



Capital Structure and Financial Performance of Quoted Manufacturing Companies in Nigeria

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Abstract

The capital structure involves the decision about the combination of the various sources of funds a firm uses to finance its operations and capital investments. These sources include the use of long-term debt finance called debt financing, as well as preferred stock and common stock also called equity financing. One of the most important goals of financial managers is to maximize shareholder's wealth through the determination of the best combination of financial resources for a company and maximization of the company's value by determining where to invest their resources. The study evaluated the effect of capital structure on the financial performance of listed manufacturing companies in Nigeria. The study employed the ex post facto research design. The population of the study consisted of the quoted manufacturing companies in Nigeria made up of 71 companies as of 31st December 2017 according to the Nigeria Stock Exchange (NSE), which formed the entire population of the study. The study employed convenience sampling in the selection of the sampled companies. Data from the research were obtained from the annual reports of the sampled companies. The study adopted descriptive and inferential statistics. The finding of the study indicated that capital structure influences the performance of the quoted manufacturing companies in Nigeria. The study concluded that capital structure has a significant relationship with the financial performance of listed manufacturing companies in Nigeria. The study recommended that management should ensure that proper capital structure is maintained to improve financial performance and to allow for an increase in dividend payment and retained earnings for expansion.

Keywords: Capital structure; Enhanced return on capital employed; Equity; Financial performance and Return on equity.

1. Introduction

Capital structure involves the decision about the combination of the various sources of funds a firm uses to finance its operations and capital investments. These sources include the use of long-term debt finance called debt financing, as well as preferred stock and common stock also called equity financing. One of the most important goals of financial managers is to maximize shareholders wealth through determination of the best combination of financial resources for a company and maximization of the company's value by determining where to invest their resources (Ibrahim, 2016). Financial performance may vary widely between for-profit organizations and nonprofits, depending on the business structure, revenue structure, and an overarching goal of the organization. I intend to ascertain how leverage components of a firm's capital structure may increase the level of efficiency and thereby increasing financial performance.

A large number of business failures in the past were attributed to the inability of financial managers to properly plan and control the working capital of their respective firms. Inefficient capital management in the face of economic and political crises in Nigerian businesses today has led to a loss of profit; owing to high bad debts, over/under stocking; liquidity problem; inability to expand; financial losses; vulnerability to liquidation and insolvency (Nwankwo and Osho, 2010). In spite of the apparent growth in the food and beverage manufacturing industry in Nigeria today, there is little research on capital structure management and performance in this sector.

Accordingly, previous studies on capital structure have used different proxies to measure capital structure. The measures commonly used in the literature in the form of ratios include total debt to total assets, total debt to total equity, short-term debt to total assets and long-term debt to total assets. Total debt to total assets is the amount of debt used to finance firms' assets and other capital expenditures that can improve a firm's performance. Thus, it is expected that increasing leverage components of a firm's capital structure may increase the level of efficiency and thereby increasing their financial performance. Company's managers who are able to identify the level of leverage as components of firms' capital structure are rewarded by reducing the firm's cost of finance thereby maximizing the firm's revenue (Zeitun and Tian, 2007). Total debt to total assets measures the amount of the total funds provided by

outsiders in relation to the total assets of the firm. It shows the extent of coverage for the debts of a company by total assets. It described the extent to which a business or investor is using the borrowed money.

Generally, investors would prefer a low ratio for all debts, because the lower the ratio the better the cushion against the creditor's losses in the event of liquidation. Most firms use debt to finance their operations with the hope of improving their performance. By doing so, a company increases its leverage because it can invest in business operations without increasing its equity. It is based on this fact that the study seeks to examine the capital structure and financial performance in quoted food and beverage manufacturing companies listed on the Nigerian Stock Exchange.

2. Literature Review

2.1. Conceptual Review

2.1.1. Capital Structure

Capital is a critical tool for all firms, the supply of which is uncertain. This uncertainty enables the suppliers of finance to exert control over the firm (Nyanamba *et al.*, 2013). Capital structure is the combination of debt and equity used by firms to run their long term and short-term operations. A firm can fulfill its financing needs in two ways. It can either be debt financing or it can either be equity financing. Maximization of shareholders wealth is the main goal of the management of every firm. Capital structure refers to the percentage of Capital (money) at work in business by type; two forms of capital: equity capital and debt capital (Kennon, 2010).

