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## A STRUCTURED LITERATURE REVIEW OF CAPITAL STRUCTURE AND IT'S IMPACT ON FINANCIAL PERFORMANCE

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### Abstract

The literature on capital structure theory and its impact on different variables are abundantly available. Search for the term “Capital Structure” on Google Scholar shows more than 4.5 million results. However, the topic retains attraction for researchers. Regular development in the domain, like buyback of shares has kept the subject vibrant and open for debate. This article takes stock of recent research on the subject with a focus on the linkage between capital structure (CS) ie Debt/Equity and financial performance (FP) variables . The structured literature review shows interesting results. While there is consensus amongst researchers that CS impacts FP, there is a clear conflict about the direction of the impact. This article presents an analysis of 30 recent research works on the linkages between CS and FP.

**Keywords:** structured literature review, research, Debt/Equity performance variables.

### Introduction and method for the review

Despite loads of investigations taken up in the area of capital structure, the topic remains most favorite research candidates in the domain of finance. Regular development in the field, like buyback of shares has kept the subject vibrant and open for discussion and debate. This article showcases findings from a structured literature review of recent research of 30 studies on the impact of capital structure (CS) on financial performance (FP).

The University of Queensland, Australia (2020), a world top 50 University ([www.topuniversities.com](http://www.topuniversities.com), 2020), has given a framework for carrying a literature review. It has outlined the process as under –

- 1 Establish research territory
  - 2 Establish the significance of research territory
  - 3 Establish a research forte
  - 4 Motivate the subsequent part of the review of literature
  - 5 Further, justify the need to investigate the topic
  - 6 Discuss one important paper at a time and for each paper:
  - 7 Overall conclusion that states the reason why a particular methodological approach has been selected.
- In line with the above steps, a preliminary literature review of around 50 items was carried investigating the subject of capital structure theories and its impact. Following research gaps were found from the preliminary literature review–
1. The literature review showed that limited factors or few determinants of capital structure have been analyzed.
  2. Some researchers have studied predominantly the Trade-off theory or Pecking order theory and their relevance to the firm’s CS, while others have excluded them from the study.
  3. The methods used for analysis are majorly descriptive statistics, regression analysis; however other methods of analysis have not been used much for investigation.
  4. A complete set of financial performance factors has not been listed down by the researchers. Few parameters like ROA, ROE, and EPS are the ones that are predominantly studied.

5. Financial data analysis has been for short time durations and so the measurements are not sufficient to predict future trends.

The gap motivated the researcher for further review as per step 4 specified in The University of Queensland guidance. The fifth step is to further justify the need to investigate the topic. The sixth step points out towards carrying a rigorous literature review so that there is a clear ground established for further research. This background laid the foundation for attempting a structured literature review in the area. Structured literature review (SLR) or systematic literature reviews allows to inspect contradictory and/or instantaneous result, as well as to recognize themes that require further inquiry (Journal of European Psychology Students, 2018).

#### **The settings for the SLR were –**

- a. Focus on the impact of capital structure (CS) on financial performance (FP),
- b. Selection of recent 30 studies on the topic so that a reasonable size is formulated,
- c. Analysis of the studies based on parameters like sample, size, method used for analysis, and findings of the study.

#### **Methodology for the SLR was as under –**

- a. A popular search engine Google Scholar was chosen and search terms used were “impact of capital structure on financial performance”.
- b. First, relevant recent studies that have been carried in the year 2020 were selected for the review.
- c. Additional studies were selected going backward into earlier years and selection was stopped when the sample size of 30 articles was reached.
- d. Two specific aspects were probed – does the research support a connection between capital structure and financial performance and if yes, is the direction of the association positive or negative?

#### **Following hypotheses were accordingly set –**

Ho1 – There is no significant association between capital structure and financial performance as reported by researchers in recent times

Ha1 – There is a significant association between capital structure and financial performance as reported by researchers in recent times

In this case values of 1 and 0 were used for association and non-association respectively.

Ho2 – There is no difference between the results of the association between capital structure and financial performance as reported by researchers in recent times

Ha2 - There is a difference between the results of the association between capital structure and financial performance as reported by researchers in recent times

In this case values of -1, 1, and 0 were used for a negative association, positive association, and only specific or non-association respectively.

A t-test was used at a 95% confidence level to test the hypotheses.

