

THE EFFECT OF CAPITAL STRUCTURE ON FIRM PROFITABILITY

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Abstract

This work examines the current state of capital structure impact on firms' profitability, from the literature by reviewing empirical investigations most recurrent impact of capital structure from 2015 till 2020 on different firms' performance have been evaluated. The result explains distinctive finding, many explain appositve association while, from findings of some scholars' firm's performance negatively associated with capital structure. Thus, Inconclusive result on this topic explains a necessity for more academic work in this regard. But, quite easily finding explains a significant implication on capital structure on organizations performance and reflects financial health and firms- survival.

Keywords: Capital Structure, Firm, Performance.

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1. INTRODUCTION

In this paper capital structure & profitability of several firms was explained. Ideally structure of capital in a contemporary era is a unique puzzling common debate in corporate finance literature (Brounen & Eichholtz, 2001; Budur, 2020; Rashid & Sabir Jaf, 2023). The determinant of this concept is defined as the collection of debt and equity that jointly create the total capital of economic entity (Mahmood & Sabir, 2023; Rashid, 2017). This combination considers as a strategic choice for financial and other managers. Thus, the proportion of each capital structure determinants in firm capital is a vital decision since the profitability of each business entities is easily affected by such decision (Fatah & Jaf, 2023; Rashid, 2018).

With no proper capital structure, usually companies fail to economic use of their funds. Corporate to be able rise the use rate of its funds and to adapt more easily their conditions, it should aware of plans and make proper decision regarding its capital structure (Pandy, 2009; Rashid, 2020; Budur et al., 2018).

This study helps to concentrate the expected problems related to performance and how capital should be structured. The competitive business environment in the modern era is greatly not easy and quite complex, thus such kind of reviewed studies will be in advantage of optimum choice of capital structure. Majority of the capital structure literature has focused on concentrating pattern of the different sector firm's capital structure, but this issue year by year has become increasingly popular in recent years, which gives academicians the chance to make cross sectional comparisons among distinctive states and industries around the world (Budur et al., 2023; Rashid, 2023). More specifically Rajan and Zingales (1995) carried out the capital structure model is derived from a US setting to firms in the G-7 countries and shows that variables has forced influence with leverage in the united states were also connected with leverage of firms in other G-7 states. Usually, the common sources of companies finance are: retained earnings, debt and equity. the least costing source of corporate finance is the retained earning which is not have related costs as it does not obtained from outside sources. more use of debt to finance business investments which has the more probability of cost rising and thus, increase the financial risk because the firms should carefully look to the priority of the structure of debt, debt maturity, decision of mixed debt and other types of debt contracts (Peirson, Brown, Easton and Howard, 2002; Barclay et al., 2003; Noori & Rashid, 2017).

On the other hand, if common stocks or preferred stocks uses by economic entities as its capital structure, the stockholders of those stocks have been the owner of the company. Mainly, debt has maturity date, but the stocks do not have such kind of specification (Rashid, 2023). Hence the payback of stocks is not necessarily required since stocks are liquidated if the company went bankrupt. More stock issuing may decrease the authority of previous owners in the firm. The cost of the issuing new stocks is dividend for the stockholders. Tax relief can be deductible expenses for cost of debt, while common and dividend of the common stock and preferred stocks do not have tax deductible (Rashid & Noori, 2017). One prominent way to find out the operating and financial characteristic with ability and efficiency of business management unit is financial analysis ratio, as reflected in the financial statements and reports (Amalendu bhunia, 2010). One proper model to measure financial performance is financial ratio analysis, and can be seen that financial ratio model is the most used model to evaluate the current and other period performance of the business (Dick W. Feenstra, et al, 2000; Budur et al., 2023).

2. LITERATURE REVIEW

A study by Iqbal, et.al 2018 in Pakistan explores the impact of capital structure on firm's financial performance. The examination has evaluated the association between measures of performance variables (dependent) and independent variables (capital structure variables).

Mainly, net profit margin (NPM), return on assets (ROA), Return on equity (ROE) and total asset (TA) used as a performance variables. And short term debts (STD), total equity (TE) and debt equity ratio (DER) as a measure of capital structure. Sample of study includes 61 medium and small sized and commercial corporations in distinctive sectors for the period "between" 2012 to 2014. Concluded result explains firms performance positively in a great extent related to the capital structure. And the level of effect was not the same among small, medium and large entities.

