

Effect of Capital Structure on Corporate Profit. Evidence from Cement Manufacturing Firms in Nigeria

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Abstract *The study empirically investigated the effect of capital structure on corporate profit; evidence from cement manufacturing firms in Nigeria. It focused on quoted cement manufacturing firms in Nigeria from 2004-2013 using ex-post facto research design. Multi regression analysis was used to test the hypotheses. The findings were that, there exists a positive and significant effect of short term debt, long term debt and shareholder's fund on the profit of cement manufacturing firms in Nigeria. The study recommends among others that, management should adopt a sound financing mix which will be beneficial to firms in the long run also; policies by Government should create a favourable macro-economic environment for cement companies to operate profitably.*

Key words Capital structure, corporate profit, short term debt, long term debt, shareholder's fund, cement manufacturing firms

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1. Introduction

Cement manufacturing firms no doubt play a significant role in the Nigerian economy. They engage in production of cement for construction needs of other sectors of the Nigerian economy. Capital structure in cement firms is made up of long term and short-term debts, retained earnings and equity (Messbacher 2004). The importance of capital structure to corporate financial stability, growth and adequate returns of cement manufacturing firms is very important. Yet, these vital issues of capital structure and its effect on financial performance of cement firms are under researched (Akintoye 2008). Primarily, capital structure consists of external and internal sources of financing which includes, long term and short term debts, retained earnings and equity (Okwoli 2011).

According to Amidu (2007), finances are crucial to the survival of firms as blood is to the human body. As crucial as financing decisions of the firm are, most financial managers make capital structure decisions not necessarily out of empirically verified evidence (Akinsurile 2008). Myers (2005) discovered that large number of business failures in the past have been due to the inability of the financial managers to correctly identify and take advantage of the economical sources of financing for their firms based on empirically verified information.

To Jensen and Meckling (2011), some of the criteria some financial managers use in practice to make capital structure decisions are not based on empirically proven principles; rather they use impressive rules of thumbs for identifying sources of financing. The result is collapse of such firms in the long run due to financial distress. Abor (2005) observed that, most company failures are due to capital structure decisions taken by financial managers without empirically verifying the effect of such sources of financing on the profitability of such companies. Though literature exists on capital structure and profits of firms, the collapse of firms due to wrong combination of capital structure necessitated the researchers to undertake a study of the effect of capital structure on corporate profits of cement manufacturing firms in Nigeria.

The study has the following specific objectives:

- i. To examine the effect of short term debt on the profit of cement manufacturing firms in Nigeria.
- ii. To examine the effect of long term debt on the profit of cement manufacturing firms in Nigeria:

iii. To examine the effect of shareholders fund on the profit of cement manufacturing firms in Nigeria.

1.1. Research Hypotheses

The following null hypotheses were constructed in order to examine the above objectives.

Hypothesis One (H₀₁): There is no significant effect of short term debt on the profit of cement manufacturing firms in Nigeria.

Hypothesis Two (H₀₂): There is no significant effect of long term debt on the profit of cement manufacturing firms in Nigeria.

Hypothesis Three (H₀₃): There is no significant of shareholders fund on the profit of cement manufacturing firms in Nigeria.

The rest of the paper is organized and presented in the following sections seriatim: Literature review, Methodology, Data presentation and analysis, Conclusions and recommendations.

2. Literature review

2.1. The Concept of Capital Structure

Many authors have defined capital structure in several ways. According to Akinsurile (2008). Capital structure is described as the components of debts and equity, used by a company to finance its operations, and which usually consist of ordinary share capital, preference share capital and debt capital. These definitions are not specific as to the nature of debts that constitute part of the capital structure since debts could be short term or long term. Pandey (2004) opines that, capital structure is the proportionate relationship between debt and equity financing of firms. In the views of Okwoli (2011), capital structure deals with the question of what happen to the total valuation of the firm and its cost of capital when the ratio of debt to equity or degree of leverage is varied. In others words, Capital structure is a mix of equity and debt. Equity he posits is taken to mean ordinary shares plus retained earnings while debt is taken to mean all fixed interest bearing stock.