## **Literature Review**

### **2.1 Theoretical Foundations**

Before venturing into the SLR a brief review was carried in respect of the theoretical foundations of the concept of capital structure.

In the early 1960s, which was considered as the earliest study of the capital structure was completed by Modigliani and Miller(MM), with the assumptions like perfect markets and no tax world they proposed that the choosing debt-equity was not dependent on the value of the firm and later it was followed by the other investigators. Jensen and Meckling (1976) identified that there are 2 types of conflict between holders of debt and equity shareholders & shareholders and managers. Agency cost theory suggested that a firm’s managers are mainly interested to maximize their benefits and least in

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maximizing wealth of the shareholders'. Therefore, the shareholders of the firm try to discourage the interests by control and monitoring actions which also projects cost that is the agency cost. Myers (1984) and Myers and Majluf (1984) made a valuable contribution in CS literature and provided Static Trade-off and Pecking Order Hypothesis respectively. According to the Pecking Order Theory, the firm should implement a specific pecking order for financing its assets. To begin with, the firm should utilize funds generated internally i.e. retained earnings there after debt and if more finances are required then assets should be through equity capital. The trade-off posited that firms should have an best possible capital structure based on balancing linking the benefits of debt and the costs of debt. In other words, the firm sets target DE ratio according to the necessity and nature of business and then steadily moves to attain it. Many researchers find that multiple variables are there that have an effect on the capital structure selection in different countries. Scott (1972), Carleton and Silberman (1977), Marsh (1982), Bradley et al (1984), Castanias (1983), Long and Malits (1985) Titman and Wessels (1988), state that operating risk, durable assets, non-debt tax shields, increased growth opportunities, and firm size all these factors have positive correlation with the leverage, as a substitute of capital structure (dependent variable), although, profitability and individuality of the product, volatility, advertisement expenses, bankruptcy probability, R&D expenses have negative correlations with leverage. Ferri and Jones (1979) studied the determinants of capital structure and considered, risk associated with business, type of industry, size of the firm, and operating leverage. They found independent variables, except for risk associated with business, seemed strongly related, although the type of industry, had a weak relationship. Aggarwal (1981) expressed that, profitability, rate of growth, and risk associated with international trade are not sufficient factors to decide the choice of capital structure, and some significant variables such as type of industry need to be considered. He adds "country-effect" as an additional significant variable in shaping a firm's capital structure. Park (1998) also states the national culture is to be regarded as an independent variable(IV) in such studies. From the pecking order theory point of view, highly profitable firms usually use more internally generated resources to back the firm at the cost of using debt or putting shares in the market. Profitability is related to the accessibility of internal funds and hence may be related to less leverage according to the pecking order theory (Baker and Wurgler, 2002). Therefore, firm leverage & profitability are negatively related to each other. Bartoloni (2013) found confirmation to lend credibility to the inverse firm leverage & profitability relationship. He states that more lucrative firms generally tend to use more of internal finance, as by the inverse relationship connecting a firm's debt ratio with the return on sales. Further author states that, the role of profitability in lessening the need for external finance features all firms, in spite of their size as measured by employment, although large firms tend to show a low sensitivity of leverage to variations in profit. This finding is also supported by the pragmatic proof found by Lemma et al (2014); Al-Najjar et.al (2011); Ahmad et al (2011); Ahmed et al (2010); Frank et.al (2009); Antoniou et al (2008); Utrero-González (2007); Faulkender et.al (2006); Hovakimian et al (2001); Booth et al (2001); and Rajan et.al (1995) amongst others. Contrarily the trade-off theory posits positive association between leverage and profitability. From the trade-off theory perspective, highly profitable firms are likely to make use of more debt, in order to gain from the debt-interest tax shield and maximize the value of the firm. As per Hovakimian et al (2004), the positive firm leverage-profitability relationship can arise due to a number of reasons. For instance, other things remaining the same, higher profitability leads to potentially high tax savings from the debt, potentially higher overinvestment, and lower probability of bankruptcy, which means a debt ratio with higher target. This view is supported by Myers (2001) who declare that high profitability implies that the firm has at its disposal more taxable income to shield and that the firm can serve more debt without assuming the risk of financial distress. Notwithstanding this, it is plausible to infer that prediction of both the pecking order and trade-off theories are accepted as they are supported well by practical findings of equivalent measure. However

it is informative to state that the predictions go together and do not contradict with each other. This was verifiable in Hovakimian et al (2004) who suggested that their results on profitability could be regarded as an interface of the trade-off and pecking order theories. They go on to observe that particularly, if firms have any target debt ratios, also if the firms have a preference for internal funds over the external financing, then the firm's tendency to debt issuance when operating performance is higher, as stated by the target leveraged hypothesis, will be tempered by a preference for financing internally. The policy of issuing equity when operating performance is poor shall be reinforced by the internal funds that are lacking, leading the firm to look for equity an external financing.

