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THE EFFECT OF SHARE CAPITAL FINANCE ON PROFITABILITY OF PETROLEUM MARKETING FIRMS IN KENYA

Motanya Daniel Omai
DBA-Finance, Department of Commerce and Economics, College of Human Resource Development, Jomo Kenyatta University of Agriculture and Technology (JKUAT), Kenya
motanyaomai@gmail.com

Florence S. Memba
Jomo Kenyatta University of Agriculture and Technology (JKUAT), Kenya

Agnes G. Njeru
Jomo Kenyatta University of Agriculture and Technology (JKUAT), Kenya

Abstract

The petroleum sector in Kenyan is highly regulated by the government such that, the government sets all prices for most energy products. It is expected that the increased number of petroleum marketing companies over time is as a result of good returns in the sector but there opposite going by happenings in the market. The study's main objective was to assess the effect share capital finance on profitability of petroleum marketing companies in Kenya. A positivist philosophy was adopted to enable testing of the study hypothesis. The study adopted cross-sectional survey design with criterion sampling being used to arrive at 35 firms' between 2007-2016. Primary data was collected by use of Questionnaires along with secondary data. Descriptive statistics and Univariate tests (t-test and Pearson correlation) were carried out. The results indicated that share capital has a negative but insignificant effect on profitability at 5% level. This is based on the p-values corresponding to the coefficients equivalent to -0.174, hence the study failed to reject the hypothesis with 95% confidence level as during the period of study, use or lack of use of share capital finance doesn't affect firm profitability. The study recommended the need to institute appropriate regulatory mechanisms meant to cushion investors by initiating corporate finance practices in the industry.

Keywords: Share capital finance, profitability, Shareholders, Preference shares

INTRODUCTION

Globally, recent studies on financial structure and profitability have demonstrated that firms operating in a highly competitive environment like the petroleum industry have over time shown that profitability is not guaranteed due to stiff competition and the oligopolistic nature of such industries. Bhutta & Hasan, (2013) contends that a financial structure is an instrument that concerns itself on decision making about components of both capital and short-term financing. A suitable financial structure goes a long way in ensuring that the firm has adequate cash flows to meet its financial current and long term obligations (Akoto et al., 2013). The petroleum sector is divided into three main sectors based on the steps from drilling to refinement; the upstream sector, midstream sector and downstream sector respectively. The upstream sector involves the exploration activities and production operations of the crude oil. Midstream involves storing, transporting and distribution of the crude oil while downstream is composed of the refinery of the crude oil and natural gases before distribution and selling of the finished products.

Wamugo, et al., 2014) observed that balancing between liquidity and profitability is a major dilemma for most managers. Explaining why most firms have not found or formulated an appropriate financial structure that could maximize their profits. On the other hand, Jape & Korde (2013) contend that corporate finance focuses on the main decisions about financial investment, issuance of dividends and financing which, has resulted into greater attention being put on long term investment (capital structure) than on financial structure which addresses both current and long term aspects of corporate finance. The uniqueness of the energy petroleum sector arises from the fact that it is very significant as it a strong pillar to economic performance in Kenya, due to the fact that, the sector drives other industries by proving energy without which other industries can't operate (IEA, 2014).

In Kenya, the energy sector is highly regulated characterized by price caps, bond payment at point of entry to ensure energy imports reach desired destinations and through other social-economic mechanisms that are meant to be strictly adhered to. Additionally, the sector depends on raw materials like; crude oil, natural gas and other specialized equipment that are all imported and are significantly affected by international price fluctuations making profitability in the sector almost a pipe dream in a competitive and demanding sector.

Petroleum Marketing Firms in Kenya

Just like elsewhere globally the petroleum sector in Kenya is always faced with numerous challenges. The hostile business environment has been made worse by the introduction very strict and tough tax regime. Usually KRA imposes an upfront payment of 50% taxes on imported petroleum products. Besides the above there is the requirement that imported crude oil must be

supplied by a petroleum marketing firm so as to minimize related costs. This meant that the PMCs must have good cash flow to enable them buy the petroleum products and pay the upfront taxes as per the Petroleum Amendment Act, 2006.

