatives such as research and development or acquiring assets”

3.1 Group Research Studies in Logical Sequence

The literature has shown extensive interest in the relationship between capital structure and firm performance in financial leverage. Hasan, Ahsan, Rahaman & Alam (2014) carried out a study of influence of capital structure on firm performance. Evidence from Bangladesh, they used a total of 36 firms from Bangladesh during the period for 2007-2012, using pooling panel data regression method, they found out Earning per Share significantly related to short term debt while significantly negatively related to long-term debt, on the other there is no statistically significant relation that exist between Capital structure and firm performance as measured by ROE and Tobin’s Q.

Muhammad, Shan & Islam (2014), did a work as the impact of capital structure in firm performance of Pakistanis, their result reveal a strong and firm performance variable using cement companies listed on Karachi stock exchange during the period of 2009-2013, they also fund out a positive relationship between debt to equity and firm performance variable.

Soumad and Hayadnch (2013) Studied Capital structure and corporate performance Empirical study in the public Jordanian shareholding firms listed in Amman Stock market using 76 firms (53 industrial firms and 23 service corporation) for a period of 2001-2006. The results of the study concluded that capital structure associated negatively and statistically with firm performance as the study sample generate.

Taani (2013) examines the impact of capital structure on performance of 12 commercial banks listed on Amman stock exchange during 2007-2011. He finds that bank performance measured by net profit, return on capital employed and net interest margin related significantly and positively with total debt, whereas total debt is found significant with return on equity in the banking industry of Jordan.

Salman and Hendrawn (2012) examine the impact of capital structure toward performance of two new groups of banks, conventional and Islamic banks in Indonesia by using profit efficiency approach. Two stages procedure were employed. In the first stage, they measure profit efficiency score for each bank in Indonesia during the year 2002-2008 by using distribution free approach (DFA). In the second stage, they employ bank standard profit function model and their performance. They discovered in the two approaches that there is appositive relationship between capital structure and performance.

Iorpev, Luper and Kwanum (2012) examined the impact on capital structure on the performance of the manufacturing of manufacturing companies in Nigeria from 2005-2009. Multiple regression analysis was applied on performance indicators such as Return on Assets (RAO) and profit margin (PM) as well as short term debt to Total assets, Long-term debt to total asset etc. Positive relationship was also established between leverage and profitability.

Olokoyo (2012) carried out a study in capital structure and corporate performance of Nigeria quoted firms. A panel data approach using a total 101 quoted firms from 2003 to 2007. It was found out that a firm leverage has a significant negative impact in firms accounting performance measure (RAO). An interesting finding is leverage measures (Tobin's Q). It was established the maturity structure of debt affect the performance of firm's significantly and size of the firm has a significant positive effect on the performance of firms in Nigeria.

Khan (2012) studied the relationship of capital firms in pakistani market listed in Karachi stock exchange during 2003-2009. He finds a negative and significant relationship between

financial leverage measured by short term debt to total assets (STDTA) and total debt to total assets (TDTA) and firm performance measured by return in assets (ROA), gross profit margin (GPM) and Tobin Q.

Nor and Fatimah (2012) studied the impact of debt and equity financing on the performance of the firms listed in bursa Malaysia. Using sample of 130 firms for the period of 2001-2010 combined with multiple regression analysis, they cited a statistically significant negative relation between capital structure and firm performance.

San & Heng (2011) study the relationship between capital structure and performance of Malaysian construction industry in the financial crises of 2007-2008 that study badly affected the economies of Malaysian. They demonstrate a weak relationship exist between leverage and performance measured by return on assets and return in equity of Malaysian construction industry.

Ali and Imam (2011) observed that firms performance calculated by Earning per share and Tobin's Q is positively related with capital structure, while they got a negative relation between capital structure and ROA. However they witnessed no significant relationship between ROE and capital structure.

Aduda and Musyoka (2011) evaluated the relationship between executive compensation and firm performance in the Kenyan banking industry between 2004 and 2008. The study found negative relationship between executive compensation and the bank size and this was attributed to the diminishing influence of key owners as the bank grows in size. The study did not consider the intervening effects of other variables on the relationship between corporate governance and firm performance.

Omorgie and Erah (2010) examines the capital structure and corporate performance of manufacturing industry in Nigeria between 1995 and 2009 using the ordinary least Squares

(OLS) technic of model estimation. They established appositive relationship between the firm's capital structure and its performance in the manufacturing industry.

Onolapo and Kajola (2010) examined the impact of capital structure on firm's financial performance in a non-financial firm using the ordinary least square (OLS) method on thirty non-financial firms listed in Nigeria stock exchange and found that's firm's capital structure surrogated by Debt Ratio, has a significantly negative impact on the firm's financial measures.

Modigliani and Millers (1958) study gave a substantial boost to the development of a theoretical framework that has since been used by most financial studies (Abor 2005).

Modigliani and miller (MM),1958 illustrates that under certain key assumptions, firms' value is an affected by its capital structure. Capital market is assumed to be perfect and that the insiders and outsiders have free access to information. The M-M theory (1958) argues that the value of a firm should not depend on its capital structure. The theory argued further that a firm should have same market value, of which capital structure levels of a company should depend on the return and risk of its operational and not on the way it finances those operations.

This theory has faced criticism from many researchers' objectives that there are no perfect capital markets in reality, although later they revised their earlier theory by incorporating tax benefit and argued that under market imperfection where interest payments are tax deductible, firm value will increase with the level of financial leverage (Modigliani & Miller 1963).

3.1.2 Capital Structure and firm performance

Firm's performance is significantly affected by various factors and capital structure is one of the significant factors among them. Lot of empirical studies has been done to explore if there

is any (Positive, negative or no) relation between firm s performance and capital structure and these studies produced mixed results.

