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CAPITAL STRUCTURE, PROFITABILITY, GROWTH AND FIRM VALUE: A CRITICAL LITERATURE REVIEW

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Abstract

Future research preparations and development of in-depth exploration forms the key objective of the independent study paper. The paper sought to answer this research question; what is the effect of capital structure, profitability, and growth on firm value. Aim of this paper was to determine the effect of capital structure on firm value, the effect of profitability and growth on the relationship between capital structure and firm value and the joint effect of capital structure, profitability, and growth on firm value. It discussed several empirical studies aimed at establishing research gaps. It discussed major theories namely; pecking order theory, market-timing theory, trade off theory and Modigliani and Miller theory. Trade off theory by Myers asserts that striking the balance of costs and the associated advantages of leverage improves the firm's value and profitability. Firms, which are more profitable, can use debt financing which fosters growth and value. From empirical evidence, association between capital structure, profitability, growth, and firm value is mixed. Capital structure and value is still a puzzle due to differing theoretical perspective and conflicting opinions. The conceptual framework consist the explanatory variable which is capital structure as parameterized by debt to equity ratio, debt ratio and debt to capital ratio, moderating variable is growth as measured by revenue growth, market share growth and assets growth. Intervening variable is profitability as indicated by return on assets, net profit margin, and return on equity. Value is the response variable as measured by Tobin's Q. Synthesis of the review was by defining research objectives and literature search. The key findings from the review was the empirical mixed evidence and the concepts of capital structure of entities, profitability, growth, and firm value have not been widely studied. The review concludes no conclusive findings due to inconsistencies in the outcomes, which calls for more research. Further, critical review of existing theories is critical in contributing to the contemporary debate. Additionally, more robust statistical tools and techniques are critical in the analysis of data with an aim of solving the puzzle. This review will be of great benefit to industry practitioners engaged in determining capital structure choices especially on the need by firms to decide and keep up optimal financing structure important to shield them against risks. Further synthesis of literature is key in confirming existing theoretical and empirical linkages.

Introduction

Background of the Study

Financing of firm activities is a very critical decision which management undertakes. When making financing decisions, a company must consider several factors, including entity's cost of capital, the risk profile of the organization, the expected return on investment, and the availability of funding sources (Kim, 2015). Lewellen (2006) opines that, financial risk results from too much debt, which potentially hinders growth and value. Growth initiative is high in profitable firms because they have more money, which leads to high values. Higher growth organizations have high values if their growth has the capacity of generating increased future cash flows and their growth is sustainable. Increased profitability translates to higher organization values because it is a sign of consistent earnings generation by firms. The theory of capital structure is concerned with the significance of various sources of finance. When an entity makes sound decisions on their capital structure, profitability and growth, their values are enhanced which also attract investments (Nash, 2011).

Theoretically, Modigliani and Miller (1958) concluded that, levered entity's market value should equal to unlevered entity's market value at equilibrium point. Thus, Modigliani and Miller theory opines that, capital structure does not affect the value of the entities. Pecking order theory by Myers and Majluf (1985) asserts that financing hierarchy exists where entities start by financing with retained earnings, then debt and finally external equity. Market-timing proposition coined by Baker and Wurgler (2001) infers that, entities' choice on capital structure is by an attempt of timing equity market and trade-off theory by Myers (1984) proposes that a firm balances the costs and debt benefits when determining its optimal capital structure, which increases value and

performance. Costs are financial distress costs and benefit is tax shield.

Capital structure is critical because it determines the final values of firms, therefore necessary decisions pertaining to financing need is critical with an aim of improving the values (Shehzad, 2015). Globally, firm values have declined in the recent decade and among the causes is the failure by entities to address the capital structure component. Firms can have negative effect due to cash flow challenges from poor capital structure decisions. However, those that have addressed capital structure decisions adequately have improved their values (Saboo, 2014). Moreover, profitability has turned out to be very critical since it plays a critical role in the firms' value improvement. A firm's capital structure decision is at the heart of many other decisions and has a huge role to play on profitability, growth, and value. This review intends to act as a critical tool in decision making by the firm's management by providing knowledge to help in future projection of a firm's financial structure and value.

Capital Structure

Linter (2013) infers that capital structure is an entity's equity and debt proportion as well as the cost and the availability of the financing options. According to Mas (2016), capital structure represents the combination of an entity's debt, preferred stock, and common equity, which determines its financial risk and flexibility. Capital structure outlines how organizations fund their operations and investments by using debt and equity, as well as the relative proportions of each type of financing used (Laer, 2014). According to Allen (2016), capital structure is the composition of organization financing sources, including long-term debt, preferred equity, common equity, and other types of securities, as well as the mix of each type of financing. Capital structure

entails the way in which an organization combines various sources of capital, such as retained earnings, debt, and equity finance its day-to-day operations and investment opportunities (Petit, 2001).

Capital structure of an organization is a critical factor because it determines cost of capital, which is the amount an organization must incur in order to obtain monies from investors. The cost of capital can have a significant bearing on organization's profitability and value. When the proportion of debt is very high, its corresponding cost of capital will be high because debt interest payments is a fixed cost, which an entity must pay regardless of its performance (Rehman, 2013). Application of debt can increase an organization's financial risk, as it needs to make regular payments on the debt. On the other hand, use of equity can increase organization's operational risk because equity investors can influence an organization's decision-making. By having a balanced mix of equity and debt financing, a company can ensure it has sufficient funds to meet its obligations while still having the resources to invest in growth (Lukas, 2019). Maximizing values of organizations by adopting right mix of equity and debt is capital structure underlying principle.

According to Roy (2004), financing and investment decisions are integral financial decisions for organizations. Financing decision focuses on how organizations raise monies needed in financing growth and all operations. Financing decision has a bearing on the ability of firms to take on new risks, financial flexibility, and cost of capital. Further, investment decision is critical because it addresses the issue of resources allocation to different investment opportunities. Profitability and future growth of firms are dependent on these decisions.

In measuring an entity's capital structure, Stuart (2018) applied debt to capital ratio. It indicates extent to which a company is financed by debt and the amount of financial leverage it has. High financial leverage makes an entity more vulnerable to financial distress, but can also increase potential returns to shareholders. A lower debt to equity ratio generally indicates a more conservative financing structure. Rozeff (2020) measured capital structure by debt ratio. Jean (2019) parameterized capital structure by analyzing debt levels to amount of equity and debt ratio. Okwar (2017) operationalized capital structure by two measures namely: equity ratio as well as debt ratio. In analyzing capital structure of an organization, debt to capital as well as debt to equity ratio are critical in assessing capital structure.