A business concern can go for different levels of the mixture of equity, debt and other financial facilities with equity having the emphasis on maximizing the firm's market value. Capital structure refers to the various financing options of the asset by a firm and it affects the profitability of such a firm (Rahemen, Zulfiquar and Mustafa, 2007). Capital structure of a company is a subset of the financial structure: which in addition to the components of capital structure also includes short term debt and accounts payable. Capital structure in this case can be seen as a mix of a company's long term debt, specific short term debt, common equity and preferred equity (stock).

Thus, capital structure could be referred to as the financial leverage of a company or the proportional relationship or ratios between the company's debt and equity.

2.2. Composition of Capital Structure of a Firm

The capital structure of a firm comprises of both the long-term sources of finance which include debt and equity financing, and the short-term sources of finance. Myers (2005) in his study identifies that the capital structure of a firm ranges from internal financing to external financing. The internal financing is made up of largely retained earnings while the external financing include debt financing and equity financing. In similar fashion, Lewellen and Lewellen (2005) and Frank and Goyal (2007) concur that the capital nature of a firm ranges from internal finance, which include retained earnings to external finances, that is, debt and equity. Zoppa and McMahon (2002) identify a more comprehensive capital structure composition, based on their study of Australian small and medium scale businesses capital structure behavior. Consequently, they identified that a company's capital structure should include the following;

- i. Reinvested profits (retained earnings);
- ii. Short-term debt financing like trade credit;
- iii. Long- term debt financing like debentures and long term debts among others;
- iv. New equity capital injections from existing owners;
- v. New equity capital from un-invested parties like outside investors, venture capitalists among others.

2.3. The Concept of Profit

Profit is the excess of revenues over associated cost/expenses for an activity, transactions or events in a period. The term has similar meanings with words such as earnings, income, and margin. Every business should earn sufficient profits to survive and grow over a long period of time. It is the index to economic progress, improved national income and rising standard of living. Profit is not only concerned with the proprietors but also income-tax authorities, managers, directors among others. This is because all of them are to get a percentage of net profit (Chandra, 2002).

The term profitability refers to a situation where the income generated during a given period exceeds the expenses incurred over the same length of time for the sole purpose of generating income (Banwo, 1999; Sanni, 2006). The fundamental requirements here are that the income and the expenses must occur during the same period of time (Matching Concept) and the income must be a direct consequence of the expenses. According to Harward and Upton (2007), profitability is the ability of a given investment to earn a return from its use. The importance of profitability, therefore, stems from its being the 'raison d'etre' (purpose) of business. A company remains in operation because it expects to make profits. Once that expectation is confirmed unattainable, the most rational decision is to liquidate. Sometimes, the terms 'Profit' and 'Profitability' are used interchangeably. But in real sense, there is a difference between the two. Profit is an absolute term, whereas, the profitability is a relative concept. However, they are closely related and mutually interdependent, having distinct roles in business.

Profit refers to the total income earned by the enterprise during the specified period of time, while profitability refers to the operating efficiency of the enterprise. It is the ability of the enterprise to make profit on sales. It is the ability of enterprise to get sufficient return on the capital and employees used in the business operation.

2.4. Review of Empirical Studies

Modigliani and Miller in Woods (2009) studied the impacts of capital structure on firm profitability in America. They used times series and regression analysis. Their major findings were that there exists a significant relationship between capital structure and firms profits. They recommended that managers should ensure an optimal capital structure mix for enhanced performance. Titman in Wilshere (2010), empirically investigated the collapse of some firms in Kenya, using simple regression analysis, he concluded that, most managers take financial decisions based on primordial motives. He recommended a careful analysis of the best debt-equity mix by firms for improved value.

Myers and Majluf in Gbolaham (2010) did a study on firm distress in India. Regression analysis was used. The major finding of the study was that, managers take financing decisions for selfish reasons. He recommended that, firms should rather take advantage of the services financial analysts before taken financing decisions. Adereti (2012) investigated that relationship between profitability and firm's leverage in Oyo state in Nigeria. He used multiple regression analysis. He discovered that firm's with high profits maintain relatively lower debts levels. He recommended the use of internally generated sources of revenue. Cassar and Holmes (2003) carried out a study on the collapse of banks in Nigeria, using regressing analysis. They discovered that most bank managers took financing decisions based on selfish motives. They recommended that financial experts' opinion be sought before such decisions are made.