Similar study by Musah 2017 explains the impact of capital structure on profitability but in commercial banks in Ghana. Study employ short term debt ratio, long term debt ratio and total debt ratio as a measure of capital structure, and each of the return on assets and return on equity as a measures of profitability. Secondary data for the 6 year between the periods 2010 to 2015 have been to draw conclusion.

Result of paper explains banks are quite leveraged in Ghana and reaches 84%, of total capital, and short term debt represent 77% of that leverage. On the other hand, interpretation of the result explains each of short and long term debt in a negative trend connected with banks profitability. But, total debt ratio has its positive impact on banks profitability.

In turkey by Nassar 2016 the impact of capital structure on the financial firm performance of industrial companies have been explained. The annual financial statements of 136 industrial companies listed on Istanbul Stock Exchange (ISE) were used for this study which covers a period of 8 years from 2005-20012. A multivariate regression analysis is applied to test the relationship between capital structure and firm performance. To measure firm performance used indicators such as Return on Asset (ROA), Return on Equity (ROE) and Earning per Share (EPS) as well as Debt Ratio (DR) as capital structure variable. The results show that there is a negative significant relationship between capital structure and firm performance.

Nevertheless, firm's profitability by Singh and Bagga 2019 has been explored by its variations by capital structure. Empirically 50 companies on India national stock exchange have been

empirically investigated for the period "between" 2008 - 2017. Descriptive approach, correlation and panel data with panel data regression model have been used to analysis the study data. Total debt and total equity ratio effect on ROA and ROE as a measure of profitability have been assessed. Remarkd result shows the positive association between capital structure and profitability of firms.

On the other hand, theories of optimal capital structure and their Non-linear association with performance of manufacturing firms in India have been under consideration of researchers Jaisinghani & Kanjilal 2017.

The results confirm the significance of a single threshold for size, thereby indicating the presence of two separate regimes in which capital structure differentially impacts profitability. It is found that firms which exceed the threshold size are positively impacted by the use of debt in their capital structure and vice versa. The findings have useful implications for small size firms as they can reduce their overall costs of doing business by reducing the debt in their total capital. The empirical evidence supports both trade-off and asymmetric information theories of capital structure.

In United Kingdom firm performance effect by capital structure has been examined by Abeywardhana & Krishanthi (2016). The Period of study sample represents 11 years performance of manufacturing SMEs firms. Each of firm's performance measures ROA and ROCE negatively in a significant extent corrected with the leverage measure.

Also, liquidity strongly in an opposite trend associated with firm's performance, while size of the firm variable positively correlated with firm performance. Other remarkable result explains SMSs perform well in case relying on retained earnings than debt capital financing.

Then, Vaicondam, Y., & Ramakrishnan 2017 have examined the effect of capital structure on the firm's profitability. Malaysian 708 firms from distinctive sectors for the period "between" 2001 to 2014 represent sample of the study. Return on asset, short term debt to total debt (STDTD) and long term debt to total debt represent studies performance variables.

By analyzing the data from regression analysis model explains positive significant effect of STDTD on ROA, and negative significant of LTDTD on ROA in the fixed effect analysis. Although, positive significant effect of LTDTD on ROA. These results justified by consistency of agency theory cost that capital structure has extent on the firm's performance based on large

sample size. Moreover, the effects of the firm variables on the relation between financial distress and capital structure decisions have been explained by Abdioğlu 2019, in turkeys manufacturing firms for specific 11 years (2007 to 2017).

Finding of the study explains financial distress level rises in the condition where short-term debt maturity usage has been increased. Size of the firm, ROE and asset tangibility measures are reported as effective on the connection between leverage and financial distress. Hence, ROE and asset tangibility have effect on the connection among financial distress and debt maturity.

In Nigeria by Ayuba, Bambale, Ibrahim, & Sulaiman, (2019) the Effects of Financial Performance, Capital Structure and Firm Size on Firms' Value of Insurance Companies have been investigated. Specifically 27 quoted insurance companies in Nigeria stock exchange for the period between 2012 to 2017 covered studies investigation. Measures of financial performance to express variation include return on capital employed, return on asset and return on equity. While, short term debt/total assets, long term debt/total assets and total debt/total assets measured of capital structure and firm size measured by natural logarithm of total assets. Finally, Tobin's Q proxies firms value.