Profitability

Profit of an organization is the difference of the revenue and its expenses. When an organization offers quality goods and services that outweigh costs, it becomes profitable compared to the competitors (Ruan, 2011). An organization's quality of goods and services it offers is key because clients can pay a higher price provided goods and services are of high quality hence generation of profits. Further, entities must ensure pricing of goods and services is competitive by ensuring it is not too low or too high. Additionally, organizations must ensure costs are minimal by finding ways of producing goods and services efficiently (Ruan, 2011).

Profitability implies the ability and capacity of an organization to generate profits or earnings during its operations. An organization is profitable if it has the capacity to realize more revenue than expenses, which leads to a positive net income (Jumane et al. 2020). Profitability implies the level of yielding a financial gain by organizations. Profitability of a firm is the difference between revenue an

organization receives and its costs (Jeffrey et al. 2022). According to Pipeda (2016), profitability implies efficient management of firm operations to yield a gain. According to Opey (2020), profitability of an organization entails the capacity to derive benefits in an organization within a particular period.

Profitability forms a critical component of an organization because it allows an organization to invest in its future growth, pay dividends to shareholders, and create value for all its stakeholders. A close link is evident between profitability and value. A profitable company is likely to have a higher value than an unprofitable one because it has the ability to generate earnings and cash flows, which it uses in the creation of value for all stakeholders (Rehman, 2013). A company's profitability also affects its stock price, as investors can pay more for shares of a company that is generating strong earnings. Profitability is a key driver of value and a critical factor in assessing a company's financial health and prospects for future growth (Sanghani, 2016).

Profitability ratio indicates the ability of an entity to make profits. Profitability ratios include; operating profit margin, net profit margin, and gross profit margin. These measures vary from firm to firm because of variations of cost structures in different industries, differences in competition and sizes (Jean, 2019). A profit of an entity acts as a benchmark in the determination of alternative financing and various indicators for instance return on assets parameterize it as well as return on equity. (Luh, 2019). ROA measures the ability of an entity as a whole in the generation of profits utilizing the available assets. It also assesses the level of operating efficiency of an entity as a whole. ROE is also critical in measuring profit, which is the measure of an entity's capacity to earn income.

Growth

Growth denotes the point of expansion reached by an organization, seeks additional funding options aimed at generating more profits, and is dependent on; the desire of the owners for equity value creation, growth trends in industries and business lifecycle (Johari & Rosely, 2011). According to Stuart (2018), growth is the organization's financial metrics increase, namely: assets, profits, and revenue. This increase is due to effective cost management and successful market penetration. According to Laer (2014), growth is the extension of operations of a business entity by tapping into different markets. Desy and Nita (2022) opines that, growth is market share expansion of an entity within its industry or target market with an aim of improving its value.

When organizations expand, it leads to improved brand reputation and improved market share (Rozeff, 2020). Growth of organizations is not uniform because it can vary over time. Some organizations can experience rapid growth periods, then slower growth and finally decline. Growth of organizations is by strategic alliances, mergers and acquisitions and internal expansion (Rehman, 2013). According to Penrose (1959), growth of organizations is not always ideal. In some instances, when entities grow rapidly, problems are bound to happen. Some of the problems include loss of focus, financial difficulties, and managerial overload.

Different indicators are critical in operationalizing growth of firms. Common measures include; assets growth, which indicates how, the assets of an organization have increased over time. Sales growth and market share growth are also critical because they indicate increase in sales and a market that a firm controls respectively. A study by Setiadharna (2018) parameterized growth by market share and size of profit. Market share is that proportion of total

market sales an organization captures. Increased market share is an indication that an organization is gaining competitive advantage and expansion of its customer base compared to its competitors (Dinata & Yadnya, 2014). Profit growth highlights how well an organization has managed costs with an objective of generating profits. A study by Adnan and Hamdan (2020) employed assets growth and return on investments in measuring growth. A study by Putu et al (2021) parameterized growth by sales growth and number of employees.

Firm Value

According to Frank (1989), firm value refers to the estimated worth of a business entity, including all its tangible and intangible assets and liabilities, as determined by market capitalization or other valuation metrics. Johnson (2010) opined that firm value is a measure of the intrinsic value of the business, reflecting the quality and sustainability of its earnings, the strength of its brand and reputation, the effectiveness of its management, and its ability to create and capture value over time. According to Lintner (2013), value implies the price, which a buyer incurs in the acquisition of an organization, taking into consideration its strategic fit as well as its current financial position. Common expressions of value include; market value, economic value added, book value, enterprise value and realized value.

Value of an organization is a crucial concept because it aids in the attraction of investors. When the value of an organization is high, potential investors, who are more likely to invest in a company is high because of a strong financial position and growth potential. The value of an organization can have a bearing on the company's stock price, because potential investors employ value as a key measure of organization's financial health (Falope,

2011). A company's firm value is also critical in determining its borrowing capacity, as lenders normally employ it in assessing the company's creditworthiness and ability to repay debts when they are due. Finally, when an organization wants to merge with or acquire another organization, they will consider the target company's value in determining whether it is a worthwhile investment (Kamar, 2013).

Measures of value include; Tobin's Q, price to earnings ratio, dividend yield, and book value of equity. In measuring value, Saven et al. (2017) employed market capitalization. Market capitalization is critical in measuring outstanding shares of stock of a company. Mas (2016) measured value by market to book value of equity. The market to book value of equity (MB ratio) evaluates the value of an organization's equity in relation to its book value. The determination of MB ratio is by the proportion of the market value per share to book value per share. The MB ratio is an important measure for investors because it can help to identify whether a company's stock is overvalued or undervalued. A ratio of less than one indicates undervalued stock, while a ratio of more than one suggests that the stock is overvalued. Market capitalization is critical in measuring value.

Research Problem

Capital structure is of great value and plays a big role in the value of the entities if it is well formulated and managed by the owners of the firms. Optimal capital structure composition and value is still a puzzle in corporate arena. From theoretical perspective, conflicting opinions are evident; Modigliani and Miller (1958) concluded that any capital structure is optimal which implies that a capital structure adopted by any entity cannot change their values. On the other hand, Myers (1984) tradeoff theory concluded that when firms balance costs and benefits

of debt, values are improved. Additionally, growth and profitability effect on firm value is still unresolved because of mixed outcomes. Some literature has confirmed that, high amount of debt translates to high profits while others have confirmed high amount of debt translates to lower profitability and lower growth. In practice, when entities make good decisions on their capital structure, it lead to improved profitability and values.