Ishola (2011) examined the corporate survival and profitability of some selected firms in Ibadan. He used multiple regression analysis. He found out that some financing decisions were based on attempt to post profits at all cost so that managers' jobs will be saved. He cautioned that expert opinion should be considered. Amidu (2007) examined the impact of capital structure and profitability of commercial banks in Ghana. The study used multiple regression analysis. One of his major findings was that, there was a significant relationship between total debt and profitability. He therefore recommended the prudent management of such external debt for optimal impact on banks' profits.

Akintoye (2008) investigated the rampant cases of failure of public firms in Lagos state in Nigeria. He used a regression analysis. He found out among other things that managers of such collapsed firms took financing mix decisions based on personal interest and that of their superiors. He recommended that professionals be involved in such decisions.

Pandey (2004) empirically examined the effect of corporate debt on profitability of firms in the hotel industry in India. He used regression analysis and found out that, there was no significant relationship between corporate debt and profits of firms. He recommended the use of internally generated sources of funds.

3. Methodology of research

An ex-post facto research design was adopted; it is a quasi-experimental study examining how independent variables present prior to the study, affect dependent variables.

3.1. Population of the Study

The population of this research work comprise of ten cement manufacturing firms quoted on the Nigerian stock exchange (NSE). These are Cement Company of Northern Nigeria Plc, Bua Cement Plc, Dangote Cement Plc, Obajana Cement Plc, Bauchi- Gwana Cement Company Plc, Ashaka Cement Company Plc, Lakataba Cement Company Plc, West Africa Portland Cement (WAPCO) Plc, United Nigeria Cement Company Plc and Nigerian Cement Company (NigerCem) Plc.

3.2. Sample Size

The sample consisted of four firms They are Ashaka Cement Plc, West Africa Cement Company Plc Lagos, United Nigeria Cement company(UniCem) and Lakatabu Cement company. The sample was drawn using purposive sampling technique. Four cement companies with the highest values of total assets were selected for the study.

3.3. Data collection Technique

Secondary source of data was used for this study. The data was extracted from the audited annual financial reports of the sampled firms for ten years (2004-2013).

3.4. Techniques of Data Analysis

In analyzing the data collected from the documentary sources, multiple regression technique using panel data was used.

3.5. Variables Definitions

The dependent Variables: One dependent variable is used to operationalize firm profit in the study. This is return on assets (ROA). ROA is the ratio of net income to total assets.

The Independent Variables: These are long term debt measured by the ratio of long term debt to total capital, short term debt measured by the ratio of short term debt to total capital and shareholders fund measured by the ratio of shareholders fund to total capital.

Control Variable: Firm size has been used as control variables to minimize specification bias. The size of the firm will be measured by the logarithm of its total assets as the original large value of the total assets may disturb the analysis.

3.6. Model Specification

The theoretical and empirical literature in corporate finance has identified a vector of variables that influence firm profitability including debt, decomposed into short-term debt, long term debt and retained earnings. The relationship between Capital structure and cement manufacturing firm's profitability in Nigeria is thus estimated in the following regression models:

$$\text{Profit}(Y) = f(\text{Capital Structure}) \quad (1)$$

$$P_{it} = \Delta_0 + \beta_1 \text{STDA}_{it} + \beta_2 \text{LTDC}_{it} + \beta_3 \text{SHF}_{it} + \beta_4 \text{CoSIZE}_{it} + \epsilon_{it} \quad (2)$$

Where:

P_{it} = represent ROA return on the assets for firm i in time t ;

ROA = It is Net Income measured as the percentage change in income of the cement firms (Net Income divided by Total assets);

STDA = is the short term debt measured by the ratio of short term debt to total asset (Short-term Debt divided by Total Assets);

LTDC = is the long term debt measured by the ratio of long term debts to total capital (total assets);