According to Kayode et al (2014) it is a critical decision for any business organization for an appropriate structure, the decision is not only because of the need to maximise returns to various organizational constituencies, but on an organization's ability to deal with its competitive environment.

Pathak (2011) in his study found that the level of debt has significant negative association with firm performance which is not in accordance with the findings of many studies done for western economies but consistent with some of the studies done for Asian countries. One important reason of this conflicting result can be the high cost of borrowing in developing countries like India in comparison to western countries. Khan (2012) research results were consistent with the Jensen and Meckling (1975) agency cost model and didn't found any significant impact of efficiency on leverage. There is evidence towards nonlinearities in the relationship between ownership type with capital structure and firm's performance.

Roden and Lewellen (1995) examines the capital structure of 48 US firms during the period 1981-1990 and revealed a positive relation between profitability and capital structure. Similar results were documented by Champion (1999) and Gosh et al. (2000). Hadlock and James (2002) suggest corporations with high level of profitability use high level of debts. Abor (2005) reports a positive relation between capital structure, which measured by STD and TD, and performance over the period 1998-2002 in the Ghanian firms. Arbiyan and Safari (2009) investigate the effects of capital structure on profitability using 100 Iranian listed firms from 2001 to 2007. The found short-term and total debts are positively related to profitability (ROE) which indicate a negative relation between long-term debts and ROE. Kester (1986) found a negative relation between capital structure and performance (profitability) in the US and Japan.

Similar results were reported by Friend and Lang (1988), Titman and Wessels (1988) from the US firms, Rajan and Zingales (1995) in the G-7 countries, Wald (1999) in the developed countries. In addition, Wiwattanakantang (1999) reported a negative relation between book and market leverage and ROA from 270 Thai firms. Haung and song (2006), too found a negative correlation between leverage and performance (earnings before interest and tax to total assets is China firms).

Chakraborty (2010) employed two performance measures, including ratio of profit before interest, tax and depreciation to total assets and ratio of cash flows to total assets and two leverage measures, including ratio of total borrowing to assets and ratio of liability and equity, and reported a negative relation between these ones. Ebaid (2009) investigates the impact of capital structure choice on performance of 64 firms from 1997-2005 in the Egyptian capital market. He employs three accounting-based measures including ROA, ROE and gross profit margin, and concludes capital structure choices, generally, has a weak to- no impact on firm performance.

San and Heng (2011) in their research focused on construction companies which are listed in Main Board of Bursa Malaysia from 2005-2008, the result shows that there is a relationship between capital structure and corporate performance and there is also evidence that shows that no relationship between the variables have been investigated. For big companies, ROC with DEMV and EPS with LDC have positive relationship whereas EPS with DC is negatively related. A study by Saedi and Mahmoodi (2011) examines the relationship between capital structure and firm performance the study used sample of 320 firms listed on Tehran Stock exchange over the period 2002- 2009. Expect all of the financial companies and banks, the study uses four performance measures (including ROA, ROE, EPS and Tobin s Q) as dependent variable and three capital structures (including long- term debt short term debt and total debt ration) as independent variable. The study indicated that firm performances,

which is measured by EPS and Tobin's Q, is significantly and positively associated with capital structure, while reported a negative relation between capital structure and ROA, and no significant relationship between ROE and Capital structure. Pratheepkanth (2011) analyzed the capital structure and its impact on financial performance capacity during 2005 to 2009 of Business companies in Sri Lanka. The results shown the relationship between the capital structure and financial performance is negative.

Razak and Aliahmed (2008) examines the impact of an alternative ownership control structure of corporate governance on firm performance among government linked companies (GLCs) and Non GLC in Malaysia, The study was based on a sample of 210 firms over period from 1995 to 2005. Findings appear that there is a significant impact of government ownership on company performance after controlling for company specific characteristics such as company size, non-duality, leverage and growth. The finding is off significant for investors and policy marketers which will serve as a guide for better investment decision. A study by Zertun and Tian (2007) investigated the effect which capital structure has had on corporate performance using a panel data sample representing of 167 Jordanian companies during 1989- 2003. The study showed that a firm's capital structure had significantly negative impact on the firm's performance measures, in both the accounting and market's measures.

Hovakimian and Tehranian (2004) concluded that the importance of stock returns in studies of corporate financing choices is unrelated to target leverage and is likely to be due to the correlation between Pecking order theory and Market timing behavior theory. This study also found that profitability has no effect on target leverage. Unprofitable firms issue equity to offset the excess leverage due to accumulated losses. Thus, this study supports the notion that firms have a target capital structure. However, preference for internal financing and the temptation to time the market by selling new equity, when the share price is relatively high, interfere with the tendency to maintain the firm's debt ratio close to its target.

3.2 Current Trends in the relationship between Capital structure and Firm

Performance.

The trends to studies done analyzes the results of the recent empirical research on the relationship between Capital structure and Firm performance. Since there is no specific optimal debt - equity mix, companies keep on changing the pattern to meet its objective and Conditions. An attempt has been made to analyze the emerging trends in capital structure patterns in organizations.

Sukhdev and Rajui (2013) in their study on the capital structure of metal and refinery shows that the average trend of debt and equity is rising implying that these industries have access to both equity and debt financing. Initially companies were raising maximum debt fund to reduce the cost of capital which resulted in increase in financial risk. The study also found out that the average equity ratio of both industries in 2002-2003 i.e. 2.6.1 only as per standard norm of 2.1 of debt equity for all the industries.