According to Jeffrey et al. (2022), debt finance provides access to capital that may not be available through other sources. Globally, firm values have declined in the recent decade and among the causes is the failure by entities to address the capital structure component. Growth and entities' profitability trend globally indicate some entities are struggling while others are flourishing. Therefore, investigation is critical especially to aid in understanding whether capital structure, profitability, and growth of the entities explains the variations in the values of the entities.

Putu et al (2021) concluded that, capital structure positively affected profitability; sales growth has negative effect on profitability, and capital structure influences value. Desy and Nita (2022) concluded that, growth, profitability, and capital structure have effect on value. Adnan and Hamdan (2020) confirmed that, capital structure and growth positively affect value. Luh (2019) concluded that, Profitability and firm growth positively affected capital structure and value. Santos (2020) concluded that a positive linkage exist between capital structure and value of insurance business entities.

According to Onyango (2019), capital structure and profitability positively affected firm value. Koros (2019) opined that a significant link exist between capital structure and value. According to Ouma (2019), insignificant link exist between capital structure and value. Theoretically,

existing theories presented contradicting arguments leading to theoretical gaps. Literature confirmed studies in different economies and segments leading to contextual gaps. Additionally, varied outcomes were evident which confirmed conceptual gaps. Methodologically, different data collection and research designs were confirmed leading to methodological gaps. This motivated a review on what is the effect of capital structure, profitability, and growth on firm value.

Research Objectives

The following objectives guides this review

- i) To establish the effect of capital structure on firm value
- ii) To establish the effect of profitability on the relationship between capital structure and firm value
- iii) To establish the effect of growth on the relationship between capital structure and firm value
- iv) To establish the joint effect of capital structure, profitability and growth on firm value

Value of the Study (Informed by the Outcome of the Review)

Sensitization of various industry practitioners who make investment and capital structure decisions. It is critical in the determination and maintenance of optimal financing framework, which aids firms in the exposure against risks. This boosts confidence of the investors as well as maximizing their returns.

Policy makers (government) to formulate necessary mechanisms and strategy to aid in monitoring and evaluating financing aspect of various entities. Identification of specific industry debt thresholds prevents exposure to financial distress.

Acts as an empirical evidence in academic research by adding to the growing literature. It opens room for more studies by academicians and scholars who are researching on capital structure and how it relates to different variables of research.

Organization of the Paper

This paper consists of four main chapters, with the first chapter being the introductory segment of the paper, which includes the background of the study, capital structure, profitability, growth, and firm value, as well as discussed in this part. This part further outlines the research problem, research objectives which guide this review, the review's value and eventually how the paper is organized.

Second chapter is a highlight of major theories namely; trade off theory, market timing theory, pecking order theory, and Modigliani and Miller theory with an aim of establishing their arguments and relevance to this review, and finally interrelation of different study variables.

Third chapter is the discussion of various empirical studies around capital structure: profitability, growth, and firm value. This chapter further gives a highlight of empirical literature reviewed and identified research gaps from the studies and finally the operationalization of the concepts.

In the fourth chapter gives details on, a summary from the reviewed literature, the conclusions on the linkage between study variables, knowledge gaps from the review are also highlighted, and finally areas recommended for further studies are identified. Areas for further studies are critical since it forms the basis for exploration for more insights.

Theoretical Literature Review

Introduction

This segment reviews key theoretical underpinnings guiding the research under

section 2.2 and the theoretical associations among the study concepts, which include capital structure, profitability, growth, and value.

Review of Key Theories

The following key theories explain the link among capital structure, profitability, growth and entities value and they include; pecking order theory of Myers and Majluf (1985), trade off theory of Myers (1984), Modigliani and Miller theory of Modigliani and Miller (1958) and market timing theory of Baker Wurgler (2001).

Pecking Order Theory

Myers and Majluf (1985) coined pecking order theory which was a modification of Donaldson's proposition of 1962 and it asserts that financing hierarchy exists where entities start by financing with retained earnings, then debt and finally equity. Theory assumes that firms have information asymmetries with respect to their financial condition and future prospects, and they would like to minimize the costs associated with such asymmetries (Myers & Majluf, 1985). This theory further assumes existence of information asymmetry and optimal capital structure does not exist.

Some empirical studies have challenged the validity of the pecking order proposition. Theory assumes that organizations will always prefer to use internal funds to other sources of financing, but this may not always be the case (Falope, 2011). For example, firms may not have enough internal funds to finance growth or may prefer to use external financing to take advantage of market opportunities. The theory simplifies the financing decision-making process, but in reality, capital markets are complex, and firms have to consider a variety of factors, such as cost of capital, the terms of financing option, and the impact on their credit ratings, when

making financing decisions (Lintner, 2013).

Overall, pecking order theory is critical in understanding the financing choices of firms, and has significant relevance for financial practitioners of the firms (Myers & Majluf, 1985). It aids in choosing the best financing mix by considering the cost of capital. When managers and investors understand pecking order, they can better understand various variables that influence decisions pertaining financing of the entities and their implications. Therefore, management of firms have a duty to ensure internal financing gets a priority instead of external financing sources with an aim of improving the values of entities.

Pecking order theory has room for improvement by considering assumptions, which are more realistic with regard to asymmetric information. Currently, pecking order theory assumes that, managers of organizations possess perfect information pertaining the value of their organizations; however, it is not always the case. Reality is that, organization's managers may have inaccurate or incomplete information on organization's values. Additionally, more studies are key in confirming how appropriate pecking order theory can predict the behavior of organizations.

Trade off Theory

Myers (1984) coined trade-off theory and it proposes that a firm balances the costs and debt benefits when determining its optimal capital structure, which increases value and performance. According to this theory, companies can benefit from using debt in their capital structure because debt is typically less expensive than equity, as interest payments on debt are tax deductible. However, there is a trade-off because use of too much debt exposes organizations to financial risk, as the firm must repay the debt regardless of its

financial performance (Myers, 1984). On the other hand, equity is more expensive than debt but does not require repayment and does not carry the same level of financial risk.

A number of economists who include; Stewart C. Myers, Richard Brealey and Stewart Myers first founded trade off proposition in early 1970s. Kraus and Litzenberger in 1972 coined the tradeoff proposition, which infers that organizations balance tax advantages of employing debt against financial distress costs. In 1984, Myers improved trade off theory further. Evolution of tradeoff theory was because of key development, which include, Modigliani and Miller concept of interest tax deductibility in 1963.