SHF = is the shareholders fund measured by the ratio of shareholders fund to Total assets;

CoSIZE = is firm size and is measured as the logarithm of the total assets of the firm;

t = is error structure defined as firms unobserved effects;

Δ_0 = the regression constant (That is intercept of the equation);

$\beta_1, \beta_2, \beta_3, \beta_4,$ and β_5 = the change coefficient for the independent variables;

I = Number of firms (1-4);

t = the number of firms and time period for the series (2004 to 2013);

A priori expectation

$\beta_1 > 0, \beta_2 > 0, \beta_3 > 0, \beta_4 > 0.$

3.7. Decision Rule

- (i) A p-value lower than 0.05 is taken as evidence to reject the null hypothesis.
- (ii) A p-value greater than 0.05 is taken as evidence to accept the null hypothesis.

4. Data Presentation and Analysis

4.1. Data Presentation

This section presents data collected and utilized for the analysis of the research objectives and testing of the hypotheses of the study. Raw financial data were collected on return on assets (ROA), short term debt (STD), long term debt (LTD), shareholders fund (SHF), total liabilities and total debt. The data were regressed using E-view 7.0 and inferences were drawn from it. The summary of the regression result from the E-view 7.0 output were presented in a tabular form from which detailed analysis was given.

Table 1. Regression Results

Dependent Variable: ROA

Method: Panel Least Squares

Sample: 2004- 2013

Periods included: 10

Cross-sections included: 4

Total panel (balanced) observations: 40

VARIABLE	Coefficient	Std. Error	t-Statistic	Prob
STD	0.214859	0.043932	2.159220	0.00338
LTD	0.558745	0.257916	2.166383	0.0075
COSIZE	-0.023017	0.029519	-.167383	0.2957
SHF	0.241387	0.031776	3.505381	0.00439
C	1.116958	0.568641	1.964261	0.00529
R-SQUARED	0.635111	MEAN		31.55952
		DEPENDENT VAR		
ADJUSTED R-SQUARED	0.559567	S.D DEPENDENT VAR		0.368174
S.E OF REGRESSION	0.062499	AKIAKE INFO CRITERION		2.612699
SUM SQUARED RESID	0316394	SCHWARZ CRITERION		2.362718
LOG LIKELIHOOD	126.5715	HANNAN-QUINN CRITER		-2.511892
F-STATISTIC	35.11227	DURBIN-WATSON STAT		1.605655

Source: E- VIEW.7.0

Based on the E-view 7.0 output above, profit as impacted by the independent variables can be determine by the equation:

$$P_{it} = 1.12 + 0.2148 \text{ STD} + 0.5587 \text{ LTD} - 0.0230 \text{ CoSIZE} + 0.2413 \text{ SHF}$$

The result of the regression analysis is interpreted as follows:

- a. The coefficient of determination R^2 shows that only 63% of the variation is explained by the independent variables while 37% remain unexplained
- b. The coefficient of correlation, $R = 0.55$ means that there is a strong positive relationship between profit and the capital structure in the cement manufacturing firms in Nigeria.
- c. The F- statistic of 35.11 is statistically significant. It shows that the regression model is valid and that the proportion of the variation in the capital structure explained by the regression equation is significant.
- d. The value of the intercept $C = 1.12$ is the predicted capital Structure if all the in dependent variables are equals to zero.
- e. The coefficient of the independent variables shows that if all other variables are held constant:
 - i. Every NI increase in short term debt will increase profit value by 21 units;
 - ii. Every NI increase in long term debt will increase profit value by 55 units;
 - iii. Every 1N increase in shareholders fund will increase profit value by 24 units.

4.2. Test of Hypotheses

This section analyses the three hypotheses using the E-view 7.0 supported by the analyses of correlation matrix of the variables of the data collected. The correlation matrix was employed to establish the strength of the relationship between firm capital structure and profit. This applies to hypotheses 1 - 3. This method was chosen because each of the hypotheses measures the relationship between one dependent variable and several independent variables. The main objective is to determine which has significant effect on the profit of cement companies in Nigeria.