Doku et.al. (2011) studies into the relationship between financial development and choice of finance of listed firms in Ghana revealed that the financial market development in developing economy like Ghana will expose more financial options in attempt to minimize financial Constraints .The study found out that a side firm specific factors recognizes in extant literature responsible in explaining financing choices of firms ,financial market development also account for financing decision of listed firms.

Meyers (1984). Further argued that firms would prefer the internal finance rather than external finance so that to save the transaction costs. Subsequently, he concluded that the capital structure influences the firm performance.

Early research done by Miller and Modigliani, (1958) looked at the relevance of capital structure decisions in an efficient capital market and also investigated the determinants of capital structure decisions. (Al-Najar, B and Hussainey, k,2011). Miller and Modigliani

(1963) added that the change in capital structure does not influence firm value when considering taxes and transactional costs.

3.3 Theories in the area of study

Theory is a system of interconnected ideas that condense and organize knowledge about the world, Neurman, (2006). In other definitions; theory is a system of ideas intended to explain something, especially one based on general principles independent of the thing to be explained.

The following capital structure theories have evolved from capital structure literature.

Modigliani and miller (MM) theory (1953,1963): In Modigliani and Miller provided the seminal in capital structure under certain assumptions includes no taxes, homogeneous expectations, perfect capital markets, and no transactional cost. This theory which called “capital structure irrelevance” states that the relationship between capital structure and cost of capital is irrelevant, that means the increase in debt does not affect on cost of capital. In a result the investors’ expectation of future benefits are totally on firm value and cost of capital. Later, Modigliani and Miller introduced new evidence that cost of capital effect on capital structure, and thus effect on firm value with taking taxes as assumption into consideration, which refer that borrowing gives a tax advantage, because the interest will deduct from the tax which result what is known as tax shields, which in turn reduce the cost of debt and then maximize the firm performance.

Pecking Order Theory: Pecking order theory is the result of asymmetric information. The pecking order model does not discuss the optimal capital structure as significant point, but states that firms has two sources to fund its financial needs which are internal and external finance. The theory claims that firms prefer to use firstly internal finance such as excess liquid assets or retained earnings then external finance. If internal financing is not enough to fund investment projects, firms may or may not obtain external financing financial, and if

they do, in order to minimize additional cost of a symmetric information, the managers head for choosing between the different sources of external finance, firms prefer to use debt leverage firstly, secondly issuance of preferred stock and finally issuance of common stock.

Trade-off theory: Trade off theory is an extension of the MM theory developed by Miller. The theory proposes that the firm optimal capital structure include the tradeoff among the influences of firms and personal taxes, agency costs and bankruptcy cost, etc. tradeoff theory expect that corporations choose levels of debt in order to achieve a balance among the benefits from the interest tax shield with the cost related to a future financial distress or with current financial inflexibility.

The agency theory: Agency cost theory which provided by Jensen and Meckling is discussing the conflict of interest between principals(Shareholders) and decision makers(agents) of firms (managers, board members ,etc.),this conflict stems from the differences behavior or decision by point out that the parties(agents and shareholders) often have different goals, and different tolerance towards risk .In this case the managers who are responsible in guiding the firm towards achieving personal goals rather than maximizing benefits to the shareholders. Hence, the main conflict that shareholders face is to ensure that managers (agents) do not invest the free cashflow in unprofitable projects. In another hand, increasing the debt to equity ratio would assist firms to make sure that managers are running the firm more efficiently.

3.3.1 Theoretical Perspectives on Debt capital and Firm's Financial Performance

Firm's use of debt in capital structure composition is usually surrogated by the concept of financial leverage which involves the debt securities that a firm issue in order to raise the much-needed capital (Berger and Patti, 2006). Financial leverage shows the degree to which a business is utilizing borrowed money (Deesomsaket *al.*, 2004). Kinsman and Newman (1999) posit that careful attention must be given to the amount of financial leverage a firm

carries in its capital structure as this might affect firm financial performance. Managers must keep in mind the uncertainty of future profitability, as well as the amount of bonds the firm will have outstanding. As pointed out by Brigham and Houston (2001), this is important because the company is committing itself to periodic interest payments in addition to the repayment of principal. Due to the legal requirement that a firm commits itself to when issuing bonds, the bondholders have the recourse to force the firm into liquidation if the firm is unable to meet its payment obligations and adversely affect its financial performance.

Given the consequences of issuing debt, it would stand to reason that firms would avoid issuing bonds (Abor, 2005). Consequently, as noted by Van Horne and Wachowicz (2005), companies that are highly financially leveraged may be at risk of bankruptcy if they are unable to make payments on their debt and as result, they may be unable to find new lenders in the future (Deesomsak *et al.*, 2004). The decision on the level of financial leverage is fundamental for any business organization due to the need to maximize returns to the various stakeholders and also because of the fact that such a decision has great impact on the firm's ability to deal with competitive financial environment (Deesomsaket *al.*, 2004).

Theoretical literature links use of debt in the capital composition to financial performance of listed firms both positively and negatively (Khan, 2012, NSE Handbook, 2011 and Pandey, 2006). This means that financial leverage level is fundamental for any business organization due to the need to maximize returns to the various stakeholders. Companies that are highly financially leveraged may be at risk of bankruptcy if they are unable to make payments on their debt and as result, they may be unable to find new lenders in the future.

For example, Victor and Badu (2012) report a study aimed at investigating the relationship between financial leverage and performance of listed banks in Ghana from 2000 to 2010 using panel regression methodology. The results reveal that banks listed on the Ghana Stock

Exchange are highly geared and this is negatively related to bank performance measured in terms of ROE and Tobin's Q. Descriptive statistics reveal mean ROE, ROA, Tobin's Q and financial leverage of 25.7%, 4.3 %, 0.440 and 8.7 % respectively. The study concludes that there is high level gearing among listed banks. This can be attributed to over dependency on short term debt as a result of relatively high Bank of Ghana lending rate and low level of bond market activities. However, only listed banks were studied as opposed to listed firms.