Trade off theory however has faced criticism. The trade-off theory provides a general prediction about the optimal capital structure, but it does not provide clear guidance on how a firm should adjust its capital structure in response to changes in the economic environment or its own financial position (Gidado, 2020). Theory assumes that entity's capital structure is static and does not change over time. However, in reality, a firm's capital structure may change as it grows and evolves, and the trade-off theory does not account for this dynamic nature.

The trade-off theory is relevant in highlighting capital structure and entity's value linkage. Firms must consider the trade-off and make informed decisions about their capital structure to maximize their value and minimize their risk of financial distress. In conclusion, the trade-off proposition aids in understanding the association between value of organizations and capital structure as it highlights the trade-off between the benefits and costs of using debt with an aim of improving entity values as the key firm objective.

There's need to improve tradeoff theory further by taking into consideration other factors that are likely to affect an organization's optimal capital structure. Currently, the theory only puts more emphasis on debt's tax benefits and financial distress costs. Risk tolerance of organization's management, organization's growth opportunities, and organization's cash flow volatility are other critical factors that can affect organization's optimal capital structure. Incorporating the factors in the model can improve it. More research can also aid in supporting the tradeoff theory theoretical foundations.

Market Timing Theory

Baker and Wurgler (2001) coined market-timing theory. It infers that, entities' choice on capital structure is by an attempt of timing equity market. This implies that, organizations issue equity when they are certain that stock price is high. The following assumptions are critical on the foundation of market timing theory; Debt financing cost is lower whenever the prices of stocks are low. Equity financing cost is lower whenever the prices of stocks are high and finally entities have some capacity of forecasting stock prices in future (Baker & Wurgler, (2001).

Evolution of market timing theory stems from Modigliani and Miller publication of 1958, which attempted to analyze the link of cost of capital of firms, corporation finance, and the theory of investment, which made a conclusion that, firm's capital structure does not affect value. In 1985, Myers and Majluf surveyed corporate financing and investment decisions with the focus when entities have information that investors do not have. Their argument was that, entities having investment opportunities, which are good, might make a choice of financing these opportunities using equity at a high price. Baker and Wurgler (2001) coined market timing theory, which they argued, is the total

outcome of previous attempts of timing equity market.

Market timing theory however has faced criticism. It is not practical to time the market because of high volatility of stock market. Prediction when it will be undervalued or overvalued is not possible because even professional investors tasked with timing the market have always failed to be consistent (Kurshev, 2005). Stock market tends to be unpredictable in most cases. Trying to time the market by too many organizations can be self-defeating since it will become tedious to do so successfully. This is because it will lead to efficiency in the market at pricing stocks making it difficult for organizations to find stocks, sell, or to buy.

Market timing theory is critical in linking capital structure and value by asserting that issue of equity at high prices by organizations increases cost of capital. On the other hand, repurchase of equity at low prices by organizations reduces cost of capital (Graham, 2003). Therefore, timing of the market by organization can select a capital structure that is capable of minimizing cost of capital hence maximum value. Market timing theory aids organizations by supporting the idea that organizations should give priority to equity financing.

There's need to improve market timing theory further by taking into consideration other factors that are likely to affect an organization's capital structure. Currently, the theory only puts more emphasis on cost of equity as the sole determining factor of entities capital structure. Agency costs of debt and tax benefits of debt are other critical factors to consider when doing an evaluation of market timing theory. Market timing theory assumes that organizations can do a perfect timing of the market, do an issue of equity when equity cost is low, and do a repurchase of equity when equity cost is high. Cost of trading and cost of

information are some costs associated with market timing, which can potentially reduce market-timing benefits. Adjustments is critical to this market timing theory to incorporate other facts such as managers having other motives when issuing equity.

Modigliani and Miller Theory

Modigliani and Miller (1958) opines that, capital structure does not affect the value of the entities. Following assumptions guide MM theory: capital markets are perfect which implies access of similar information to all investors. Transaction costs are not incurred which facilitates buying and selling of securities. No existence of bankruptcy costs which include; financial distress costs, loss of reputation or legal fees. No agency costs, which implies there is perfect alignment of all stakeholders' interests. Theory further assumes same expectations existing among the investors regarding riskiness of the organization or future cash flows. Finally, investment policy of entities is unaffected by various decisions on financing and it remains constant.

Modigliani and miller theory has witnessed some refinements and extensions. The theory has witnessed some modifications aimed at incorporating real-world factors, which potentially affects value of firms. Modigliani and Miller (1963) did extensions in the model to make it realistic by introduction of agency costs, bankruptcy costs, and taxes. Agency costs affects organization's value. For instance, taking on riskier projects by management with an objective of increasing their own compensation. This leads to utilization of more debt by firms leading to increased risk of bankruptcy and reduced firm values. Bankruptcy costs infers to costs of a firm when it goes bankrupt. Some of the costs include administrative costs and legal fees. High-levered organizations are more likely to go bankrupt, which can lead to

significant costs leading to loss of value. Taxes positively affects value because of tax shield.

Some scholars have criticized Modigliani and Miller theory, according to Gibbs (2005), markets may always not be efficient based on the assertions of access to information and same investors' expectations. This leads to mispricing and theory's predictions deviations. Additionally, Modigliani and Miller theory overlooks agency costs. Agency costs emanates from the management of conflicts of interest arising between agents who are the employees or principals and managers who are the shareholders or owners of organizations. MM theory does not take into consideration the critical function of capital structure in signaling the market. In reality, corporate organizations may utilize decisions on capital structure in signaling future prospects (Gibbs, 2005).

Modigliani and Miller theory remains relevant because it highlights the driving fundamental factors, which are critical in an organization, which include riskiness of cash flows and the capacity of the entities in generating operating income. Thus, Modigliani and Miller theory opines that, capital structure has no effect on organization's value. What matters is how these firms employ the resources. Additionally, it emphasizes the risks of debt use since high levels of debt can amplify occurrence of financial distress, which can negatively affect the operations of organizations. Therefore, the firms should ensure minimal wastage of the resources to guarantee maximum values (Modigliani & Miller, 1958).

Modigliani and miller theory has some future improvements; it can incorporate more other factors. Modigliani and miller theory ignores a number of key factors, which can equally affect value. Some of the factors include company's growth opportunities, risk, and cost of equity.