After analysis of the employed data, study explains total measures of firms performance except return on capital employed have positive significant effect on Tobin's Q. However the study shows that the explanatory variables affect insurance firm's value.

Related research Voung, Vuand mitra 2017 have empirically investigated the extent of capital structure on financial performance of every large company in United Kingdom. Totally 739 firms in London stock exchange the "between", 2006 to 2015 have been represent studies investigation.

ROE, ROA, Tobins Q and EPS represent the study measures for performance measure. But, each of long-term, short-term liabilities and growth rate of total assets as measures of capital structure. Size is a control variable. Concluded result of study employs that performance measures of ROE and Tobin's Q have a negative connection with long-term liabilities, while no significant impact of these ratios exists with short-term liabilities. But, performance of EPS has no relationship find to Tobin's Q. Besides risk and corporate performance by capital structure has been analyzed by Nenu, Vintila & Gherghin 2018. Study examiners panel data of companies listed on Bucharest stock exchange for the period "2000-2016".

They explain depended on the analysis leverage has a positive association with size and share price relativity. And debt structure has distinctive impact on market share price.

Although petroleum financial performance by decision of capital structure in Nairobi stock exchange in Kenya, Five firms listed in NSE for the period 2004 to 2014 represented studies population. Explanation of the result indicates debt ratio, liquidity and firm size as independent variable had a negative trend on financial performance, but the trend of this effect is not the same. Each of debt and firm size explains positive role whereas liquidity had a negative role.

Mouna, Jianmu. Havidzard Ali (2017) in morocco explains the impact of capital structure on firm's performance. Totally 53 firms panel data for the period "between" "2014 to 2016" have been selected and data analyzed by Hausman test. The output provides each explanatory variable debt ratio has significant effect on ROA. Debt equity ratio has negative and significant impact on ROE. This indicates profitability of firms in morocco minimize as much as relay on debt financing. This result contradicts of trade-off theory which explains positive association.

Performance of Iraqi private banks by the effect of capital structure has been explained by Ibrahim 2019. Sample of the study includes 6 banks mainly; Babylon bank, investment bank, credit bank, commercial bank, Shar Al- Awsat bank and Baghdad bank for the period "between" 2005 to 2015.

Principally, total debt to capital, bank size and asset growth represent studies independent variables, while, each of ROA and ROE represent studies dependent variables.

Proposed result explains ROA was not varieties by independent variables. But, total debt to capital has a positive impact on ROE.

Finally, from Egypt firm level determinants of capital structure have been studied by Sake & Bedeir 2019. From the reported financial statements of 62 firms between the years of 2003 to 2016, researchers investigated, to what extent capital structure decisions in Egyptian companies are closer to the postulates of tradeoff theory, peaking order theory and agency theory.

Result of study remarked that behavior of capital structure of the Egyptian firm's looks to be quite closer to trade off and peaking order theory, while there was little evidence to support the agency theory.

3. METHODOLOGY

Capital structure is defined as a mixture of equity and debt to finance firms overall operations. Brealy and Myers (2005) explains the option of capital structure is crucially a marketing problem. The capital structure of business organizations likely influenced by the amount of bankruptcy cost and agency cost, Bankruptcy costs are significantly occurred when company employ addition debt beyond a certain point. More financing of firms activities by debt usually incurred corporates to pay debt service by paying required interest payments and such payments convert firms earning as well as cash flow. Titman (1984) has demonstrated two types of bankruptcy cost; the direct cost of financing is the statutory and administrative costs, while the indirect bankruptcy costs are illegal and make firms loss earnings because stakeholders are not interested to do business with them.

Also, employ debt financing has relative agency costs. The potential cost emerges because of the unfair relationship between shareholders and managers, and among debt holders and shareholders (Jensen and Meckling 1979).

