Impact of the Organisational Attributes on Capital Structure Efficiency

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Abstract

Deciding the capital structure of a firm is one of the leading challenges faced by both well established and new enterprises. Although extensive studies have been done in the past yet the studies on analyzing the impact of company attributes on the efficiency of the capital structure are limited. The current review paper analyses as to how the company attributes such as size, type, performance plays a major role in making financial decisions and improving the capital structure efficiency. This research will aid the firms in estimating their debt and equities and making decisions regarding the division of their capital structure. Furthermore, the current study will provide an understanding and new small scale firms to improve their efficiency by choosing the appropriate ration of their debt and equities.

Keywords: *capital structure, firm's performance, finance, debt, equity, stakeholders, leverage, corporate performance.*

Classification-JEL : *N35, H54, E63, A 11*

1. INTRODUCTION

For every company, one of the leading challenges is capital structure. Although numerous theorists have tried to explain the meaning of capital structure, yet it remains a challenge for most companies. Capital structure is imperative from the return maximization point of view along with having a greater amount of impact on the firm's ability to operate successfully in the competitive environment (Nenu, Vintila, & Gherghina, 2018). The companies' ability to work as per the needs of their stakeholders is correlated to the capital structure. The Capital structure is a financial term which means the way a firm is able to finance its assets through the amalgamation of equity, debt, or hybrid securities (Saad, 2010). In recent times, the capital structure decision of companies is under scrutiny. Since the past few decades, numerous theories have evolved in relation to the capital structure decision of the company in different directions. A balanced proportion of equity and debt is necessary for capital structure. In other words, capital structure is a blend of long-term debt that includes loans and bonds, equity which comprises of preferred and common stock, and hybrid securities which includes preferred shares and convertible debt (Joshua, 2017). Capital structure can be defined as the mix of numerous sources of long-term funds used by an enterprise to finance its assets. Debentures, mortgage bonds, common stock, preferred

stocks, and retained earnings are some of the long-term sources of financing (Ezenwakwelu, 2017). This means, the percentage of capital at work in an organisation. But on the basis of nationality, it becomes difficult to foresee the financial structure of the company. The prime determinants of the future of the firm's course of action are the economic as well as the business cycles. A firm uses the capital structure for its operations. Substantial time is used by managers in both small and big enterprises in order to attempt and find the perfect capital structure concerning the reward and risk for the shareholders. Different sources of long term capital are involved in the capital structure of the firm and it is through this, that an enterprise finances its assets (Kirmi, 2017). Both the shareholders' return, as well as their ability of a firm to survive economic depression, is influenced by the capital structure (Joshua, 2017).

Mohammad and Jaafer (2012), asserts that either equity or debts can be used by the firms so as to finance their assets. Firms maximise the value which is accruable by using more debt, in the case when the interest is tax-deductible. The shareholders' contribution is referred to as equity capital. The debt capital in the capital structure of a business firm refers to borrowed money, such as loans, debenture, bonds and commercial papers. The decision for capital structure becomes vital for the business firms that have the requirement to maximize shareholders' return and achieve competitive advantage. The ratio of equity and debt in the company's mode of financing is referred to as capital structure. Equity and debt differ from firm to firm. Some business firm prefers more equity whereas others prefer more debt in financing their assets (Mohammad & Jaafer, 2012). Another term which aids this study in providing a better understanding of capital structure is financial leverage. It refers to the use of debts in order to acquire additional assets. In other words, it means trading on equity which occurs when other debts, bonds and preferred stock is used by a firm in order to increase their earnings on common stock (Kanatani & Yaghoubi, 2017). Long term debt might be used by a business firm to purchase assets that are expected to earn more than the interest on the debt. The earnings in excess of the interest expense on the new debt will increase the earnings of the firm's common stockholders. An increase in the earnings of the firm depicts that the business firm was successful in trading on equity. When the interest expense on the new debt is higher than the earning from the newly purchased assets in a firm then, there can be seen a decrease in the earnings of the common stockholders (Ezenwakwelu, 2017).

The purpose of this study is to find the impact of the company's attributes on capital structure efficiency. This study will help the firms in estimating their debt and equities and dividing their capital structure as per the size of their firm. The current study will aid the firms to improve their efficiency by looking at the characteristics of their respective firm. This study will also be useful for future researchers in this area and provide them with a better understanding of the correlation between the company attributes and its capital structure.