Improvements can lead to a more comprehensive model that incorporates these factors. Some of the assumptions that MM theory bases its arguments on unrealistic assumptions. Hence, the need for improvement aimed at relaxing the assumptions and developing a model, which is more realistic. More research is paramount since the theory has been widely challenged; this will give room for more rigorous empirical tests to confirm the validity of Modigliani and Miller theory. Theoretically, a gap exist because Modigliani and Miller theory contradicts trade off theory.

Theoretical Relationships

This section covers the theoretical relationships between the variables, which include independent variable, response variable, intervening variable, and moderating variable.

Capital Structure and Firm Value

Johnson (2010) opines that, capital structure has a positive link with value because debt financing can lower the cost of capital because debt is generally cheaper than equity financing because lenders expect to receive a fixed interest rate on their investment, while equity investors expect a higher return to act as risk shield. Therefore, companies can reduce their cost of capital by using more debt financing. This can increase the company's value, as the lower cost of capital can lead to higher value. However, using too much debt can decrease the company's value, as investors may perceive the company as riskier and demand higher returns to compensate for the risk.

Trade off theory opines that, capital structure positively affects value. When an entity uses debt financing, it benefits from the tax shield, which focuses at improving the values of entities. Achievement is by identifying an optimal financing strategy of the firms. Tax shield is critical in enhancing firms' values. On contrary, when debt is in

excess, cost of capital and financial risk increases which potentially reduces value of the entities. Pecking order theory by Myers and Majluf (1985) opines that, the order of financing is critical, for firms to attain higher values, they must adopt financing hierarchy strategy. Hierarchy exists where entities start by financing with retained earnings, then debt and finally external equity.

Capital Structure, Profitability and Firm Value

According to Hauge and Senbet (1988), the industry in which business organizations operate in determines their success and value. For instance, some business organizations are more capital-intensive which can directly affect their capital structure. Such firms invest heavily in equipment and plant thus debt financing is the best option. A positive link exist between profitability and value because when firms are more profitable, they can easily repay their obligations in time and can generate enough cash flows for supporting future growth. According to Gopi (2013), efficient utilization of debt enhances profitability and value.

Market inefficiencies is a powerful tool managers employ to better the value of their firms. Market timing theory of Baker and Wurgler (2001) opines that, management can issue equity when share prices are high and do a repurchase when stock prices are low by considering investors' pessimism or over optimism. Additionally, high profitable entities are likely to use debt to finance their activities because they can generate high returns from investment and repay their debts. If organizations can time the market, they will increase profits and values.

Capital Structure, Growth and Firm Value

Johari and Rosely (2011) asserts that, a link exist between capital structure, growth, and value and it varies among different entities. When organizations have high growth

opportunities, the entities have the capacity to apply debt financing since the application of debt can aid them in financing growth and ownership of the shareholders cannot get dilution. This leads to high values. On the other hand, organizations with low growth opportunities do not have capacity for high debt financing due to inadequate resources hence low values. Additionally, competition is key in shaping this relationship because firms in competitive industries use more debt.

According to trade off theory, growth prospects of a firm has a bearing on its optimal capital structure. Repayment of debt is high in high growth prospects firms with an objective of taking more debt. It will be easier to service debt payments because future earnings of entities will be high this will better the values of organizations. However, if plans of growth do not go as expected, organizations with high growth will fall into financial distress (Myers, 1984). Because more cash will fund growth, which could adversely affect debt payments thus reducing values of the entities.

Joint Effect of Capital Structure, Profitability and Growth on Firm Value

Value of an entity is dependent on amount of debt it uses. Business organizations with high debt levels are very risk thus low value. Contrary, debt is also critical in financing growth, which translates to high values, which will also be dependent on access to capital, growth opportunities, and risk profile (Kim, 2015). More organizations that are profitable can easily generate more cash flow critical in investing in growth to attain high values. Further, growth of organizations determines their values because organizations growing rapidly are more valuable compared to organizations growing slowly.

The Peking order theory opines that, entities, which are highly profitable, have positive cash flows. This implies that, organizations are less reliant on financing with external funds because of lower costs of capital leading to high values. Additionally, organizations with high growth opportunities are compelled to use external sources of funds to enhance profits (Myers & Majluf, 1985). Profitability of the firms implies that firms can easily offset the higher costs of debt. Thus, growth and Profitability have a positive association with value because business organizations, which are more profitable and have high growth opportunities, have high values.

Empirical Literature Review

Introduction

This segment presents various empirical studies on study variables; this section further highlights the summary of empirical literature review and research gaps and finally the conceptual framework.

Empirical Studies

This section reviews past studies with an aim of identification of future extension and research gaps, which include; conceptual gaps, contextual gaps and methodological gaps.

Capital Structure and Firm Value

Bilalif and Ibrahim (2019) carried out a research in Kenya aimed at assessing capital structure and value linkage. Continued losses despite increased use of debt was the motivation of the survey. Two hundred and twenty firms was the population and the survey analyzed 170 manufacturing entities as study sample with the utilization of primary information. Equity and debt ratios indicated capital structure and Tobin's Q indicated value. Positivism research philosophy, cross sectional design and multiple regression, technique were key in the analysis. Study

ignored diagnostic tests. Conclusion was that high debt levels increased values. Study contradicted a study by Lawal (2018) which confirmed insignificant relationship of capital structure and value. Survey disregards other critical variables controlling CS and value link. The survey used primary data. Future studies to consider secondary data because of collection of large volume of data to ensure conclusive results.

Galpin (2019) carried out a research in Ghana's manufacturing sector aimed at assessing capital structure and value linkage from 2016 to 2019. Variations in values motivated the survey to test whether CS explain the disparity. Sample of 112 firms was the target of the survey. Secondary data was critical in the analysis and descriptive research design. Market capitalization and EPS were the indicators of value; debt to equity was a key measure of capital structure. Positivism research philosophy and multiple regression analysis aided the analysis. Survey disregards other critical variables controlling CS and value link. Survey confirmed that capital structure had insignificant effect on the value of the firms. Research conducted some diagnostic tests. Future studies to adopt longer study period since it aids in identification of changes over time.

Lawal (2018) analyzed how the value the firms were related with their capital structure. High regulation of capital structure of insurance sector motivated the study. The study focused in Nigerian insurance sector from 2015 to 2018. The study used secondary data in the analysis and descriptive research design. Sample of the study was 64 banks. Despite use of panel data, study used descriptive research design instead of longitudinal research design. Market capitalization and debt ratio were key indicators of capital structure. Positivism research philosophy and multiple regression analysis aided the

analysis. Survey opined a link between capital structure and value with insignificant effect. Study contradicted a study by Bilafif and Ibrahim (2019). Survey disregards other critical variables controlling CS and value link. Outcome is limited to insurance sector. Different sectors have unique characteristics that can influence values.