Firms' capital structure implies the proportion of debt and equity in the total capital structure of the firm (Alfred, 2007). Pandey (1999), differentiated between capital structure and financial structure of a firm by affirming that the various means used to raise funds represent the proportionate relationship between long-term debt and equity. Inanga and Ajayi (1999), does not include short-term credit but means the composite structure is described as the capital mix of both equity and debt capital in financing its assets. Firms, in a bid to raise needed funds mostly use capital structure, preferred stock, and common equity. The capital structure shows the relationship between the various sources of long-term financings, such as equity capital, preferred share capital and debt capital. Deciding on the appropriate capital structure is an important decision of financial management because it is closely related to the company's value (Paramasivan and Subramanian, 2009).

Capital structure policy seeks a trade between risk and expected return (Akeem *et al.*, 2014). The firm must consider its business risk, tax positions, financial flexibility, and managerial conservatism or aggressiveness, while these factors are crucial in determining the target capital structure, operating conditions may cause the actual capital structure to differ from the main capital structure. According to Akeem *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 on an organization's ability to deal with its competitive environment. Capital structure is the combination of both equity and debt and equity structure of a company, it can also be referred to like the way a corporation finances its assets through some combination of equity, debt or hybrid securities; that is the combination of both equity and debt. A firm's capital structure is then the combination of both equity and debt (Amah and Ken-Nwachukwu, 2016).

2.2. Firm Performance

The concept of the performance of a business firm is based upon the idea that an organization is the voluntary association of productive assets, including human, physical, and capital resources, for the purpose of achieving a shared purpose (Carton, 2004). It is said that the essence of performance is the creation of value. Therefore, value creation, as defined by the resource provider, is the essential overall performance criteria for any organization. A business organization could measure its performance using financial and non-financial measures. The financial measures include profits, return on assets, return on investment and sales, while the non-financial measures focus on issues pertaining to customer's satisfaction and customer's referral rates, delivery time, waiting for time and employee's turnover.

Firm performance is often compounded by criteria such as profit margin or increased turnover (Elizabeth and Baines, 1998). In several pieces of research, the word performance and success are used interchangeably. Sandberg *et al.* (2002), stressed that performance is the ability to contribute to job and wealth creation through firm start-up, growth, and survival. According to Pasanen (2003), opined that success is often equated with the achievement of defined and measurable goals or objectives in all sectors of human life, which may be of subjective (Non-financial nature) as well as objective (Financial nature). Firm performance is substantially influenced by so many factors. In business, there are two major streams on the determinants of firm performance. One is based primarily upon an economic tradition, emphasizing the importance of external market factors in determining firm success. The other line of study builds on the sociological and behavioral paradigm or factors and sees organizational factors and their environment as the major determinants of firm success.

2.3. Theoretical Review

2.3.1. Irrelevant and Relevant Theory

Modigliani and Miller (1958), illustrate that under certain key assumptions, the firm's value is unaffected by its capital structure. The capital market is assumed to be perfect in Modigliani and Miller's world, where insiders and outsiders have free access to information; no transaction cost, bankruptcy cost, and no taxation exist; equity and debt

choice become irrelevant and internal and external funds can be perfectly substituted. 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 the same market value and the same Weighted Average Cost of Capital (WACC) at all capital structure levels because the value of a company should depend on the return and risks of its operation and not on the way it finances those operations. Miller brought forward the next version of the irrelevance theory of capital structure. He appealed that, capital structure decisions of firms with both corporate and personal tax circumstances are irrelevant (Miller, 1977). If these key assumptions are relaxed, capital structure may become relevant to the firm's value. So, research efforts have been contributed to relaxing the ideal assumptions and describing the consequences. This theory was criticized on the ground that a perfect market does not exist in real life situations. Attempts to relax these assumptions particularly the no bankruptcy cost and no taxation led to the static trade-off theory.