2. LITERATURE REVIEW

a) Capital framework and its determinants: Any business organisation can have the advantage of accessing the markets and loan premiums on their debt and equity issues if their business confidence and projections are high. The global economy is not in a robust state (Pal, 2014). An eye should be kept by the firms on the costs added to their portfolios along with the loans undertaken by them.

The capital structure changes over time and is a dynamic process. It depends on the variables that impact the overall evolution of the economy or might have an influence on a particular company or a sector. The capital structure of a firm also gets modified depending on the firm's forecasts of its expected profitability wherein, the capital structure act as

a risk-return compromise (Nenu, Vintila & Gherghina, 2018).

The capital structure of a firm is determined by the relation of the demand and supply variables. Thus, it can be said that the demand and supply factors of a firm governs its financial decisions. An optimal ratio of debt and equities is stated by numerous capital structure theories. The firms, by raising the capital from various sources are able to fund their operations. This mix of various sources is termed as the capital structure of a firm (Pal, 2014).

Arulvel and Ajanthan (2013) in their study states that along with working capital management, dividend policy, and capital budgeting, capital structure is one of the most crucial topics in financial management. The capital structure decision of a firm tries to answers for questions related to debt and equity. The firm needs to understand and estimate their debts in order to optimise their firm value. A firm needs to take certain steps when the wrong debt decision is taken and as a result, the firm value also gets affected. The financial framework of the firm is indicated by the capital structure. A capital structure ensures as to how a firm finances its overall operations and financial growth with the help of different sources of funds.

Since the 1950s, one of the most debatable topics has been the capital structure. Henceforth, the need to find an optimal ratio between the companies' debt and equity has arrived as this would lead to minimizing the capital cost and maximizing the companies' value (Zeitun & Tian, 2007). A discussion was done by Campbell and Rogers (2018) regarding the Corporate Finance Trilemma that occurs when the companies decide about their cash holdings, debt and equity payout policies all together at a particular time, yet they are not able to do that. The study done by using the data from numerous European companies found that some firms maintain strict capital structures but there are many firms that allow moving their capital structure substantially with time. The firms that have the most volatile debt have a propensity to be less profitable and smaller. The result of the study suggests that the firms cannot set their capital structure without considering the other factors in mind. The firms that prioritise stable debt levels, should accept fluctuations in other variables. Some firms give priority to cash holdings and equity pay-outs and are able to resolve the Corporate Finance Trilemma by enabling the debt to move easily (Campbell & Rogers, 2018).

A study conducted by Agarwal and Pradhan (2017) analysed the effect of capital structure on firm value in the Indian Hospitality Industry. The study revealed that the Modigliani Miller theory of irrelevance of capital structure is not applicable to Indian Hospitality Industry. The authors have argued that the quality of the firm, size, liquidity and leverage has a noteworthy effect on the capital structure.

b) Leverage distinction in different countries: Joeveer (2013) is of the view that about half of the variations in leverage that is associated with country factors are illustrated by recognized institutional and macroeconomic features, while the remaining is due to the immeasurable institutional variances.

Nenu, Vintila and Gherghina (2018), in their study on capital structure assessed the evolution of the main theories regarding the capital structure and its impact on the risk and performance of the firm. The study investigated the drivers of the capital structure of the firm from the Romanian market. The analyzed period for the study was from 2000–2016 that covers a cycle with noteworthy changes in the Romanian economy. The study found that there is a positive correlation between leverage and the company size and share price volatility. The study also investigated the impact of the debt structure on corporate performance is different, whether this is calculated on accounting measures or considered as the evolution of market share price.

Akinyomi and Olagunju (2013) in their research estimated the determinants of the capital structure by taking twenty-four companies listed on Nigerian stock exchange as the sample for the study. The findings revealed that leverage has a negative relationship with tax and size, and a positive relationship with the growth and profitability of the firm.

Cooper and Lambertides (2018), conducted research on the 4374 firms that are listed in the Center for Research in Security Prices over 1979-2010. The study followed the regression analysis and found that high dividend increases are followed by a notable increase in the leverage of the firms.