Capital Structure, Profitability and Firm Value

Manawaduge et al. (2019) carried out a research in Sri Lanka aimed at assessing capital structure and value linkage with mediation of profitability from 2017 to 2019. Desire to understand interplay of profitability motivated the survey. Survey used the secondary data in the analysis and descriptive research design. Despite use of panel data, study used descriptive research design instead of longitudinal research design. Study targeted 452 companies. Short study period leads to inconclusive outcomes. Positivism research philosophy and multiple regression analysis aided the analysis. Analysis concluded major findings namely; no evidence of direct association between capital structure and the entity's value and that profitability affects the market value and the association is significant. Not all diagnostic tests done. Focus of the survey was developed economies, which leads to non-applicability in developing economies. Future studies can focus in developing countries because of contextual differences.

Setiadharna (2018) carried out a research in in Greece aimed at assessing capital structure and value linkage with mediation of profitability from 2015 to 2018. Descriptive research design was critical in the analysis. Panel research design was critical in this study because of panel data with a sample of 145 insurance firms. Fixed effect regression analysis was the method of analysis. Positivism research philosophy was critical. From the analysis, it was

evident that debt ratio significantly affected profitability and the effect was a positive outcome. Not all diagnostic tests done. Profitability has no effect on value. Focus of a single sector (insurance) limits the extension of study outcome to multi-industry set up.

Sambasivam and Ayele (2018) carried out a research in Iran aimed at assessing the decisions on capital structure on value. Profitability was the mediator variable. They focused on the firms in the agricultural sector. Eighty-seven firms was the target of the survey and the survey analyzed 41 entities with the utilization of primary information in the survey. Cross sectional design with the aid of questionnaire was the study's design and data collection respectively. Positivism research philosophy and multiple regression analysis aided the analysis. Analysis concluded that capital structure decisions affected the value of the entities. Not all diagnostic tests done. Profitability has no effect on value of the entities. The survey used primary data. Future studies can use secondary data because of collection of large volume of data to ensure conclusive results.

Capital Structure, Growth And Firm Value
Ahmad and Mohamed (2019) analyzed how the values of the firms in Kuwait Stock Exchange in Kuwait changed by use of different capital structure mix and firm growth from 2012 to 2016. Desire to understand interplay of growth motivated the study. The study used the secondary data. Descriptive design was critical in the survey. Census aided in the identification of the study population of 48 companies. Panel data analysis aided in the analysis. Positivism research philosophy and multiple regression analysis aided the analysis. Survey outcome revealed that capital structure and growth opportunities of the entities are significant influential of the entities' values. Not all diagnostic tests

done. Focus of the analysis was in developed economies, which leads to non-applicability in developing economies.

Adnan and Hamdan (2020) conducted a study to establish how the value of the firms in Jordan were affected by capital structure and firm growth from 2014 to 2020. The study used secondary data in the survey due to its availability. Descriptive research design was employed in this survey with the focus on 36 industrial entities at Amman Stock Exchange. Not all diagnostic tests done. Capital structure was indicated by debt ratio and equity to assets ratio. Positivism research philosophy and multiple regression analysis aided the analysis. Survey outcome revealed that, capital structure and growth positively affect value of firms. Study focused on industrial firms, which limits the extension of study outcome to multi- industry set up.

Kreen and Sagn (2019) conducted a study to assess the relationship between leverage, growth and their effect on the value of the firms in South Africa. Focus of the survey was from the year 2016 to 2019. The study used the secondary data and panel research design to select the sample of the 67 firms in the investment sector. Market capitalization and EPS were the indicators of value. Positivism research philosophy and multiple regression analysis aided the analysis. Study indicated that there was a significant link between leverage, growth and investment firm's values. Period of survey was short. Not all diagnostic tests done. Focus of a single sector (investment) limits the extension of study outcome to multi- industry set up.

Joint Effect of Capital Structure, Profitability and Growth on Firm Value
Putu et al (2021) in Indonesia analyzed the link between capital structure, sales growth, and profitability on the values of the entities in the cosmetic and household needs manufacturing entities. Desire to understand interplay of profitability and

growth motivated the study. Focus of the survey was from 2009 to 2019 by purposive sampling which targeted five entities. The study used the secondary data. Descriptive research design was critical in analysis and path analysis aided the survey. Positivism research philosophy and multiple regression analysis aided the analysis. Study results revealed that capital structure positively affected profitability, sales growth has negative effect on profitability, and finally capital structure is capable of influencing value through profitability. Not all diagnostic tests done. Despite use of panel data, study used descriptive research design instead of longitudinal research design. Study used a very small sample and the focus was on manufacturing entities only, which limits the extension of study outcome to multi- industry set up.

Desy and Nita (2022) in Indonesia investigated the link among profitability, growth, and capital structure on value with the focus on non-go public banks from 2017 to 2020. From a population of 105 entities, 19 banks was the focus of the survey by random sampling method. The study used the secondary data in the analysis. Descriptive research design was utilized in this study. Positivism research philosophy and multiple regression analysis aided the analysis. Short period of time was used which may not give conclusive outcome. It was confirmed that, profitability, growth and capital structure have a joint effect on value. Despite use of panel data, study used descriptive research design instead of longitudinal research design. Focus of a single sector (banking) limits the extension of study outcome to multi- industry set up.

Luh (2019) in Indonesia investigated the link among profitability, growth and capital structure on value with the focus on food and beverage entities on Indonesia Stock Exchange from 2015 to 2017. Twenty entities was the focus for survey by census

sampling method. The study used the secondary data in the analysis. Descriptive research design was utilized. Positivism research philosophy and multiple regression analysis aided the analysis. It was confirmed that, profitability and firm growth positively affected capital structure and value and growth mediates the link between profitability and value. Despite use of panel data, study used descriptive research design instead of longitudinal research design. Short period of time was used which may not give conclusive outcome. Future studies can consider longitudinal research design because of panel data.

Summary of Empirical Literature Review and Research Gaps

Table 1 shows a summary of past studies done on study variables.