2.4. Agency Cost Theory

This is a theory concerning the relationship between the principal (shareholders) and the agent of the principal (company's managers). This suggests that the firm can be viewed as a nexus of contracts (loosely defined) between resource holders. An agency relationship arises whenever one or more individuals, called principals, hire one or more other individuals, called agents, to perform some service and then delegate decision-making authority to the agents. The agency theory concept, which was initially developed by Berle and Means (1932), argued that due to a continuous dilution of equity ownership of large corporations, ownership and control become more separated. This situation gives professional managers an opportunity to pursue their interests instead of that of shareholders.

Jensen and Meckling (1976), suggested that for an optimal debt level in capital structure by minimizing the agency costs arising from the divergent interest of managers with shareholders and debt holders. They suggest that either ownership of the managers in the firm should be increased in order to align the interest of managers with that of the owners or users of debt should be motivated to control managers' tendency for excessive extra consumptions. Jensen (1986) presents the agency problem associated with free-cash-flow. He suggested that free cash flow problem can be somehow controlled by increasing the stake of managers in the business or by increasing debt in the capital structure, thereby reducing the amount of "free" cash available to managers.

2.5. Pecking Order Theory

The pecking order theory of capital structure as introduced by Donaldson (1961), is among the most influential theories of corporate leverage. It goes contrary to the idea of firms having a unique combination of debt and equity finance, which minimize their cost of capital. The theory suggests that when a firm is looking for ways to finance its long-term investments, it has a well-defined order of preference with respect to the sources of finance it uses. It states that a firm's first preference should be the 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 finance to undertake their investment projects. 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 bonds. And after exhausting both internal and bank borrowing and corporate bonds, the final and least preferred source of finance is to issue new equity capital.

3. Methodology

3.1. Research Design

The *ex-post facto* research was used in this research work to analyze secondary data because there is no experiment involved, but rather is designed to test an event that has already taken place. This was used to correlate historical records to determine the true relationships between the Independent variable and dependent variables which finally led us to reasonable conclusion.

The population for this research work covers a total number of 71 manufacturing companies listed on the Nigerian stock exchange (NSE) as at 31st December 2018. Out of the 71 manufacturing companies quoted in the NSE, 20 manufacturing companies were selected as the sample representatives of this study. This represents only 28% of the target population. Convenience sampling technique was used to select the sample representative for this study.

3.2. Model Specification

3.2.1. Regression Equation

$$ROA_{it} = \alpha_0 + \beta_1 (EQU_{it}) + \beta_2 (STD_{it}) + \beta_3 (LTD_{it}) + \mu_{it}$$

$$ROE_{it} = \alpha_0 + \beta_1 (EQU_{it}) + \beta_2 (STD_{it}) + \beta_3 (LTD_{it}) + \mu_{it}$$

$$EROCE_{it} = \alpha_0 + \beta_1 (EQU_{it}) + \beta_2 (STD_{it}) + \beta_3 (LTD_{it}) + \mu_{it}$$

Where;

α_0 = Constant parameter/ Intercept

$\beta_1 - \beta_4$ = Coefficient of the independent variable

μ = error term

i = Number of sampled companies

t = Time dimension of the variables

4. Data Analysis, Results and Discussion of Findings

4.1. Descriptive Statistics

The descriptions of the data were based on mean, maximum, minimum, standard deviations, skewness, Jarque-Bera and kurtosis. This section provided an overview of the data while the attempt was also made to describe the main features of the data. The summary statistics of the pooled series of Return on assets (ROA), Return on equity (ROE), Enhanced Return on capital employed (EROCE), Equity (EQU), Long term debts (LTD) and Short term debts (STD) are shown below in Table 4.1.