Another study by Bokpinet *al.* (2010) investigated the risk exposure and corporate financial policy by firms listed at the Ghana Stock Exchange, a developing market, find that debt levels for firms listed on the Ghana Stock Exchange vary among industries. Firms use high debt levels in their capital structure and prefer the use of short-term debts to equity to finance their operations. They find a negative relationship between bankruptcy costs and capital structure. Increase in bankruptcy costs lead to a cut down in debt levels by the firms whereas firm's assets size had an insignificant relationship with the financial leverage. However, the study relates risk exposure to corporate financial policy and fails to interrogate the relationship between financial leverage and performance of listed firms using causal research design and panel approach.

On the other hand, Onaolapo and Kajola (2010) use convenient sampling and time series data in comparing capital structure and performance of non-financial listed firms in Nigeria and find that financial leverage had a significantly negative relationship with performance in Nigerian firms. Due to agency conflicts between various stakeholders, firms in Nigeria had employed high financial leverage levels which had negatively affected their performance. However, all the listed firms are not studied and the cross-sectional aspects of the data are not considered. The study concentrates on non-financial firms and all listed firms are not considered.

On the contrary, San and Heng (2011) in Malaysia, use descriptive research design, time series data and correlational analysis to examine the relationship between capital structure and performance of the firms in the construction industry in the aftermath of financial crises of 2007-08 that badly affected most of the economies of the world including Malaysia. They find that the financial crises do not show any major impact on the performance of the construction industry because of the large scale development work going on in the country. Weak relationship exists between financial leverage and performance measured by assets returns, equity returns and profitability in the Malaysian construction industry including small, medium and large sized companies. However, the study focuses on firms in the construction industry as opposed to listed firms and used only accounting measures of performance and fails to employ panel methodology.

In Kenya, Gicheha (2012) uses convenient sampling and time series data in comparing capital structure and performance of non-financial listed firms and finds a negative and positive relationship between capital structure and return on equity and return on assets respectively among commercial banks in Kenya. However, all the listed firms are not studied and the cross-sectional aspects of the data are not considered. The study concentrates on on-financial listed firms only leaving out listed firms in other sectors. Financial performance was measured using accounting metrics, and not market based measures.

Moreover, a study by Wanjeri (2012) in Kenya uses convenient sampling and time series data to investigate the effect of capital structure on performance of non-financial listed firms. He finds that financial leverage had a significant and negative impact on financial performance. However, all the listed firms are not studied and the cross-sectional aspects of the data are not considered. The study concentrates on non-financial listed firms only instead of all listed firms at the NSE.

Using correlation research design, Maniagiet *al.* (2013) in Kenya uses convenient sampling and time series data to analyze capital structure and performance of listed non-financial firms on the NSE and finds a negative significant relationship between financial leverage and return on assets and an insignificant positive relationship between financial leverage and return on equity and earnings per share. In other findings, the mean values of ROA, ROE and financial leverage were 17.6 %, 9.84 % and 22.64 % respectively. The highest ROE, ROA and financial leverage values are 96.30%, 92.99% and 26.4% respectively with the lowest values been -73 %, -0.08 % and 0.000%. However, all the listed firms are not studied and the cross-sectional aspects of the data are not considered. The study concentrates on non-financial listed firms only instead of all listed firms at the NSE.

Therefore, this paper seeks to establish the causes of mixed findings on the relationship between debt financing (financial leverage) and financial performance of listed firms.

In a nutshell it can be deduced from the reviewed literature that mixed results are due to use of diverse research methodologies ranging from descriptive, surveys, time series, cross section and panel methodologies and inconsistent measurement metrics for the study variables.

3.3.2 Relationship between Equity Capital Structure Composition and Firm's Financial Performance

According to Pandey (2006), equity capital structure composition is measured using ownership concentration which is measured with respect to a group of block holders, frequently as the fraction owned by the top five, ten, or twenty largest shareholders. In this study, ownership concentration was measured in terms of the sum of the percentage of ownership of five greatest shareholders of each company. The strength of ownership concentration is that it pays more attention to the ability of the owners to monitor and control managerial discretion, whilst its weakness is that it fails to take into consideration the

investment preferences of the owner (s) and how they affect the priorities and strategies of the firm. Additionally, studies using ownership identity addresses the issues of risk aversion, wealth creation and shareholder value but dismally fail to pay attention to the powers to control and monitor management that are conferred by actual shareholding (Brighm and Houston, 2001). Due to limited data, this study used the stake of the top five largest shareholders relative to the total shareholding of the firm to measure ownership concentration (Kapelyushnikov, 2000).

Theoretical literature (Nickel *et al.*, 1997 and Januszskiet *al.*, 2002) links equity capital structure composition to firm's financial performance both positively and negatively. Nickel *et al.* (1997) posits that firm performance is positively related to the majority shareholder. This is because firm performance and majority shareholder are substitutable. This is contrary to Januszskiet *al.* (2002) who indicate that a majority shareholder has a negative influence on firm performance. Their reasons being that firms have single ultimate owner, which operate under strong ownership, experience higher productivity growth. Moreover, this effect is grown up by stronger product market competition (Januszewskiet *al.*, 2002).

Further, theoretical literature shows that equity capital financing which precipitates to ownership concentration is an important aspect of enhancing company's performance and competitive advantage. However, increased ownership concentration in companies can decrease financial performance because it raises the firm's cost of capital as a result of decreased market liquidity or decreased diversification opportunities.