Table 1: Summary of Literature Review

Author	Focus of Study	Methodology	Findings	Research Gaps
Setiadharm (2018)	Capital structure, profitability, capital structure growth, and value of insurance firms in Greece	Fixed effect regression analysis	Debt ratio significantly affected profitability and profitability was confirmed to have no effect on value	Focus was financial sector and non-financial sector was excluded
Sambasivam and Ayele (2018)	Profitability, capital structure and value of agricultural firms in Iran	Multiple regression analysis	Capital structure affected value and profitability has no effect on value	Researcher used limited variables. Limited variables limits study scope
Lawal (2018)	Capital structure and value of insurance firms in Nigeria	Multiple regression analysis.	Capital structure had insignificant effect on value	Short time period considered. Longer study period not considered
Manawaduge et al (2019)	Capital structure, profitability and value of insurance firms in Sri Lanka	Multiple regression analysis	Capital structure has no effect on value and profitability positively affects value	Focus was developed economy. Developing economies were excluded
Kreen and Sagn (2019)	Leverage, firm growth and value of the firms in South Africa	Multiple regression analysis	Significant relationship between leverage, growth and value	Focus was investment sector. Non-financial sector was excluded
Luh (2019)	Firm growth, capital structure, profitability and value of firms in Indonesia Stock Exchange	Multiple regression analysis	Profitability and firm growth positively affected capital structure and value	Focus was developed economy. Developing economies were excluded

Author	Focus of Study	Methodology	Findings	Research Gaps
Galpin (2019)	Capital structure and value of firms in Ghana	Multiple regression analysis	Capital structure had insignificant effect on value	A shorter period considered. Longer study period not considered
Bilafif and Ibrahim (2019)	Capital structure decisions on firm value	Descriptive statistics	Debt positively affects value.	Primary data used. Secondary data was ignored
Ahmad and Mohammed (2019)	Capital structure, growth and value of the firms in Kuwait	Panel data and panel analysis	Capital structure and growth significantly affects	A shorter period considered. Longer study period not considered
Adnan and Hamdan (2020)	Capital structure, growth and value of firms in Jordan	Multiple regression analysis	Capital structure and growth positively affect value	Focus was developed economy. Developing economies were excluded
Putu et al (2021)	Sales growth, capital structure, profitability and value	Multiple regression analysis	Capital structure positively affected profitability, sales growth has negative effect on profitability, and capital structure influences value	Focus was on private firms. Publicly owned entities were excluded
Desy and Nita (2022)	Profitability, growth and capital structure on value of non-listed banks	Multiple regression analysis	Profitability, growth and capital structure have a joint effect on value	Focus was non-listed banks. Listed banks were excluded

Summary of Empirical Literature Review and Research Gaps

Literature on empirical review discussed the studies emanating from different study variables globally and regionally. Key highlights from the literature pointed out that, studies reviewed have not combined similar moderating and mediating variables as the current survey. The focus of most surveys was the link between capital structure and value and other variables other than growth and profitability. Conceptual gaps are evident in instances where the focus was on different concepts under same topic.

Contextual and methodological gaps were too evident from reviewed literature. Use of primary data to analyze the study variables confirmed methodological gaps. Further different methods of analyzing data instead of relying on one method gives rise to methodological gaps and contextual gaps are evident when the focus of the surveys is in varied contexts. Contextual gaps were evident; focus of studies were in different geographical set up, which ranged from developed to developing economies as well as different sectors. Focus of a single sector limits the extension of study outcome to multi- industry set up.

Research Hypotheses

The study will test the following null hypotheses:

H₁: The relationship between capital structure and firm value is not significant.

H₂: The intervening effect of profitability on the relationship between capital structure and firm value is not significant.

H₃: The moderating effect of growth on the relationship between capital structure and firm value is not significant.

H₄: Joint effect of capital structure, profitability and growth on firm value is not significant.

Conceptual Framework

This review seeks to analyze the relationship among capital structure, profitability, growth, and firm value. The explanatory variable is capital structure as measured by debt to equity ratio and debt to capital ratio, moderating variable is growth as measured by revenue growth, market share growth and assets growth. Intervening variable is profitability as measured by net profit margin, return on equity and return on assets and firm value is the response variable as measured by Tobin's Q.