4.2.1. Test of Hypothesis one

Ho: There is no significant effect of short term debt on the profit of cement manufacturing firms in Nigeria. The method used and its formula is thus:

Short term debt

Total Asset

$$P_{i,t} = a_0 + \beta_1 \text{ STD}_{it} + \beta_2 \text{ LTD}_{it} + \beta_3 \text{ SHF}_{it} + \beta_4 \text{ CoSIZE}_{it} + \epsilon_{it} \quad (3)$$

Translated with values as:

$$(730607Nm)_{it} = a_0 + \beta_1 (98712907Nm)_{it} + \beta_2 (954831())_{7Nm}_{it} + \beta_3 (58890611Nm)_{it} + \beta_4 (5,005508Nm)_{it} + \epsilon_{it}$$

P_{it} = Return on Assets (ROA) represented as profit;

STD = is the short term debt measured by the ratio of short term debt to total asset (Short-Term Debt divided by Total Assets);

LTD = is the long term debt measured by the ratio of long term debts to total capital (total assets);

SHF = is the shareholders fund measured by the ratio of shareholders fund to total assets;

CoSIZE = is firm size and is measured as the logarithm of the total assets of the firm;

$\epsilon_{i,t}$ = is error structure defined as firms unobserved effects. a_0 = the regression constant (i.e. intercept of the equation);

$\beta_1, \beta_2, \beta_3,$ and β_4 = the change coefficient for the independent variables;

$i,$ = the number of firms (1-4);

t = time period for the series (2004 to 2013).

The regressed results are presented below.

Table 2. Extract of Regressed Result from Table 1

Dependent Variable: ROA

Total panel (balance) observation: 40

Variable	Coefficient	Std. Error	t-Statistic	Prob.
SHORT TERM DEBT	0.211859	0.057916	2.740950	.00338

Table 3. Correlation between Dependent and independent variables

		Return Assets
Short term debt	Pearson correlation	0.5370
	Sig. (2-tailed)	0.001
	N	40

Interpretation of Results from the table 3 and 4above, the regressed result on the relationship between profitability and short-term debt is 0.211859 which is positive and significant. Also, from the correlation table 3, it is observed that the relationship is significant and positive. The P-value is 0.00338 which is far below the set value of 0.05.

Decision

We therefore reject the first null hypothesis H_{01} .

4.2.2. Test of Hypothesis Two

H_{02} : There is no significant effect of long term debt on the profit of cement manufacturing firms in Nigeria.

The method used and its formula is thus:

Long-term debt

Total Asset

$$P_{it} = a_0 + \beta_1 STD_{it} + \beta_2 LTD_{it} + \beta_3 SHF_{it} + \beta_4 CoSize_{it} + \epsilon_{it} \quad (4)$$

Translated with values as:

$$(730607Nm)_{it} = a_0 + \beta_1(98712907Nm)_{it} + \beta_2(95483107Nm)_{it} + \beta_3(2752370Nm)_{it} + \beta_4(5,005508Nm)_{it} + \epsilon_{it}$$

P_{it} = Return on Assets (ROA) represented as profit;

STD = is the short term debt measured by the ratio of short term debt to total asset (Short-Term Debt divided by Total Assets);

LTD = is the long term debt measured by the ratio of long term debts to total capital (total assets);

SHF = is the shareholders fund measured by the ratio of shareholders fund to total assets;

CoSIZE = is firms size and is measured as the logarithm of the total assets of the firm;

ϵ_{it} = is error structure defined as firm's unobserved effects;

a_0 = the regression constant (i.e. intercept of the equation);

$\beta_1, \beta_2, \beta_3,$ and β_4 = the change coefficient for the independent variables;

$i,$ = the number of firms (1 - 4);

t = time period for the series (2004 to 2013).