The petroleum sector in Kenya is comprised of both the local firms and the multinational corporations. The industry is regulated by the Energy Regulatory Commission (ERC) a body that is tasked with ensuring fairness and quality within the industry. The sector is mainly an oligopolistic structure with a few key players. For example in the petroleum sector in Kenya the market is dominated by Total Kenya, Vivo energy and Kenol Kobil at 21.7%, 18.9% and 13.9% respectively (PIEA, 2014). The energy sector is very competitive and mainly characterized by controlled prices done by ERC, strict taxation frame work besides products that are more of the same which is compounded by a less controlled economy that all calls for serious strategies other than pricing to enhance profits (NSE, 2014).

By the fact that Kenya still imports all petroleum products, profits in the energy sector depend on identification of relevant factors that influence returns like the financial structure, capital structure and working capital. As the failure of companies to be profitable may contribute to disruption of their marketing and distribution consequently leading to industrial actions, blacklisting by suppliers and even bankruptcy of the petroleum marketing firms. Important to note is that the main challenges facing the energy sector range from high operations cots, poor infrastructure, excess regulation, volatility in exchange rates, tax administration and burden of government which all have made profitability an uphill task in the industry (Baffes et al., 2015).

Statement of the Problem Statement

Petroleum firms operate in a highly competitive environment a fact that compromises firm profitability as the competition is stiff and oligopolistic in nature in the industry. There is need for internal adjustments with a potential of increasing profits for instance the financial structure (Sheik & Wang, 2013). The above scholars agree on a correlation of the financial structure and the profitability if a company in the developing countries. However, not all findings agree with this argument as other researchers have not found a correlation of the financial structure to the profits of the firms (Muchiri, 2014). Studies in different countries have shown that, the financial structure affects profits differently depending on the industry under study.

Regionally, studies conducted have shown a significant difference in the relationship between financial structure and firm profitability with findings varying depending on the industry and country of the study (Khan, et al., 2012). An analysis in Kenya on the movement of annual gross margin profits before and after price regulation has shown decline in gross profit margin from the year 2010 to 2014 for Total Kenya, Kenol Kobil, National Oil Corporation of Kenya and

Hash Petroleum who are all leaders in the industry (KIPPRA, 2015). With numerous studies having been conducted both in kenya and in the rest of the globe, not much has been done in terms of the effect of the financial structure on profitability of petroleum firms in Kenya, further research has shown that petroleum marketing firms have continued to experience poor returns due to the fact that the industry is highly regulated leading to systematic decline in profits as formulae used by ERC to price products doesn't cover all components. Other studies by Gakure et al., (2012) investigating the significance of the financial structure on performance of manufacturing companies at the NSE; Omesa, et al., (2013) on the role of financial stricture on financial performance among 20 manufacturing firms and Nyabwanga et al., (2012) on the relationship of financial structure on performance of SMEs in Kisii county.

Despite the carrying out of the researches on the effects of financial structure and profitability of a firm in Kenya, such studies have not been carried out in the petroleum industry. Besides the above, as Kenya is keen on becoming an industrialized economy by 2030, petroleum marketing companies which are key in the provision of energy must be profitable enough to enhance sustainable development in the sector and other sector likewise as the sector is a fundamental pillar in the growth of other sectors (Ngniatedema & Li, 2014). Another rationale is that multinational firms like AGIP, Kenol Kobil and Shell & BP have either attempted or exited the Kenyan market citing profitability challenge as the main cause (Kimeli, 2012), therefore it is rational to conduct a study that was to point towards a reverse to the exit plans besides through sustainable profits.

Objective of the Study

To assess the effect of share capital finance on profitability of Kenyan petroleum marketing companies.

Hypothesis of the Study

Share capital finance has no significant effect on profitability of petroleum marketing companies in Kenya.