## **2.2 Structured Literature Review (SLR)**

The SLR focused on studies examining relationship between capital structure and financial performance.

Parikh et.al(2020) in their paper titled, 'Impact of Capital Structure on Firm's Financial Performance: With Special Reference To Selected Automobile Companies Listed on BSE' used Multiple regression analysis on 5 companies. The findings showed that there existed negative relationship between capital structure and firm performance.

Ngatno et.al (2020) in their research paper 'Moderation Effects of Organizational Environment on the Relationship between Capital Structure and Financial Performance of Central Java Rural Banks, Indonesia' studied 241 firms and used Moderating regression analysis. Results showcased that negative relationship existed between capital structure and firms performance.

Nguyen et.al (2020) in a paper titled 'Capital structure and firm performance of non-financial listed companies: Cross-sector empirical evidences from Vietnam' studied 488 firms and analysed data with the help of Regression Analysis. The researcher found that the Capital structure of listed non-financial companies of Vietnam is negatively related to the performance.

Reddy (2020), the researcher in his paper 'A Paper on Capital Structure – An Analysis of Sugar Factories in Karnataka State' applied Ratio Analysis on 8 firms. The conclusions drawn from the analysis lacked clarity.

Tripathy et.al (2020), in their research work titled 'Leverage and firm performance: Empirical evidence from Indian food processing industry' studied 56 firms. The OLS Regression was used to analyse the data collected. The finds showed that Leverage was significantly associated with the performance of the firm.

Babajee et. al (2020), in their research on the topic 'The determinants of hotel financial performance: an intellectual capital perspective, studied 43 firms and used Dynamic panel data framework for data analysis. The findings show that Leverage is observed to impact on Performance of the firm adversely.

Vu et. al (2020) in their paper, 'The impact of capital structure on the performance of construction companies: A study from Vietnam stock exchanges' used Regression analysis to analyse data of 59 Construction companies. The major findings showed that D/E had a strong and positive effect on Roe.

Doan (2020), in his paper 'Financing decision and firm performance: Evidence from an emerging country', compiled data for 102 firms and used Regression analysis. The findings have shown that an Increase in debt use decreases firm performance.

Miglo (2020) has in his research on 'A New Capital Structure Theory: The Four-Factor Model', has tried to co-relate the four factors. The conceptual framework was used by the researcher to develop a model.

Gurusanthosini (2020) in the paper, 'Impact of Capital Structure on Firm's Financial Performance: Indian Cement' has used Correlation and the Ordinary Least squares models on 38 companies. The findings showed that the Debt to Assets had a statistically negative impact on performance of the firm measured in terms of ROA.

Eleje et. al (2020), the researchers in the paper 'Debt Finance and Corporate Performance: Firm Level Empirical Evaluation' have studied a single firm and analysed that although the tenure is long and short

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debt finances may not have an positive impact on Roa and Roe. The long tenured debt could help in enhancing slightly the corporate performance of the firm.

Mutua et.al (2020) in their paper have used Regression analysis and studied 8 listed companies from the Manufacturing sector in Nairobi. The researchers found that long term debt ad a positive impact measured in terms of Roe on performance.

Ramli et. al (2019), in their paper titled , ‘ Determinants of Capital Structure and firms financial performance –A PLS-sem approach: Evidence from Malaysia and Indonesia ‘ , have used a sample size of 20 companies. The asset structure, opportunities for growth, the liquidity, the interest rate & the non-debt tax shield attributes were indirectly inclined by the leverage on financial performance of the firm.