Table-4.1. Summary of Descriptive Statistics Estimate

	ROA	ROE	EROCE	EQU	LTD	STD
Mean	8.411775	1669.861	10.07466	15.84514	14.55220	16.34894
Median	7.588833	18.26306	8.154035	16.65772	15.19350	16.46323
Std. Dev.	9.941112	23307.33	34.74286	3.956897	3.938464	1.615943
Skewness	-0.671451	14.03582	-2.595648	-3.093669	-2.337400	-0.592135
Kurtosis	5.138512	198.0045	32.40511	12.82090	8.842767	3.466147
Jarque-Bera	53.13847	323456.3	7430.083	1122.777	466.5973	13.49824
Probability	0.000000	0.000000	0.000000	0.000000	0.000000	0.001172
Observations	200	200	200	200	200	200

Sourced: Authors' Computation using E – View 9 (2019)

The mean is a measure of central tendency while the standard deviation is the sum of the squared deviation of the mean. When the mean is greater than the standard deviation, there is a possibility of a small coefficient of variation. Likewise, when the mean is smaller than the standard deviation, there is the likelihood of a large coefficient of variation. From estimated summary above, the variable (ROA, ROE, and EROCE) have their mean smaller than the standard deviation pointing towards the possibility of a large coefficient of variation while the variables (EQU, LTD and STD) have meant greater than the standard deviation, there is a possibility of a small coefficient of variations.

The skewness of a normal distribution is zero and a positive skewness indicates that the distribution has a long right tail (positive) and a negative skewness indicates that the distribution has a long-left tail (negative). From the tables above, all of the variables ROA (-0.671451), EROCE (-2.595648), EQU (3.093669), LTD (-2.337400) and STD (-0.592135) have long left tails while the variable ROE (14.03582) has a long right tail. If the kurtosis exceeds 3, the distribution is peaked (leptokurtic) relative to the normal; if the kurtosis is less than 3, the distribution is flat (platykurtic) relative to the normal. From the tables above, the variables ROA (5.138512), ROE (198.0045), EROCE (32.40511), EQU (12.82090), LTD (8.842767) and STD (3.466147) have a kurtosis greater than 3 hence they are peaked.

Under the null hypothesis of a normal distribution, the Jarque-Bera statistic is distributed as with x^2 degrees of freedom. The reported Probability is the probability that a Jarque-Bera statistic exceeds (in absolute value) the observed value under the null hypothesis, a small probability less than 0.05 value leads to the rejection of the null hypothesis of a normal distribution. All variables ROA (0.000000), ROE (0.000000), EROCE (0.000000), EQU (0.000000), LTD (0.000000) and STD (0.001172) have their *p-values* less than 0.05, hence the null hypothesis is rejected that the variables are not normally distributed.

Table-4.2. Regression Estimate for Model One

Variable	REGRESSION ESTIMATE FOR MODEL ONE			
	Coefficient	Std Error	t-Stat.	Prob.
C	-16.71740	6.856350	-2.438236	0.0157*
EQU	0.638582	0.212147	3.158993	0.0018*
LTD	0.339160	0.188050	1.803560	0.0728
STD	0.616261	0.543648	1.133567	0.2854
R ²	0.150781			
Adj. R ²	0.137783			
F-Statistic	11.60011			
Prob. (F-Stat)	0.00000*			
Obs	200			
Breusch-Pagan LH Serial Correlation Test	71.38392(0.00000*)			
Heteroskedasticity: Breusch-Pagan LH	16.57930 (0.0009*)			
Normality test: Jarque-Bera	23.70995(0.00007*)			
Hausman Test	18.345911 (0.0004*)			

Dependent Variable: ROA significance at 5%

Source: Researchers Computation, 2019 (E-Views 9)

The findings from the Hausman test carried out revealed that the probability value associated with the variables is given as a *p-value* of 0.0004 which is less than the significance level of 0.05, therefore the null hypothesis that random effect is suitable for this model is rejected and the alternative hypothesis is accepted. Thus, the fixed effect model will be used for regression analysis. The *p-value* of the *f*-statistics for the Breusch-Pagan LH Serial Correlation Test of 0.0000 less than the 5% level of significance shows that the null hypothesis that there is no presence of serial correlation is rejected. Also, the Heteroskedasticity Test shows a *p-value* of 0% less than the 5% level of significance; as such, the null hypothesis that there is no heteroskedasticity is rejected. Also, the JarqueBera statistics indicated that the model is not normally distributed as its *p-value* is less than 5% the level of significance for the study.