Table 4. Extract of Regressed Results from table 1

Dependent Variable: ROA

Total panel (balance) Observation: 90

Variable	Coefficient	Std. Error	t-Statistic	Prob
Long term debt	0.558745	0.075077	0-76229	0.0075

Table 5. Correlation between dependent and independent variables

		RETURN ON ASSETS
LONG TERM DEBT	Pearson correlation	0.107
	Sig. (2-tailed)	0.316
	N	40

Interpretation of Result

From table 4, the regressed result on the relationship between profit and long term debt is 0.0558745. Meaning profit and long term debt are positively related and significant at 5% confidence level. In the same vein, the correlation matrix also gave positive and significant results. The p-value for the long-term debt as it impact on profit is 0.0075 this is well below the set target of 0.05.

Decision

We therefore reject the second null hypothesis H_{02} .

4.2.4. Hypothesis Three

H_{03} : There is no significant effect of shareholders fund on the profit of cement manufacturing firms in Nigeria.

In determining the size of the firms, we took the natural logarithm of the total assets of the firms in the study. Logarithm of Total Assets was used as Formula.

$$P_{it} = a_0 + \beta_1 STD_{it} + \beta_2 LTD_{it} + \beta_3 SHF_{it} + \beta_4 CoSize_{it} + \epsilon_{it} \tag{5}$$

Translated with values as:

$$(730607Nm)_{it} = a_0 + \beta_1(98712\$/07Nm)_{it} + \beta_2(95483107m)_{it} + \beta_4(5,005508Nm)_{it} + \epsilon_{it}$$

STD = is the short term debt measured by the ratio of short term debt to total asset (Short-Term Debt divided by Total Assets);

LTD = is the long term debt measured by the ratio of long term debts to total capital (total assets);

SHF = is shareholders fund and is measured as the ratio of shareholders fund to total assets;

CoSIZE = is bank size and is measured as the logarithm of the total assets of the firm;

ϵ_{it} = is error structure defined as firms unobserved effects;

a_0 = the regression constant (i.e. intercept of the equation);

$\beta_1, \beta_2, \beta_3,$ and β_4 = the change coefficient for the independent variables;

i = the number of firms;

(1-4) t = time period for the series.

Table 6. Extract of Regressed Results from table 1

Dependent Variable: ROA

Total panel (balance) observation: 90

Variable	Coefficient	Std. Error	t-Statistic	Prob.
SHAREHOLDERS FUND	0.241387	0.001776	0.781339	0.00439

Table 6. Correlation between Dependent and Independent Variables

		RETURN ASSETS
SHAREHOLDERS FUND	Pearson correlation	0.151
	Sig. (2-tailed)	0.156
	N	90

Interpretation of Result

From table 5 and 6 above, the regressed result on the relationship between profit and shareholders fund is 0.241387. This means that shareholders fund is positively related to profit and the relationship is significant. The correlation results in table 6 are not far from the regressed results in table 5. The p-value for shareholders fund is 0.00439. This is well below the set target of 0.05.

Decision

We therefore reject the third null hypothesis H_{03} .

5. Conclusions

The study investigated the effect of capital structure on the profit cement manufacturing firms in Nigeria over the period 2004-2013. Using panel data methodology, it was discovered that short-term debts, long term debts, and shareholders fund have significant effect on the profit of cement manufacturing companies in Nigeria.

The study also found out that profitable cement firms in Nigeria use more debt and depend less on equity sources of financing.

6. Recommendations

Based on the findings from this research work the following recommendations have been made.

1. Bond Market: The government, through Central Bank of Nigeria, Securities and Exchange Commission should continue to strengthen the bond market so that cement firms can raise a lot of long-term debt which they need to meet their long term profit goals.

2. Debt Financing: As the current interest rates are alarming and could make debt financing unattractive, there is need for government and regulatory bodies such as the Central Bank of Nigeria to intervene by prevailing on the creditors, particularly banks to reduce their interest" rates to a reasonable level.

3. Sound Financing Policy: Since financing decision *is* the bedrock of firms' operation and activities, management should seek to develop and adopt sound financing mix that will be most beneficial to the industry in the long run.

4. Favourable Macro-Economic Environment: Policies concerning interest rates, monetary policies, exchange rate exposure and management and strengthening of the Nigerian Stock market and general improvement in the economy must be made in such a way that the business environment will be favorable for the cement firms to operate.

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