**Peiris (2019) in the paper titled ‘Capital structure, industry influence, and financial performance: evidence from Sri Lanka’** , have used Regression analysis on 51 companies. The analysis showed that Return on assets ratio is significantly correlated with all the capital structure proxies and the net profit margin has significant correlations with the long term debt to funds ratio and total debt to funds and short term debt ratio

Ajmera (2019), in the paper titled , ‘An Empirical Study on Effect of Capital Structure on Financial Performance of Paper Manufacturing Companies in India: Penal Data Analysis’ have used Ratio Analysis & Co-relation technique on 10 companies. The findings showcase that the D/E ratio, long term D/E ratio, size of the firm, log of debt and interest coverage ratio has an insignificant impact to EPS

Chavali et.al, (2018) in their research paper on , ‘Relationship between capital structure and profitability: a study of non banking finance companies in India’, has performed Correlation analysis on 23 companies. The mean value of D/E ratio indicated that debt is more than 4.17 times of the equity capital of firms under consideration. The Debt to Total Assets (TA) indicated that on an average more than 60% of the Total Assets in Non Banking Financial Cos. is in debt. NBFCs in India are found to be highly levered .

HERCIU Mihaela et.al, (2017) have studied 59 firms in their research paper , ‘Does capital structure influence company Profitability?’, and have used Correlation analysis. The major findings show that the companies under study and their profitability can be increased by implementing an optimal liabilities structure

Mohamed Tailab, (2014), in is research article , The Effect of Capital Structure on Profitability of Energy American Firms, has used Multiple Regression on 30 companies and found that their existed a negative /positive relationship between the LTD, D/E and TA and profitability.

Sivalingam et.al (2018) , the researchers have in their paper on , ‘Capital structure and financial performance: a study on commercial banks in Sri Lanka’ have studied 10 banks .They have used correlation analysis and inferred that TD to TA ratio was negatively correlated to Roe. The growth in deposits of banks under study was positively correlated to Roe. the findings also showed that STD to TA, LTD to TA and size of the firm were significantly not related to Roe.

Khun, and Ratanak, (2018) used Partial Least Square Method on 10 firms in their research article , ‘Capital Structure, Growth and Profitability: Evidence from Domestic Commercial Banks in Cambodia’ .The findings showed that the Capital structure (CS) & its variables ie. DE, equity to loan , and equity to deposit (ED) had a negative impact on Roa and Roe. The significance level used for this study was 1%..

Mahfuzah et.al (2012), researched on the topic, ‘Capital Structure and Firm Performance: Evidence from Malaysian Listed Companies’ and applied the Regression model on 237 companies. Firm performance, was measured by researchers in terms of Roa, Roe and Eps. It showed that the performance variables had a negative relationship with Std ,Ltd & Td which are regarded as independent variables.

Md. Ataur Rahman et.al (2019) in the paper titled , ‘ The Impact of Capital Structure on the Profitability of Publicly Traded Manufacturing Firms in Bangladesh’ have analysed data of 10 firms. The Coorelation

analysis technique was used to analyse the data. Finding show that the D/E ratio have a positive and significant impact on Roa but a negative impact on Roa.

Ameen et.al (2017), ‘Impact of Capital Structure on Firms Profitability: Evidence from Cement Sector of Pakistan’, have used data of 18 companies and used both the Correlation as well as Regression to analyse the data. Major findings of the study are that Debt ratio and LTD ratio have a negative relationship with Roa & Roe which are profitability determinants.

Joseph et. al, (2016), ‘Relationship between Financial Structure and Financial Performance of Firms Listed at East Africa Securities Exchanges’, have in their paper used Multiple Regression on selected 61 firms and data collected from their financial statements. The STD,LTD, retained earnings and equity that is external raised had a negative relationship with Roa but insignificant and positive relationship with return on equity Roe.

Md. Abdur Rouf, (2015), in his research work on ‘Capital Structure and Firm Performance of Listed Non-Financial Companies in Bangladesh, have used Regression analysis on 106 firms. Findings of the research are that Debt Ratio(DR), D/E Ratio and Proprietary of Equity Ratio (PER) have a negative and significant relationship with Roa and Ros.

Das et.al (2018), in a paper on ‘Influence of capital structure on Financial performance’ have performed Regression Analysis on 50 firms . The researchers found that there is a relationship that is positive & significant between ROA, ROE, ROCE and Variables of CS.

Perera (2017) in his study, ‘A Study on the Impact of Capital Structure on Financial Performance of Listed Companies in Sri Lanka (Evidence from Beverage Food’ have on 21 companies financial data used techniques like ratio analysis and correlation. The researcher found that there is a positive & significant relationship between financial performance & capital structure of selected firms.