Buvanendra et al. (2017), analysed the 90 companies which are listed in Sri Lanka and India during 2004-2013. The study used the fixed effects regressions and system generalised method of moments. The results of the study found a negative link between profitability and total debt ratio in both states. A positive link between the firm size and leverage in Sri Lanka and a negative link between the two was found in India. The study also found that the ratio of tangible fixed assets to total assets was not related to leverage for Sri Lankan firms but was positively related in the case of the Indian firms.

c) Judiciary's role in determining effective capital structure: Protecting the rights of the shareholders and creditors is essential for capital market development by the financing of equities and debt. Legal protection provided to creditors and its enforcement by the judicial system plays an imperative role in credit contracts. Although legal protection alone may not be enough to prevent parties to the credit contract from engaging in opportunistic behaviour. Galindo et al. (2001) remarks "If institutions are inadequate it is likely that the benefits that the other parties have to gain from reneging on the debt contract can be pronounced enough to prevent the contract's realisation. Hence, the ability of these institutions to align the players' incentives with the clauses of the debt contract can become an engine of promotion of financial breadth…" (p. 16). The chances of opportunistic behaviour of borrowers are reduced by an efficient judicial system (Jappelli, Pagano, & Bianco,2005). Bae and Goyal (2009) opine that uncertainties about the repayment of the loan by the borrower increases by an inefficient judicial system. The recovery rates also reduce and the time spent in repossessing collateral following default increases with a slow judiciary process (Bae & Goyal, 2009).

Extensive literature has been written that depicts a positive link between the law and the external finance and build arguments from the perspective of the fund suppliers. Numerous studies argue that investors feel more confident in increasing their fund availability when they are provided sufficient protection by the law (Haselmann et al., 2010; Djankov et al., 2007; Visaria, 2009). However, in contrast to the above-mentioned studies, there are much more recent studies that investigate the negative effects of stronger creditor rights on borrowers' risk-taking behaviour (that is, the demand-side factors) by analysing the firm-level decisions to employ debt. Many recent studies investigate the decisions of corporate leverage and creditor rights by using creditor rights indexes at the country level and cross-country data at the firm level. Cho et al. (2014) in his research shows that stronger creditor rights lead to decreased leverage ratios, by providing empirical evidence from a cross-section of 48 countries. Acharya et. al. (2011) in his work on capital structure is of the view that managers are more risk-averse with stronger creditor rights which leads them to make value-decreasing corporate decisions, such as employing sub-optimal leverage. Similar studies in support of research done by Acharya et. al. (2011) was done by Vig (2013) and Fan et. al. (2012). De Jong et al. (2008) states "macroeconomic and institutional features might influence firms with different attributes to differ in their capital structure decisions, for example, poor or strong judicial systems will

have different influences on capital structure decisions made by small or large firms, firms with more or less tangible assets, and firms with more or less volatile cash flows".

Evidence from Pakistani judicial districts is illustrated by (Shah, 2011) in his study. His results found a positive impact of judicial efficiency in increasing corporate debt-maturity structure. In addition, the research found that a larger negative impact on the debt-maturity structure can be seen on small firms rather than large firms due to poor judiciary efficiency. His study found that larger organizations have lower information asymmetry problems and are not much affected by the inefficiency of the court.

d) Capital Structure choice and corporate performance: Organizations' corporate performance can be viewed from the organizational and financial perspectives. The financial performance of a firm can be measured in terms of its profit maximization, maximizing shareholder return and by maximizing return on assets which is built on the efficiency of the organization (Tudose 2012). Margaritis and Psillaki (2010) are also of the view that the choice of higher debt to equity ratios is influenced by the performance of the firms. Yinusa et al. (2016), conducted research on the relationship between firm performance and capital structure of specific firms in Nigeria. Panel data of 115 firms over the period 1998-2012 was used for investigation. The study concluded that the past performance of a firm has an impact on the capital structure. The study suggested that the organizations in the emerging markets must take adequate measures to improve their financial performances in order for optimising their capital structure decisions.

More efficient firms have higher tendencies to have more return on their investment this prevents them from taking any financial distress and as a result, create opportunities for them in choosing more debt as compared to equity in their capital structure choice (Berger & Bonaccorsi di Patti, 2006). According to a study done by (Yeh, 2010), a positive relationship between performance and leverage is predicted by efficiency risk hypothesis. A negative relationship between performance and leverage is posited by the franchise value hypothesis (Yeh, 2010). Whereas, (Margaritis and Psillaki, 2010) states that the firms that perform better, employ lower debt to equity ratios for protecting the rents and the value generated by the management overtime against liquidation.

The studies done in the United States, Africa and Europe have found contrasting results, with respect to the relationship between capital structure and firms performance. A positive relationship was found by (Zeitun & Tian, 2007; Onaolapo & Kajola, 2010). However, Luper and Kwanum (2012) and Ebaid (2009) obtained a negative relationship between the two and concluded that capital structure has a weak or no impact on the firm's performance. The study done by Shoaib, (2011) and San and Heng, (2011) have found that various firms do not have optimal capital structure. This is because managers do not have incentives to maximize corporate performance because their compensation is not linked to it (Taiwo & Olayinka, 2012).