LITERATURE REVIEW

Agency Cost Theory and Share Capital

This theory was proposed by Jensen and Meckling (1976) who held that structure of capital can be attainable through reducing different costs that result from conflicts that arise between the management and shareholders. What this means is that optimum financial structure can lead to a compromise between different financing alternatives either external or internal which

allows or facilitates a reconciliation of different conflicts of interests mainly between finance suppliers and management (Grigore & Stefan-Duicu, 2013). This theory further focuses on how the relevant principal and respective agent are related. Hence it notes that such relationship are brought forth when one or even more stakeholders hire other individuals otherwise with an aim of ensuring performance of particular obligations as per agreement hence giving birth to delegation of decision making authority to the said agents (Lawal et al., 2014).

On the other hand Jensen & Meckling (1976) argued that a firm's financial structure is influenced by agency costs involved, these may include but are not limited to both debt and share capital issue. The costs involved when issuing share capital usually includes: principal monitoring cots (share capital holders), bond cost for the agent/manager, and decreased welfare as a result of divergent agent decisions among others. Numerous studies done have proved that there exists a relationship between firm's profits and its debts (Kester, 1986; Titman & Wessels, 1988; Fama & French, 2002). Similarly, Hovakimian et al., (2001), argues that firms with high profits are most likely those with low levels of debt. Incase firms use commercial debt financing then it implies that any growing company capable of higher leverage must always consider its financial structure (Alhaji & Yuseff, 2012). As profits soar it is expected that leverage must be on the decrease as profits are a form of revenue. Although a study by Bhaduri, (2012) found out that a firm must manage debts towards a given desirable ratio. Over time, research conducted in developing countries has supported the agency theory as pointed out by Bancel et al., (2004) who evaluated Brazil where the notion was not only held but also came out clearly in that a firm must always develop a desired priority list when it comes to financing.

Effect of Share Capital Finance on Petroleum Firm profitability

Equity capital is that part of capital which is free of debt and represents ownership interest in a firm (Moyer et al., 1999). It is therefore that amount contributed by the owners and normally includes ordinary share capital, preferential capital, retained earnings and reserves. Like debt providers, equity providers also earn returns inform of dividends from the profits generated by the firm (Titman et al., 2011). Preference shareholders receive their dividends at an agreed rate before the ordinary shareholders and any unappropriated profit is retained for firm's expansion programs (Titman et al., 2011).

Irwin & Scott (2010) in a study on the sources of financing for business enterprises notes that finances can be classified based on different sources ranging from share capital, savings, bank loans, credit finance among others. Deakins et al., (2010) while carrying out a study on sources of finances noted that it can generally be classified as internal (from within the organization) and external (usually from outside the business enterprise. In order to examine

the effect of financial structure on organizational profitability among listed firms in Nigeria, Ishaya and Abduljeleel (2014) found that commercial debt is usually negatively correlated with firm profits besides the fact that share capital is directly related with profits of the firm. Secondary data was used which showed the findings were consistent with Shubita & Alsawalhal (2012) survey and also provide evidence against the agency cost theory.

Share capital is commonly measured by the Book value which compares market of the shares as compared to firm value all as indicated in the financial reports (Phylaktis et al., 2010). The above is done in ratio form by calculating price per share over share capital value. The value of capital refers to the difference between assets book value and total value to all financial obligations commonly known as liabilities and then it is divided over the outstanding share capital shares as indicated by the statement of the financial position (Sullivan & Steven, 2003). Thus from the above argument, the share capital net book value is equated to the equivalent value of remaining assets; this goes a long way in giving the net worth of the enterprise in case there is need for liquidation (Oladeji, et al., 2015).