$$ROA_{it} = \alpha_0 + \beta_1 (EQU_{it}) + \beta_2 (STD_{it}) + \beta_3 (LTD_{it}) + \mu_{it}$$

$$ROA = -16.71740 + 0.638582EQU + 0.339160STD + 0.616241LTD + \mu$$

4.2. Interpretation of Result

The coefficient of the independent variable Capital structure is positive showed as a unit increase in Equity, Long term debt and Short term debt by 1% would cause 0.638582 increase, 0.339160 increase, and 0.616241 increase respectively in return on assets. The overall coefficient of determination of adjusted R^2 , which is the explanatory power of the model, is 0.137783. This implies that within the model context, the independence of Capital structure is responsible for 14% variations in return on assets while the remaining 86% is explained by other factors that can impact on the dependent variable. The *F* – statistics of 11.60011 associated with the coefficient of the aggregate of the subdivision of proxies under the Capital structure and return on assets at a 5% significance level, the result above showed a *p-value* of 0.00000, which is less than the level of significance of 0.05. This indicates that there is a significant relationship between Capital structure and return on assets. Capital structure has a significant relationship on the return on assets of quoted manufacturing companies in Nigeria.

Table-4.3. Regression Estimate for Model Two

Variable	REGRESSION ESTIMATE FOR MODEL TWO			
	Coefficient	Std Error	t-Stat.	Prob.
C	6846.304	16647.97	0.411240	0.6813
EQU	-1960.171	490.8359	-3.399535	0.0001*
LTD	594.0554	456.6069	1.301022	0.1948
STD	1054.375	1320.037	0.798747	0.4254
R^2	0.089162			
Adj. R^2	0.075221			
F-Statistic	6.395499			
Prob. (F-Stat)	0.000372*			
Obs	200			
Breusch-Pagan LH Serial Correlation Test	1.538323 (0.4634)			
Heteroskedasticity: Breusch-Pagan LH	20.89667 (0.0001*)			
Normality test: Jarque-Bera	2222286.4(0.00000*)			
Hausman Test	30.419429 (0.0000*)			

Dependent Variable: ROE significance at 5%

Source: Researchers Computation, 2019 (E-Views 9)

The findings from the Hausman test carried out revealed that the probability value associated with the variables is given as a *p-value* of 0.0000 which is less than the significance level of 0.05, therefore the null hypothesis that random effect is suitable for this model is rejected and the alternative hypothesis is accepted. Thus, the fixed effect model will be used for regression analysis. The *p-value* of the *f*-statistics for the Breusch-Pagan LH Serial Correlation Test of 0.4636 greater than the 5% level of significance shows that the null hypothesis that there is no presence of serial correlation is accepted. Also, the Heteroskedasticity Test shows a *p-value* of 0% greater than the 5% level of significance; as such, the null hypothesis that there is no heteroskedasticity is rejected. Also, the JarqueBera statistics indicated that the model is not normally distributed as its *p-value* is less than 5% the level of significance for the study.

$$ROE_{it} = \alpha_0 + \beta_1 (EQU_{it}) + \beta_2 (STD_{it}) + \beta_3 (LTD_{it}) + \mu_{it}$$

$$ROE = 6846.304 - 1960.171EQU + 594.0554STD + 1054.375LTD + \mu$$

4.3. Interpretation of Result

The coefficient of the independent variable Capital structure is negative and positive showed as a unit increase in Equity, Long term debt and Short term debt by 1% would cause 1960.171 decreases, 594.0554 increase, and 1054.375 increase respectively in return on equity. The overall coefficient of determination of adjusted R^2 , which is the explanatory power of the model, is 0.075221. This implies that within the model context, the independence of Capital structure is responsible for 8% variations in return on equity while the remaining 92% is explained by other factors that can impact on the dependent variable. The *F* – statistics of 6.395499 associated with the coefficient of

the aggregate of the subdivision of proxies under the Capital structure and return on assets at a 5% significance level, the result above showed a p-value of 0.000372, which is less than the level of significance of 0.05. This indicates that there is a significant relationship between Capital structure and return on equity. Capital structure has a significant relationship on the return on equity of quoted manufacturing companies in Nigeria.