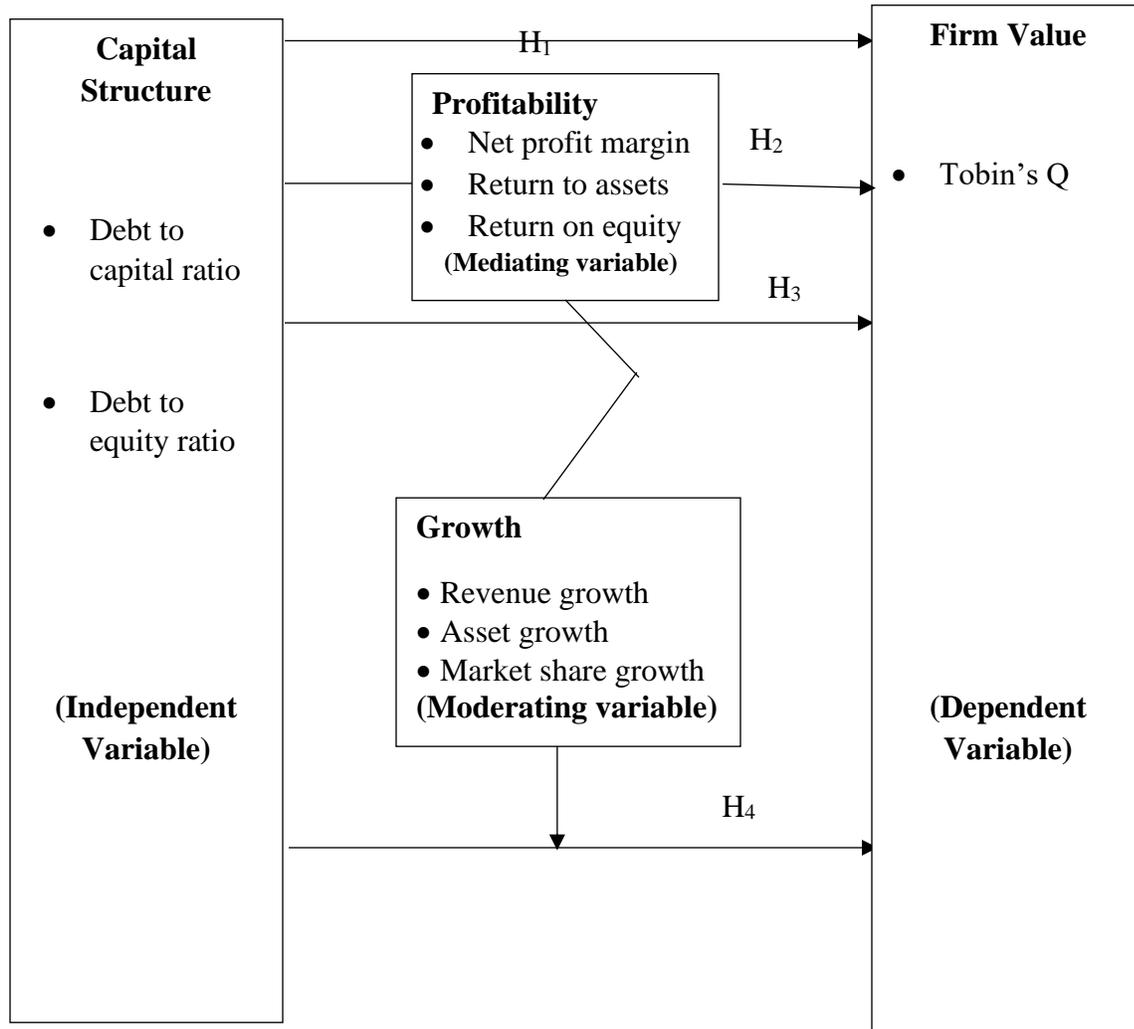


Figure 1: Conceptual Model

Summary, Conclusion And Recommendations

Introduction

This section gives the summary of the literature on capital structure, profitability, growth and value, conclusion is also given in this chapter, this section further identifies the knowledge gaps from the literature reviewed and finally recommendations for further research is provided.

Summary

Capital structure plays a big role in the value of the entities if it is well formulated and managed. Optimal capital structure composition is still a puzzle in corporate arena. The objective of this survey was to investigate the relationship among capital structure, profitability, growth, and firm value. The study also reviewed different theories namely: Modigliani and Miller theory (Modigliani & Miller, 1958), pecking order theory by Myers and Majluf (1985), market-timing theory by Baker and Wurgler (2001) and trade-off theory by Myers (1984).

Literature on empirical review discussed the studies done globally and regionally. Key highlights from the literature pointed out that, conceptual gaps were evident for instance, the focus of most surveys was the link between capital structure and value and other variables other than growth and profitability. Conceptual gaps were evident as studies confirmed different data collection and analysis methods and finally contextual gaps were evident since studies' focus were in different geographical set up leading to contextual differences.

Discussion also include hypothesis, which was key in informing research hypotheses. The four null hypothesis include; the relationship between capital structure and firm value is not significant, the intervening effect of profitability on the relationship

between capital structure and firm value is not significant, the moderating effect of growth on the relationship between capital structure and firm value is not significant. Joint effect of capital structure, profitability and growth on firm value is not significant. Highlights also include conceptual framework depicting the relationship existing among variables.

Conclusion

Capital structure decisions are critical in the determination of the survival and final values of entities. Firms must make informed decisions about their capital structure in order to maximize their value and minimize their risk of financial distress. The study reviewed the theoretical linkage between capital structure and value of firms. Mixed results was the outcome from studies. Study concludes that, some studies confirmed that capital structure was critical among different entities globally since it had an effect on their values. Some studies however confirmed that capital structure did not affect the value.

Profitability forms a critical component of an organization because it allows an organization to invest in its future growth, pay dividends to shareholders, and create value for all its stakeholders. A positive link exist between profitability and value because when firms are more profitable, they can easily repay their obligations in time and can generate enough cash flows for supporting future growth. Conceptual gaps were evident from the empirical literature, most studies failed to incorporate the intervening effect in their analysis.

When organizations have high growth opportunities, they have the capacity to apply debt financing since the application of debt can aid them in financing growth and ownership of the shareholders cannot get dilution. This leads to high values. On the

other hand, organizations with low growth opportunities do not have capacity for high debt financing due to inadequate resources hence low values. Conceptual gaps were evident from the empirical literature, most studies failed to incorporate the moderating effect in their analysis.

Profitability of the firms implies that firms can easily offset the higher costs of debt. Thus, growth and Profitability have a positive association with value because business organizations, which are more profitable and have high growth opportunities, have high values. From the study review, it was evident conclusive studies lack on the joint relationship between capital structure, profitability, growth, and value of firms. Contextual gaps were evident, focus of most studies was in different geographical set up, and segments, which ranged from developed to developing economies and finally methodological gaps indicated that, researchers employed different methodologies in their studies.

Knowledge Gaps Identified

From the review, conceptual gaps were evident. It was evident that most studies took keen interest on the direct linkage between capital structure and the value of entities but failed to consider the influence of profitability and growth exhaustively. This review therefore observes existing conceptual gap on the linkage existing between capital structure and entities values and intends to utilize a number of variables to enable better understanding of capital structure and firm values concepts. Literature review pointed out that, study period was short in some studies. The current study not only links the direct effect of capital structure on value, but also incorporates the intervening and moderating aspects.

Contextual gaps were evident; focus of studies were in different geographical set up, which ranged from developed to developing economies as well as different sectors. The study also concluded that there are no conclusive findings as the focus of most studies was in developed countries whose markets are well established. Focus of a single sector limits the extension of study outcome to multi- industry set up because of contextual differences.

Methodological gaps were evident from reviewed literature. Use of primary data to analyze the study variables confirmed methodological gaps. Further different methods of analyzing data instead of relying on one method gives rise to methodological gaps. The relevance of capital structure has more room for studies and in spite of a number of studies, the actual linkage between capital structure, profitability, growth and firm value is not clear. These inconsistencies in the outcomes call for a more conclusive review to unearth the truth on the actual linkage between capital structure, profitability, growth, and value of firms.

Recommendations for Further Research

Financial leverage which is the amount of debt financing an organization uses in the acquisition of more assets is frequently employed by firms in order to avoid the use of too much equity in funding their activities. Globally, firm values have declined in the recent decade despite increase in debt capital financing. Due to the risk of failure associated with financial leverage, this study recommends a critical evaluation of the influence of financial leverage on the value of firms.

Financial performance of the business entities seeks to assess the financial health especially during the turbulent times. Any

business entity before fully comes successful, it is always faced with challenges for example the decline of sales and its profits. This can be mitigated by making a proper capital structure decisions. Therefore, a study can be done but focus on capital structure and performance of the entities.

Research has indicated that, different research indictaors are likely to yield different outcomes. Future studies are suggested for the same study variables but applying different indicators of study variables with an aim of comparing the outcomes.

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