Thus the net book value is a very critical component in the measurement of investor share in the firm. Mostly a consideration is made on the number of shares to portray the net value in terms of investment per share. This value is then divided over the share price. Saeedi and Mahmoodi (2011) further noted that book ratio is commonly associated with the value of investment. When such a ration is low then it is considered that there is undervaluation of the stock. Equally, it could also imply that there is a fundamental issue that needs to be addressed in the organization. Usually since ratios vary depending on industry such a ration could also call for questioning if investors are paying unwarranted attention for an organization that is potentially bankrupt as up to this point, net book value can greatly influence decision of the investors in terms of buying shares of the firm under consideration.

Additionally, the value of the book as compared to the shares can be a very critical baseline for valuation of stock under consideration. Although it must be at technical levels not be based on the need for liquidation since it may proof to be not only misleading but also it may not be the best reflection of the situation at hand (Abdul, 2012). In most cases shares have traded below such value only to be end up being a not a true value due to other market factors. Thus in case, the firm's book balance as reflected in statement of financial position is not in tandem with the above position then a low price ratio may be considered as a perfect indicator of an undervalued stock. Notably, the book value may not be the best consideration incase future is being evaluated as firm prospects usually change depending on market conditions – which not only shape an organization's equity but also trends in terms of interest of investors.

An ongoing concern should be if the organization can always trade at a book value ratio while assuming other factors in the market (Iqbal et al., 2014).

RESEARCH METHODOLOGY

This study employed the positivist philosophy drawn from the natural sciences was applied. The philosophy comprises of the research hypothesis test. The hypothesis is developed from the theories and it is deductive. The testing is was done through the observation and the measurement of the social realities (Saunders et al., 2009). Positivism is founded and has a foundation build on values of reason, truth and validity besides being based on purely on data that is collected and measured in an empirical manner through use of quantitative and qualitative methods respectively (Wooldridge, 2012).

Beck (2003) describes that a research design is a plan that has details on how to find answers of the research objectives and research hypothesis respectively besides addressing any other challenges that were encountered during the study. Lavrakas (2008) notes that a research design is usually made up of the research structure, study frame work besides a study blueprint that guides the formulation of the research at different stages, as from the hypotheses up to findings and conclusion before a report is made. Therefore what comes out clear is that a good research design is logical in nature and flows a particular sequence when conducting data collection and data analysis so as to ensure that proper procedure is followed (Kothari, 2004).

Descriptive research design is adopted when describing the given situation a phenomena, it takes into consideration current believes customs and also traditions in data collection (Baumgartner, Strong and Hensley 2002). Further, descriptive research also includes surveys and different enquiries with the main reason being that while conducting a descriptive cross sectional research to the research to describe the state current state of affairs objectively (Kothari, 2004).

This study had a target population that comprised of two levels namely; the institutional level population that was made up of 35 Kenyan petroleum marketing firms that have been consistently operational between 2007 and 2016. The other second level was the finance managers or their respective designees. Finance managers were selected since they are directly responsible in the formulation, adoption and implementation of different financial structures that any firm adopts at a given time besides being responsible for managing finances and other relevant action plans. It is also paramount to appreciate the fact that, the firms under consideration in this study were categorized in the same industry, where by the petroleum marketing firms had also similar reporting patterns, design and the bare minimum disclosures expected of them by the ERC -their regulator.

Sampling frame is a technical term used to describe a list of the elements that forms the sample population (Mugenda and Mugenda, 2003 and Kothari, 2004) the scholars further point out that the sampling frame consists of all the study elements in the selected study universe (Cooper & Schindler, 2006). The petroleum marketing firms and their respective finance managers were the units of analysis while the financial statement were the units of observation, it is therefore clear that descriptive cross sectional design was adopted because it enabled the researcher to gather sufficient data for the study. Sampling frame for this study was made up of 35 petroleum marketing firms that have been in operation between January 2007 and December 2016 as listed in the Energy Regulatory Commission database besides as laid out Primary and secondary data was collected because the two sources of data are meant to reinforce each other (Stiles and Taylor, 2001). The data was largely quantitative in nature. Primary data were collected using a semi structured questionnaire. The questionnaire comprised of closed ended questionnaires as well as a few open ended ones guided by the concepts of the study, theory and other previous studies. A five point Likert scale ranging from not at all (1) to (5) a very large extent was used to construct some of the items.