Mandaci and Gumus (2010) uses cross-sectional data to assess the relationship between ownership concentration and performance of 203 non-financial firms listed on the Istanbul Stock Exchange in the year 2005. In their study, performance is surrogated by ROA and Tobin's Q ratios and ownership concentration is represented by managerial ownership. Results reveal that the relationship between managerial ownership and Tobin's Q is

significant and negative. The mean ownership concentration is 45.1 %. The study, however, does not consider all listed firms and only managerial ownership concentration is considered, leaving out other forms of ownership concentration which are also pertinent in influencing performance. Besides, only cross-sectional data is employed instead of panel data.

In Iran, Foroughi and Fooladi (2011) analyzes corporate ownership structure and performance relationship of listed firms using panel data while controlling for firm's size, financial leverage, systematic risk and industry. They use correlation analysis and descriptive statistics to actualize study objectives. The results of the study indicate that a company's ownership concentration has a statistically negative relationship with firm performance at 5% significance level. In addition, the impact of ownership structure on firm's performance is dependent on industry implying it varied across industries. However, the study focuses on accounting measures of performance and fails to test the relationship between ownership concentration and market-based measures of performance of listed firms

In Sri Lanka, Wellalage and Locke (2012) uses panel data and GMM regression approach to explore the relationship between ownership structure and performance of firms for a sample of 152 firms listed in the Colombo Stock Exchange. Ownership concentration is measured in terms of insider, institutional and local ownership and Tobin's Q ratio is used as a proxy for firm performance. In order to analyze how level of insider ownership affected company performance, insider ownership variable is further categorized into 4 groups (0 %, 0-30 %, 30-70 %, 70-100 %) according to percentage of insider ownership. The results show that there is an inverse U-shaped relationship between insider ownership and corporate performance and this relationship is positive and significant. This study omitted accounting measures of performance and left out a couple of other drivers of performance. Moreover,

ownership concentration was measured using various categories of insider shareholding which might have obscured individual effects of each category.

Similarly, Pervanet *al.* (2012) uses panel data and GMM regression approach to investigate the effects of ownership structure and company performance using data of listed Croatian firms from the Zagreb during the period from 2003 to 2010. Performance is measured by ROA while ownership concentration is measured by concentration ratio of the four largest shareholders. The study finds a significant negative effect of ownership concentration on company performance suggesting that Croatian listed firms that have more concentrated ownership result in lower company performance. However, the study used single accounting measure of performance and fails to test the relationship between ownership concentration and multiple measures of performance of listed firms

Using correlation research design, a study by Daraghma and Alsinawi (2010) in Palestine examine the effect of board of directors, management ownership and capital structure on the financial performance of the corporations listed in Palestine securities exchange. 28 Palestinian corporations are conveniently selected within four years 2005-2008. The results indicate that the chief executive officer CEO-chairman separation did not have any significant impact while the CEO-chairman duality had a significant impact on the financial performance. The results also show that management ownership has a positive effect on the financial performance. The study concludes that the debt financing has non-influence on the profitability of Palestinian corporations. However, the study did not cover listed firms, used a small sample limiting its generalizability and only CEO-chairman duality and management ownership were considered leaving out the effect of majority shareholders on performance of listed firms.

Using the data on all the listed Pakistan companies for the period of 2006–2009, Abbas, *et al.* (2013) report a study aimed at assessing the relationship between ownership concentration and firm performance. Performance is measured in terms of accounting-based metrics notably ROA and ROE while ownership concentration is measured in terms of majority shareholders. The results indicate a significant positive relationship between concentrated owners and firm performance. However, when ownership concentration of the large shareholders exceeds 50 %, the relationship between concentrated owners and firm performance becomes negative and significant. The study used only accounting measures of performance and fails to use multiple panel regression analysis test the relationship between ownership concentration and market-based measures of performance of listed firms.

Another study by Isik and Soykan (2013) in Turkey use data for the period 2003-2010 of 164 industrial firms listed on Istanbul Stock Exchange to empirically explore the impact of large shareholders on firm performance measured by ROA and Tobin's Q. Results reveal that large shareholders have a significant positive effect on the performance of listed firms. The mean value for concentrated ownership by the largest shareholder is 48.57 % and ranges from 99.28 % to 0.006 %. However, the study did not cover listed firms, used a small sample limiting its generalizability and only large shareholder was considered leaving out the effect of top five shareholders on performance of listed firms.

Uadiale (2010) use correlation analysis and accounting measures of performance to explore the impact of board structure on corporate financial performance in Nigeria. The study employs four board characteristics which include: board composition, board size, board ownership and CEO duality. The findings of the study show that there is a strong positive and significant association between board size and corporate financial performance. Also, there is

a positive association between outside directors sitting on the board and corporate financial performance. However, a negative association is observed between directors' stockholding and firm financial performance. In addition, the study reveals a negative association between ROE and CEO duality. In the study, all firms instead of listed firms were considered and it concentrates on board structure instead of ownership structure. Moreover, it fails to test the effect of ownership concentration on performance of listed firms. On the contrary, Ndwiga (2012) uses a survey research design to report a study aimed at examining the relationship between ownership concentration and executive compensation of companies listed at the Nairobi Securities Exchange. The study uses aggregate percentage of the top five shareholders in a firm as a proxy for ownership concentration while controlling for other firm specific variables such as firm size, profitability and growth opportunities. Results reveal a non-statistically significant relationship between ownership concentration and executive compensation. In other findings of the study, executive compensation is found to be positively correlated to firm size and performance as observed in other prior studies. However, the study fails to interrogate the effect of ownership concentration on performance of listed firms in Kenya and did not employ panel methodology.