3. FINDINGS AND DISCUSSION

The findings of the current study reveal that although the extensive study has been done on the capital structure, debt-equity ratio and financial decisions of firms around the world, yet the previous studies have varied findings and conclusions as per their understanding and by creating a different hypothesis and following different methods and theories related to finance. The current study is the review of the existing literature done in the past, and with the help of those studies, this research tries to analyse the impact of the companies' attributes on capital structure efficiency.

The below table summarizes various studies done in the past on capital structure decisions.

4. CONCLUSION

The capital structure of a company is a dynamic process and changes with time.

Henceforth, it is imperative to find an optimal ratio between the companies' debt and equity as this minimizes the capital cost and maximizes the firm's value. The judiciary also plays a major role in determining capital structure. The investor has a feeling of self-confidence when they are provided security and protection by the law. The study concludes that an effective capital structure improves the overall efficiency of the firm. This study analyses the impact of the company's attributes on capital structure efficiency by providing a review of the existing studies. This study will help the future researchers to provide adequate knowledge about the role of law, capital determinants, leverage ratios and capital structure decisions in improving the firms' performance.

Table 1 : Review of literature on the Capital Structure

Authors	Study area	Findings and conclusions
Campbell and Rogers (2018)	Studied on European companies.	The result of the study suggests that the firms cannot set their capital structure without considering the other factors in mind. The firms that prioritise stable debt levels, should accept fluctuations in other variables.
Agarwal and Pradhan (2017)	Effect of capital structure on firm value in the Indian Hospitality Industry.	The study revealed that the Modigliani Miller theory of irrelevance of capital structure is not applicable to Indian Hospitality Industry. The authors have argued that the quality of the firm, size, liquidity and leverage has a noteworthy effect on the capital structure.
Nenu, Vintilă and Gherghina (2018)	Evolution of the main theories regarding the capital structure and its impact on the risk and performance of the firm in the Romanian market (2000-2016)	The study found that there is a positive correlation between leverage and the company size and share price volatility. The study also investigated that the impact of the debt structure on corporate performance is different, whether this is calculated on accounting measures or considered as the evolution of market share price.
Akinyomi and Olagunju (2013)	The determinants of the capital structure in twenty-four companies listed on Nigerian stock exchange.	The findings revealed that leverage has a negative relationship with tax and size, and a positive relationship with the growth and profitability of the firm.
Cooper and Lambertides (2018)	4374 firms that are listed in the Center for Research in Security Prices over 1979-2010. Followed the regression analysis.	The study found that high dividend increases are followed by a notable increase in the leverage of the firms.

Buvanendra et al. (2017)	90 companies which are listed in Sri Lanka and India during 2004-2013. The study used the fixed effects regressions and system generalised method of moments	A positive link between the firm size and leverage in Sri Lanka and a negative link between the two was found in India. The study also found that the ratio of tangible fixed assets to total assets was not related to leverage for Sri Lankan firms but was positively related in the case of the Indian firms.
Cho et al. (2014)	Creditor rights and capital structure 48 countries as the sample of the study.	The study found that strong creditor protection disregards companies to make long-term cash flow commitments to service debt. This is because shareholders and managers avoid the risk of losing control when in financial distress.
Acharya et al. (2011)	Creditor rights and corporate risk-taking (cross-country analysis)	The study found that managers are more risk-averse with stronger creditor rights which leads them to make value-decreasing corporate decisions, such as employing sub-optimal leverage.
Shah (2011)	Impact of Judicial Efficiency on Debt Maturity Structure: Evidence from Judicial Districts of Pakistan	The study found a positive impact of judicial efficiency in increasing corporate debt-maturity structure. A larger negative impact on the debt-maturity structure can be seen on small firms rather than large firms due to poor judiciary efficiency. Furthermore, the study found that larger organizations have lower information asymmetry problems and are not much affected by the inefficiency of the court.
Yinusa et al. (2016)	A relationship between firm performance and capital structure of specific firms in Nigeria. Panel data of 115 firms over the period 1998-2012 was used.	The study concluded that the past performance of a firm has an impact on the capital structure. The study suggested that the organizations in the emerging markets must take adequate measures to improve their financial performances in order for optimising their capital structure decisions.
Yeh (2010)	Bank loan loss provision decisions: Empirical analysis of Taiwanese banks.	The study found a positive relationship between performance and leverage by testing the efficiency risk hypothesis. A negative relationship between performance and leverage is posited by the franchise value hypothesis.

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