Secondary data was collected by panel method where a series of data from the annual audited financial statements of the target companies were reviewed. The time series observed was from 2007 to 2016 while the sources of data were the targeted petroleum marketing companies. Of interest to the researcher was the annual income statement and the statement of financial position besides the statements of equity of the targeted firms. In this study, assets, total liabilities, short term/current liabilities, retained earnings besides other shareholders' funds and profits after tax were obtained through use of the data collection sheet in the annexure.

Primary data was collected by administering questionnaires to the petroleum marketing firms finance managers in each of the 35 firms. Two research assistants were engaged for the purpose of assisting the researcher to carry out self-administration of the questionnaires. In cases where the assistant researchers were faced with challenges the main researcher addressed this by making personal follow through telephone contacts as provided in the appendix. The entry points used for the firms in question was majorly through the public relation officer the customer service departments of the targeted firms. Louis, Lawrence and Morrison (2007) acknowledges that primary data helps address the original study problem as it gives firsthand information on the study variables (Ember and Ember, 2009).

Panel data for this study was obtained from the 35 petroleum marketing firms' annual reports which are regularly submitted to the ERC. Dawson (2009) notes that secondary data collection may also involve collection and use of information other past studies on the subject

matter. Khan (2012) and Saaedi and Mahmoodi (2011) concurred that the use panel data especially when investigating financial structure and profitability or even capital structure and firm financial performance. To ensure the panel data that was collected various quality test were conducted as explained below besides using only audited accounts since these accounts are verified and counterchecked by a credible internationally recognized audit firm. Additionally, closed ended questions were adopted to enhance content validity and research permission letters and company logos used to enhance face validity firm in Kenya. Based on the scope of this study (petroleum marketing companies), the researcher found it sound to analyze statements from 2007 to 2016 using panel method.

Table 1: Reliability Results

Variable	Cronbach's alpha	No of items
Share Capital finance	0.8145	3

A high coefficient indicates that the items are consistently measuring the same underlying construct. George and Mallery (2003) provide the following rules of thumb: "_ > 0.9 – Excellent, _ > 0.8 – Good, _ > 0.7 – Acceptable, _ > 0.6 – Questionable, _ > 0.5 – Poor, and _ < 0.5 – Unacceptable". As such, having yielded all coefficients greater than 0.8 and greater than 0.9 for some sections, the questionnaires were accepted as consistent and reliable for the study.

Table 2: Response Rate

	Frequency	Percentage
Questionnaires Issued	35	100.0%
Questionnaires Returned	29	
Response Rate (%)		82.85%

The response rate is considered adequate since Mugenda and Mugenda (2003) advise on response rates exceeding 50% and Hager, Wilson, Pollak and Rooney (2003) recommend 50%. Saunders, Lewis and Thornhill (2009) suggest a 30-40% per cent response rate.

The study sought to examine the effect of commercial debt finance on profitability of petroleum companies in Kenya. These ranged from long- term debt as preferable to short term debt, commercial debt financing and internal sources of finance and commercial debt financing interest rates in comparison with other sources. The following series of tables show the results of the Likerts scale on various share capital finance characteristics.

Table 3: Firms' floating of shares through security exchange markets and private placements

	Frequency	Percent	Cumulative Percent
Strongly Disagree	9	31	31
Disagree	6	20.8	51.8
Neutral	4	13.8	65.6
Agree	9	31	96.6
Strongly Agree	1	3.4	100.0
Total	29	100.0	
Mean = 2.633		Mode = 4.000	

From the findings 31% of the respondents agree while a few (3.4%) strongly agree that their firms usually float shares through security exchange markets and private placements. This yields a cumulative 34.4% of the respondents agreeing to the statement, 13.8% of the respondents were neutral about the statement, while 51.8% cumulatively disagreed. The proportions yield a mean of 2.633 indicating "disagree" with majority disagreeing to it (mode = 4). The above findings were in line with Ouma, (2012) who found out that most firms in Kenya do not raise their capital from NSE.