On the contrary, Ongore (2011) use descriptive research design, cross-sectional data, logistic and step wise regressions to investigate the relationship between ownership structure and performance. Ownership structure is measured in terms of ownership concentration and ownership identities (foreign, insider, government and institutional) while performance proxies are ROA, ROE and dividend yield. The results reveal a negative relationship between ownership concentration and ROA, ROE and dividend yield with coefficients of -0.761, -0.654 and -0.888 respectively. However, he only considers cross-sectional aspects of listed firms as opposed to panel which encompasses both time and cross-sectional aspects. In addition, he used step wise regression analysis, which fails to show overall explanatory

power of the predicted model. Moreover, NSE (2007) uses a survey research design, a small sample size and descriptive statistics in analyzing investor profiles at the NSE. The findings of the study are that over 70 % of available shares are in the hands of 20 % of the shareholders. The study concludes that shares at the NSE are closely held by a few shareholders who are largely institutional investors. However, investor analysis instead of firm analysis is considered, did not cover the extent of ownership concentration of listed firms.

Empirical findings of investigations into the relationship between ownership concentration and firm performance have yielded mixed results leading theory stagnation (Ndwiga, 2012, Uadiale, 2010, Isik and Soykan, 2013, Mandaci and Gumus, 2010, Ongore, 2011, NSE, 2007). Globally, empirical evidence (Forough and Fooladi, 2011, Wellalage and Locke, 2012 and Pervan et al., 2012) report both positive and negative relationships. Continental and Kenyan studies have also yielded mixed results (Uadiale, 2010, Ongore, 2011 and NSE, 2007).

Reviewed literature shows that equity financing (ownership concentration) is an important aspect of enhancing company's performance and competitive advantage. However, increased ownership concentration in listed companies can decrease financial performance because it raises the firm's cost of capital as a result of decreased market liquidity or decreased diversification opportunities. Prior researches use convenient sampling methods and descriptive or correlational research designs, descriptive statistics, logistic and step-wise regression analyses; study non-financial companies, SMEs, and general business enterprises. They employ either time series or cross-sectional data and use single measures of performance, but fail to study listed firms using panel methodology.

Therefore, this paper seeks to establish the causes of mixed findings on the relationship between equity financing (ownership concentration) and financial performance of listed firms.

3.4 Major Flaws and Gaps on the Basis of Specific Objective of Study

The classical thinking from the theories propounded since then was premised on causal relationship that capital structure choice determines or affect performance thereby impact on the value of the firm (Kraus & Litzenberge,1973; Meckling & Jensen,1976; Myer & Majful,1984).

In a study on the effect of capital structure on performance of a case study of listed firms. According to okiro, Aduda & Omoro (2015) revealed that there was a significant relationship between corporate governance and firm performance. The study also confirms that there is appositve significant intervening effect on capital structure on the firm performance. This study however was based on the listed companies at the East Africa Securities exchange which may limit the generalization of results to other jurisdictions such as to develop countries or to the non-listed companies. The population from which the sample was drawn is the listed companies therefore, results of this study may not be generalized to smaller and non-listed companies.

Rabelo & Vasconcelos, (2002) attributed that a number of developing countries have embraced the corporate governance ideals. However, they practice different corporate governance models that are different from models adopted by developed countries. This is partly due to the unique economic and political systems found in developing countries.

Mensah (2002) argues that developing countries are poorly equipped to implement the type of corporate governance found in the developed market economies because developing countries are charecterised by state ownership of firms, interlocking relationships between

governments and financial sectors, weak legal and judiciary system and limited human resource capabilities.

Capital structure in developing countries are weak consequently, several measures have been suggested on how to improve such structures .Notable suggestions including the use of equity instead of debt for growth ,increasing overall investor confidence through increased transparency ,strengthening of capital market structures and encouraging the use of competition to improve performance of domestic firms (Reed,2002).This means that there is need to research more on the relationship between capital structure and firm performance.

4.0 DISCUSSION

Since Modigliani and Miller's theory has been published many of the researchers are still studying the relationship between capital structure and firm performance ,some of them found that there is a negative relation between capital structure and firm performance ,while others found a positive relation between capital structure and firm performance .In another hand many papers referred to a significant relation between structure and firm performance, while some of them referred to an insignificant relation between structure and firm performance.

The literature shows that most studies on the subject of debt -equity composition of firms mostly commonly ignore the many difference among countries. The few who try to consider these conditions limits the study to generalization such as developing countries and developed countries. But do all developing countries have the same financial conditions? Is there common pattern in the choice of financing a project? According to Dokuet.al. (2011) studies into relationship between financial development and choice of finance in listed firms revealed that financial market development in developing economies will expose more financial options in attempts to minimize financial constraints. The study found out that a side firm specific factors recognized in extant literature responsible in explaining financing

choices of firms, financial market development also accounts for financing decisions of listed firms.

Recent research on capital structure composition and financial performance around the world has established a number of empirical regularities. Salman and Hendrawan (2012) examine the impact of capital structure towards performance of two groups of banks, conventional and Islamic banks in Indonesia by using profit efficiency approach. Two stages procedure were employed. In the first stage, they measure profit efficiency score for each bank in Indonesia during the year 2002-2008 by using distribution free approach (DFA). In the second stage, they employed bank standard profit function model and their performance. They discover in the two approaches that there is a positive relationship between capital structure and performance.

Therefore, this paper seeks to establish the causes of mixed findings on the relationship between debt financing (financial leverage) and financial performance of listed firms.

In a nutshell it can be deduced from the reviewed literature that mixed results are due to use of diverse research methodologies ranging from descriptive, surveys, time series, cross section and panel methodologies and inconsistent measurement metrics for the study variables.