The relationship between capital structure and profitability make a sound capital structure choice and this association cannot be neglected and such association is uniquely improve the firm's long-term survivability. Cost of finance is tax shield, thus more proportion of debt for firms distinctive activities will upgrade profitability. From empirical investigation we have been witnessed a great deal of positive connection between capital structure and leverage. For instance, Roden and Lewellen (1995) have investigated data of 107 leveraged buyout firms for the period "between" 1981 to 1990. The examination of this data by regression model expressed a positive association between firms profit and total outstanding debt as a percentage of total buyout –financing.

Wald (1999) employed the 1993 world scope data set to concentrate data from near forty countries. Generally, 3300 firms represent study sample size just for united stated alone. And regression model analysis provides a negative association between leverage and profitability. Then, Chiang, Chan and Hui (2000) investigated data of 17 countries and the other 18 developers from Hong Kong by employing a data of electronic financial data base. The result explains the mix of debt and equity are interrelated with profitability.

Present paper depends on the findings of reviewed articles in order to obtain the objective of the study which includes obtain sufficient justification for implications of capital structure on

firms profitability. Distinctive articles have been selected from many distinctive sectors and different geographic regions in order to collect a wider vision about variation of firms performance by structuring their structurally have been reviewed. Based on them this paper was contracted.

Mainly concluded result is about implications of capital structure a firm's profitability. Many distinctive financial ratios have been employed to address the variation of firm's performance by capital structure. The most and recurrent use of performance measures are (ROA, ROE, TA and firms growth). While, some other measures such as short term debts (STD), long term debt (LTD), total equity total debt ratio, debt equity ratio (DER), Tobin's Q and total debt to total capital.

Main objective of studies are examines the impact of capital structure on the financial performance. Via the above mention variables researchers contract their findings and depict main contribution. Many studies contribute that capital structure have a positive impact on firms' profitability. (e.g. 19 bal, Farooq 9, Sandhu and Abbas 2018, Singh & Bagga 2019, Jaisinghani & Kanjilal 2017, Rashid, 2019; Rashid, 2021; Jaf & Rashid, 2023) on the other. Hand many other reviewed articles explain a negative impact of capital structure of studies explanatory variables, for instance Nassar, 2016 and Mutwiri 2015. In addition, there are other investigations explain a positive implication in case employ some variables and on the same time negative in case employing some other variable. In conclusive, similar association among findings does not mean the same effect of capital structure on firms' profitability, it can be easily noted there are different level of effect among small, medium and large entities.

Regarding the negative impact of short-term debt and long-term debt on firms share price, it is quite common firms' management should take appropriate financial decisions and contract optimal capital structure which is the mixture of debt and equity in turn would minimize cost of capital (Goyal 2013). Three different theoretical developments to find lasting solution to arguments about choice of capital structure, despite findings of the empirical articles, the above-mentioned capital structure theories have been evolved from capital structure literature. Theoretically as described by Modigliani and miller 1958 each business has a certain portion of cash flow; thus, the market value of a business is based on it is earnings and by the potential risk of it is main assets.

In addition the performance is not relying on the way it selects to finance it is investments or distributes dividends. This theory is a justification of those findings that explain firms' value not variable by management decisions to determine financing.

It can be noted many discrepancy among the findings and effect on the financial performance of distinctive business sectors. One in petroleum sector explains debt ratio and firm size had a positive association whereas liquidity had a negative relationship. This is quite contradicts to some of studies earlier that explain liquidity positively associated with returns of firm. Even though, my view point is that further studies should be done to establish such discrepancy. On the other hand, theoretically was explained the proportion of debt in a point increase firms value. Up to that point, any increase in leverage has high capital cost and lower market value of firm. Firms lie at different points on this trade-off line (Barine, 2012). The result from these studies explained of some common features in the capital structures regardless of juridical area. But, further explorations were suggested to put more forth on determinants of capitals structure in specific institutional sector or countries.

4. CONCLUSION

Investigation of the relation between capital structure and firms performance has been the concern mater of many individual and even responsible organizations. This paper has helped to improve image about capital structure of different industries and distinctive countries and related implications on firm's performance. Measures of explanatory variable are common among articles mainly includes ROA, ROE, EPS and firms size. Generally, result highlights commercial and manufacture sector firms share value significantly affected by variables of capital structure. In addition this implication was quite sensitive on financial institutions. In banks highly leverage was quite common and constitutes major part of capitals.

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