Table 4: Share capital and decision making

	Frequency	Percent	Cumulative Percent
Strongly Disagree	7	24.1	24.1
Disagree	4	13.8	37.9
Neutral	2	6.9	51.7
Agree	13	44.8	89.7
Strongly Agree	3	10.3	100.0
Total	29	100.0	
Mean = 2.75		Mode = 4.00	

From the findings 44.8% of the respondents agreed while a few (3.4%) strongly agreed that share capital dilutes ownership and consequently decision making. This yields a cumulative 48.2% of the respondents agreeing to the statement, 6.9% of the respondents were neutral about the statement, while 37.9% cumulatively disagreed. The proportions yield a mean of 2.75 indicating "disagree" with majority disagreeing to it (mode = 4). The above findings contradicted findings by Goessl (2010) who noted that the merits of it as a source of finance are far much better as compared to their effect on decision making and consequently the firm profits.

Table 5: Share capital financing and stakeholders' support

	Frequency	Percent	Cumulative Percent
Strongly Disagree	9	31	31
Disagree	3	10.3	41.3
Neutral	5	17.2	58.5
Agree	10	34.9	93.1
Strongly Agree	2	6.9	100.0
Total	29	100.0	
Mean = 2.883		Mode = 4.000	

From the findings 34.9% of the respondents agree while 6.9% strongly agreed that share capital financing enjoys the support of all stakeholders. This yielded a cumulative 41.3% of the respondents agreeing to the statement, 17.2% of the respondents were neutral about the statement, while 41.3% cumulatively disagreed. The proportions yield a mean of 2.883 indicating "neutral" with majority not giving any opinion to it (mode = 4). The above findings are different from those of Abduljeleel, (2014) who disagreed by noting that stakeholders have different interests hence their support may not be unanimous

The test statistic is a chi-square distribution for both individual and joint measures of skewedness and kurtosis. The test was carried out against the null hypothesis of normal distribution. The results indicate that the chi-square statistic for all variables except size and profitability had corresponding p-values equal to 0.0000. This means that the alternative hypothesis of normality is rejected at 5% significance level; implying that the data was normally distributed. Pairwise correlation coefficient was used to gauge the relationship between share capital finance and profitability. The results indicated that share capital finance have an insignificant inverse relationship with ROA. And, showed that the p-value was at p = 0.1843 and this met the threshold since p>0.05. The inverse relationship was represented by correlation coefficient of 0.0676.

The regression results show that share capital finance has coefficients of -0.006. The coefficients are negative and statistically insignificant at 5%, 1% and 10% percent level as signified by *p*-values of 0.174. The results indicate that during the period of study, use or lack of use of share capital finance did not affect firm profitability. The above findings agree with the findings of Titman et al., (2011) who notes that increased use of equity can adversely affect returns of the firm as dividends must be paid to different shareholders

CONCLUSION AND RECOMMENDATIONS

The study found that during the analysis period, share capital finance had a negative and insignificant effect on profitability of petroleum companies in Kenya. The study found that during the analysis period, share capital had a negative and significant effect on profitability of petroleum companies in Kenya. It is also evident from the findings that share capital financing seem to be the preferred choice by majority of firms. Firms are therefore at liberty to raise capital through equities since they have marginal negative impact on returns.

In addition, the general preference of external equity clearly negates the provision of the agency theory implying that it may not be applicable in practice. Thirdly, the study recommends that in configuring their financial structure, financing managers of petroleum firms should prioritize the use of internally generated capital such as retained earnings and reserves ahead of externally issued equity. There is need to institute appropriate regulatory mechanisms meant to cushion investors from loss of their hard earned wealth and hence restore confidence in their investments. The study recommends a similar study be carried out within larger jurisdictions that could present unique economic and regulatory dynamics.

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