Hence the proposition is debt financing and plays a significant role in financial performance of Listed Firms.

Further, it is evident from the mixed findings on the relationship between equity financing and financial performance of listed firms can be attributed to the use of diverse research methodologies and financial performance metrics yielding mixed results, some positive, negative and still others reporting no relationship at all.

Hence the proposition is Equity financing and plays a significant role in financial performance of Listed Firms.

Conceptual framework

This paper aims to find if there is an impact of capital structure composition on performance evidence from listed firms.

The Proposed model for these propositions is as shown in Figure 2.1 below

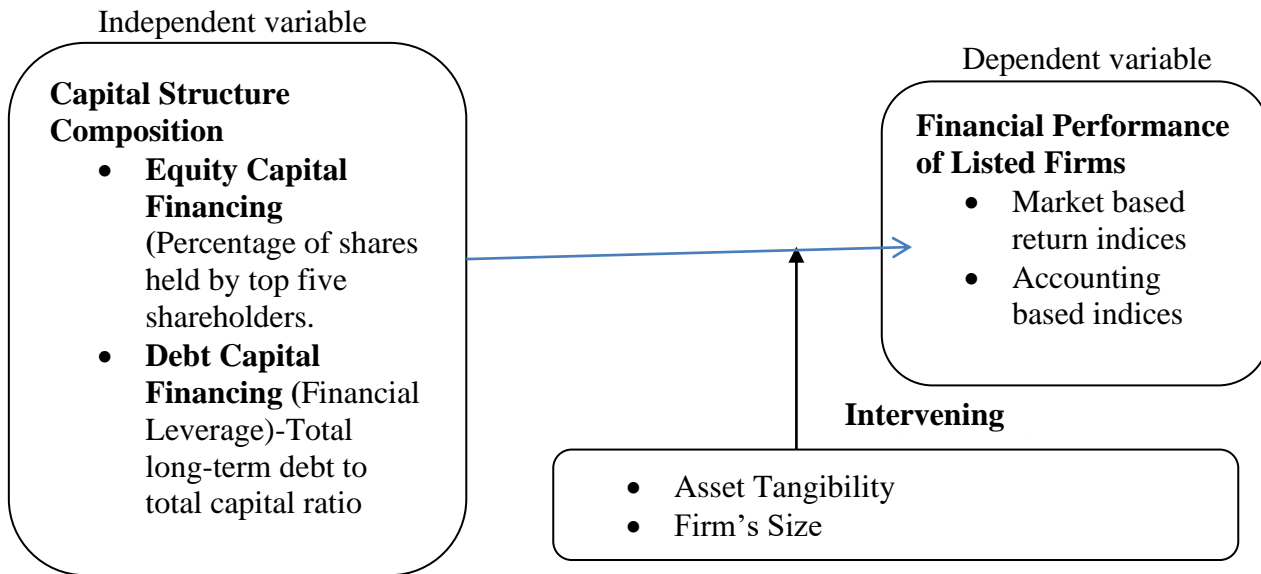


Figure 2.1: Capital Structure and Financial Performance

RelationshipSource: Adapted and modified from Wellalage and Locke (2012) and Berger *et* Variables of the study illustrated above in figure 2.1 which was modified from researcher Wellalage and Locke (2012) and Berger et al.

Capital structure (independent Variable): Capital structure of a firm is measured by different accounting-based methods like short term liability to total assets, long term liability to total assets and total debt to total assets. This study takes total debt to total assets as a proxy for capital structure of the firm.

Firm performance (dependent Variables): A number of variables measuring firm performance are commonly accounting based measures of performance calculated from financial statements as ROE, ROA, EPS and Net profit margin, while stock market return and volatility in returns are also used as performance measures of firms. Tobin's Q measurement of performance is also used by some studies which are a mix of market performance and

accounting measurement. The studies adopted the three accounting-based measures of performance including earning per share (EPS), return on equity (ROE), and return on assets (ROA) computed as follows:

$$\text{Earnings per share (EPS)} = \frac{\text{Net Income} - \text{Dividends on preferred stock}}{\text{Average outstanding share}}$$

$$\text{Return on Equity (ROE)} = \frac{\text{Net income}}{\text{Equity}}$$

$$\text{Return on Assets (ROA)} = \frac{\text{Net income}}{\text{Total Assets}}$$

Hypotheses

The following hypothesis were formulated for the study

H1: There is a negative relationship between capital structure (DR) and financial performance (ROE)

H2: There is a negative relationship between capital structure (DR) and financial performance (ROA)

H3: There is a negative relationship between capital structure (DR) and financial performance (ROA)

4.1 Major Contributions of Significant studies

According to the researchers understanding capital structure decision of firms is the focus of all the theories as reviewed above. Modigliani and Miller (1958) theorem of capital structure irrelevance which was developed based on the fundamental nature of debt and equity of the firm and unrealistic assumptions pave the way to the other theories of capital structure.

The pecking order theory explains how a company raises funds following a hierarchy whereas trade-off theory advocates tax shield advantage and value maximizing through the optimal debt to equity mix. Ladder of preference use in the pecking order theory. Differences in capital structure theories occurs in their explanations of significance of taxes and changes in information and agency costs. These theories that have been developed based on Modigliani and Miller (1958) would work healthy under some assumptions only but they do not clarify actual gearing level adopted by firms. Further market timing theory do not explain an optimal capital structure and according to this theory capital structure is an outcome of various different financial decisions the firm has taken overtime. This theory suggest that firms issue new shares when they notice they are overrated and that firms repurchase own shares when they consider these to be underrated. It is important to have more comprehensive view on capital structure composition and firm performance as this theory are not being able to explain everything. This proposes that there is no single theory on capital structure which incorporates all important factors and predictions of this theories suggest that capital structure puzzle still remains.