Pinto et. al (2017), in his paper on ‘Capital Structure and Financial Performance of Banks’, have used Regression on financial data collected of 21 banks. Findings show that CS has a positive & significant impact on the FP of the selected banks.

Mohammad et. al (2019) in his paper on Capital structure and financial performance of Malaysian construction firms have studied financial data of 41 firms. Regression was conducted on the data and it was found that there existed positive association between long term debt and Roe.

Sivalingam et. al (2018) in his paper on , ‘Capital structure and financial performance: a study on commercial banks in Sri Lanka’ have conducted regression on 10 banks and found that TD to TA ie Total Debt to total assets are negatively correlated to Roa

## Results

Results on the association of capital structure (CS) with financial performance (FP) vary. While most of the researchers have found a significant association, there are cases where this association was not found. Moreover, wherever significant association was found three results were reported – positive correlation, negative correlation, and only significant association. The summary of the result analysis is shown in Table 1 below :

**Table 1 Summary of SLR outcomes**

Sr. No	Association	Type of Association
1	Found – 25 studies	Positive association 11 studies
		Negative association 11 studies
		Only significant 3 studies
2	Not found – 5 studies	No association 5 studies
	Total - 30 studies	Total - 30 studies

The SLR data was processed further to test following hypotheses –

Ho1 – There is no significant association between capital structure(CS)and financial performance (FP) as reported by the researchers in recent times.

Ha1 – There is a significant association between capital structure (CS)and financial performance (FP)as reported by researchers in recent times.

In this case values of 1 and 0 were used for association and non-association respectively.

Ho2 – There is no difference between the results of the association between capital structure and financial performance as reported by researchers in recent times.

Ha2 - There is a difference between the results of the association between capital structure and financial performance as reported by researchers in recent times.

In this case values of -1, 1, and 0 were used for the negative association, positive association, and only specific or non-association respectively.

A t-test was applied at 95% confidence level and summary of calculations are given in Table 3 below –

**Table 3 Statistical testing of the hypotheses**

Parameter	H1	H2
Average	83%	0%
SD (Standard Deviation)	0.37905	0.870988
H1 (Average of sample)	0%	0%
Ho (Hypothesized mean of population)	0.83	0.00
N (Sample size)	30	30
t-value (t-statistic value)	12.04	0.00
p-value (probability value)	<0.00001	0.500000

While the first hypothesis was rejected, the second one could not be.

Thus it was concluded that even though there is a significant association between CS& FP as reported by researchers in recent times but it is difficult to decide the direction of the association (positive or negative).

## Discussion and conclusion

The median sample size of the 30 SLR studies is 30. Most of the studies have taken the sample sizes on an ad-hoc basis without applying any scientific basis. Sample sizes like 1, 5, 8, 10, 20 etc. can be called as case-studies. But their conclusions cannot be generalized. It is important that the sample size has to be reasonable enough to lead to proper conclusions. Some sectors like the pharmaceutical sector have been ignored to a great extent. This is quite surprising given the fact that pharmaceutical firms are capital intensive and capital structure decisions are quite important in terms of financial management. Further the number of studies carried in developing nations like India is relatively limited if compared to other regions of the world. Indian economy is the world's 5th largest in terms of GDP. At the same time, money in India is quite costly. These factors warrant for more research on capital structure in India.

The preliminary review, one that dealt with theoretical foundation and the SLR shows that –

1. Studies on capital structure and its impact are on a large scale.
2. Two theories ie. Trade-off and Pecking Order, have been largely researched, discussed and debated.
3. Financial performance is generally measured in terms of Roe,Roa,etc.
4. By and large there is a consensus among researchers that CS has an impact on FP variables.
5. The SLR shows that –
  - a. Most of the researchers carry a sector-wise study of the impact of capital structure on financial performance,
  - b. The median sample size of the organizations studied was 30. The minimum sample size was 1 organization while the maximum was 488 organizations.

- c. Regression analysis is a commonly applied tool for the study.
- d. Findings from the 30 studies are a mixed bag as discussed earlier. While there is a clear majority in favor of an impact of CS on FP variables, the direction and impact is not at all clear. Very interestingly, the analysis revealed exact 11 positive impact studies for 11 negative impact studies. Given the conflicting outcomes of the direction of the impact of CS on FP, more research is warranted. While doing so, it is suggested that researchers should draw the sample size scientifically. Further impetus is required for research in this area in a country like India where the existing levels of research are pretty low.

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