Table-4.4. Regression Estimate for Model Three

Variable	REGRESSION ESTIMATE FOR MODEL THREE			
	Coefficient	Std Error	t-Stat.	Prob.
C	-98.27018	22.9711	-4.277990	0.0000*
EQU	1.782820	0.677263	2.632392	0.0092*
LTD	2.379387	0.630033	3.776608	0.0002*
STD	2.781250	1.821406	1.526980	0.1284
R ²	0.219565			
Adj. R ²	0.207620			
F-Statistic	18.38071			
Prob. (F-Stat)	0.000000*			
Obs	200			
Breusch-Pagan LH Serial Correlation Test	17.35608 (0.0002*)			
Heteroskedasticity: Breusch-Pagan LH	10.73995(0.0132*)			
Normality test: Jarque-Bera	8252.097(0.00000*)			
Hausman Test	6.465357 (0.0910)			

Dependent Variable: EROCE significance at 5%

Source: Researchers Computation, 2019 (E-Views 9)

The findings from the Hausman test carried out revealed that the probability value associated with the variables is given as a *p-value* of 0.0910 which is greater than the significance level of 0.05, therefore the null hypothesis that random effect is suitable for this model is accepted and the alternative hypothesis is accepted. The *p-value* of the *f*-statistics for the Breusch-Pagan LH Serial Correlation Test of 0.0002 less than the 5% level of significance shows that the null hypothesis that there is no presence of serial correlation is rejected. Also, the Heteroskedasticity Test shows a *p-value* of 1.32% less than the 5% level of significance; as such, the null hypothesis that there is no heteroskedasticity is rejected. Also, the JarqueBera statistics indicated that the model is not normally distributed as its *p-value* is less than 5% the level of significance for the study.

$$\text{EROCE}_{it} = \alpha_0 + \beta_1 (\text{EQU}_{it}) + \beta_2 (\text{STD}_{it}) + \beta_3 (\text{LTD}_{it}) + \mu_{it}$$

$$\text{EROCE} = -98.27018 + 1.782820\text{EQU} + 2.379387\text{STD} + 2.781250\text{LTD} + \mu$$

4.4. Interpretation of Result

The coefficient of the independent variable Capital structure is positive showed as a unit increase in Equity, Long term debt and Short term debt by 1% would cause a 1.782820 increase, 2.379387 increase, and 2.781250 increase respectively in an enhanced return on capital employed. The overall coefficient of determination of adjusted R², which is the explanatory power of the model, is 0.207620. This implies that within the model context, the independence of Capital structure is responsible for 21% variations in an enhanced return on capital employed while the remaining 78% is explained by other factors that can impact on the dependent variable. The F – statistics of 18.38071 associated with the coefficient of the aggregate of the subdivision of proxies under the Capital structure and enhanced return on capital employed at a 5% significance level, the result above showed a *p-value* of 0.000000, which is less than the level of significance of 0.05. This indicates that there is a significant relationship between Capital structure and enhanced return on capital employed. Capital structure has a significant relationship on the enhanced return on capital employed of quoted manufacturing companies in Nigeria.

5. Conclusion and Recommendations

This study evaluated the effect of capital structure on the financial performance sustainability of quoted manufacturing companies in Nigeria. The study concluded that capital structure had a significant relationship on the financial performance sustainability of quoted manufacturing companies in Nigeria.

Based on the findings made from the study, the following recommendations were made we recommend that, management should ensure that financial performance is sustainability maintained to allow for an increase in dividend payment and retained earnings for expansion. Also, it is important that listed companies should encourage investment in long-term debts and also should be well balanced to allow for the coverage of its interest by profit.

Management should also ensure that short-term debts should be well managed through the settlement of its obligations by current assets as at when due. Finally, the management of listed companies should ensure that they consider other matters that affect the financial performance sustainability of companies to ensure that returns on capital employed and equity are increased.

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