4.2 Major Inconsistencies in Theory, Concept, Findings and Conclusions

The term capital structure has attracted intense debate in the financial management arena. The basic question always raised is whether there is a unique combination of debt and equity capital that maximizes firm value, and if so ,what factors determines a firm optimal capital structure, many researchers have approached the study of capital structure composition and firm performance under less restrictive assumptions .This has led to the confirmation of an existence of the optimal choice of capital structure. Unfortunately, there has been little consensus among researchers on what comes out to be their findings.

Modigliani and Miller (MM),1958 illustrates that under certain key assumptions, firms' value is unaffected by its capital structure. Capital market is assumed to be perfect in Modigliani

and Millers world, where insides and outsides have free access to information. The theory argued further that a firm should have some market value, of which capital structure levels of a company should depend on the return and risk of its operational and not on the way it finances those operations. This theory has been criticized by many researcher's objective that there are no perfect capital markets in reality, although later they revised their earlier theory by incorporating tax benefit and argued that under market imperfection where interest payments are tax deductible, firm value will increase with the level of financial leverage (Modigliani & Miller 1963).

Pecking Order Theory argues contrary to the idea of firms having a unique combination of debt and equity finance, which minimizes their loss of capital. It states that a firm's first preference should be that utilization of internal funds (i.e. retain earnings). followed by debt and then external equity. He argues that the more profitable the firms become, the lesser they borrow because they would have sufficient internal project. He further argued that it is when the internal finance is inadequate then a firm should source for external finance and most preferably bank borrowings or corporate bond.

Market timing theory (Banker and Wurgler (2003) recommend this new theory of capital structure, which suggest that managers can increase current shareholders wealth by timing the issue of securities. Therefore, firm times their equity issues by selling new stocks when the stock price is perceived to be overhauled and buying back own shares when they are undervalued.

4.3 Relationship between the Topic and General Discipline

Capital structure is the composition of debt and equity securities that are used to finance companies' assets. Both debt and equity securities used by most of the companies to raise funds. Having determined its environment policy, a company should plan the sources of finance and their mix. Companies which do not formally plan their capital structure are likely

to face difficulties in raising capital on favorable terms in the long-run. Financial experts and authorities differ as the composition of funds in capital structure. Many authors include only long-term sources of finance under the capital structure. Broadly speaking capital structure comprises owned funds and borrowed funds. The owned funds include the share capital and free reserves and surplus and the borrowed funds represent debentures, long-term and medium-term loans provided by various financial institutions.

The concept of capital structure is extremely important (Martis 2013). One of the importance's of capital structure is that it is tightly related to the ability of firms to fulfill the need of various stakeholders. The term capital structure is defined by Weston and Brigham (1979) as the permanent financing of the firm represented by long-term debt, preferred stock and net worth. According to Van Hone and Wackomic (1995) Capital structure is the mix of a firms permanent long-term financing represented by debt, preferred stock and common equity.

The current crisis has put great pressure in domestic and international firms especially underperforming firms. The supply of credit has dropped dramatically, while increase risk and increased cost of capital structure pressure firms in finding the right balance between debt and equity. (Olokoyo 2012). According to Akeem, Edwine, Kiyanjui & Kayode (2014) the corporate sector in the country is charecterised by a large number of firms operating in a largely deregulated and increasingly competitive environment. This proposes that there is no single theory on capital structure which incorporates all important factors and predictions of this theories suggest that capital structure puzzle still remains. According to the above, it is apparent that the exact effect of capital structure composition on financial performance is yet to be established and it is calling for further investigations.

4.4 Propositions based on thematic areas

Proposition 1. According to Modigliani and Miller, quoting Pandey (2000), the firms market value is not affected by capital structure: that is, any combination of debt and equity is as good as any other. In M-M's world of perfect capital market, because of borrowing and lending rates for all investors and no taxes, investors can borrow on their own.

Proposition 2. Here Modigliani and Miller accept that borrowing increases shareholders return. They show that increased risk exactly offsets the increased return, thus leaving the position of shareholders.

The Static Trade-off theory hold that firm's capital composition of debt and equity is determined by taxes and cost of financial distress. Based on this theory, it is deductible interest payment has benefits since the tax deductible therefore preferred to equity financing.

The theory predicts that firms will choose their mix of debt and equity financing to balance the cost and benefit of debt. A range is reached beyond which debt become more expensive because of the increased risk (financial distressed) of excessive debt to creditors as well as to shareholders.

The major prediction of the model is that firms will not have a target optimal capital structure, but will instead follow a pecking order of incremental financing choices that places internally generated funds at the top of the order, followed by debt issues, and finally only when the firm reached its 'debt capacity' new equity financing.

5.0 CONCLUSION

The literature review has established that the relationship between capital structure and firm performance still show diverse findings. The literature further shows that while studying debt financial performance and equity capital financing it is imperative to combine both time series and cross-sectional data. This approach enhances efficiency of the data and give more robust estimates. Moreover, these studies are disaggregated and none has considered debt

capital financing, equity capital financing and listed firms financial performance relationship, yet when investigated separately, have shown inconsistent result.

The literature review has shown three main limitations: The studies were concentrated on the data of only one market of the developing economy so it cannot represent all the markets of transition economies. Secondly the studies include few years data and to explore consistent result long time series of data could be required. Finally, the impact of capital structure on firm performance should be done per sector then comparison of the result to know the real picture of the relationship.

In conclusion, Capital structure still remains a puzzle concept especially in emerging economies. Further study can be conducted by comparing the relationship between capital structure composition and firm performance for both small and large firm.

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