



CRITICAL LITERATURE REVIEW ON CAPITAL STRUCTURE AND FIRM FINANCIAL PERFORMANCE IN KENYA

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Abstract

Financing is one of the most critical decisions in corporate finance. Empirical researches have been carried out in different contexts about the relationship between capital structure and firm financial performance. Findings of these studies have largely returned conflicting outcomes. This study sought to perform an analytical and critical review of the various studies that have been undertaken on this subject in order to establish the research gaps that might be responsible for the diversity of results. In addition, the study also intended to find out the contributions made by various studies on this subject as well as document the various theories that underlie this subject. The study had a special focus on the Kenyan context. The following gaps were noted in studies that have been done so far: The study established that some studies employed measures of firm financial performance that are not tenable. Such measures are not capable of bringing out the consequences of capital structure choice among different firms. Secondly, other studies were found not to comprehensively operationalize both the measures of capital structure and financial performance. This means that the outcome of such a study ignores some important dimensions of capital structure and firm financial performance. Thirdly, majority of the studies employed regression analysis in modeling the relationship(s) between/among the study variables. However, most of the studies did not perform important diagnostic tests necessary in the Ordinary Least Squares (OLS) in order to validate the model (s).

Keywords: Critical literature review, Capital structure, financial performance, Kenya



INTRODUCTION

Financing is one of the most critical decisions in corporate finance. A firm can source funds from broadly two sources, that is, either from owners of the firm or from parties external to the firm. The funds supplied by owners of the firm are known as equity while those sourced from external parties are known as debt. The mix of equity and debt employed by a firm is variously referred to as capital structure, leverage or gearing. Capital structure has turned out to be one of the most contentious issues if not a puzzle in corporate finance (Al-sakaran, 2001). Forty years after the Modigliani and Miller research, our understanding of the firm's financing choice is still limited (Myers, 2001). The different capital structure theories are not in consensus on how (or whether) variation in debt ratios across firms affects a firm's performance. While some argue that having more debt has a positive effect on firm's performance, others give the contrary opinion. Yet others opine that capital structure does not affect a firm's performance. This lack of consensus has prompted many studies on this subject in different contexts. But interestingly, the empirical evidence has been as polarized as the theories themselves.

The relationship between capital structure and firm financial performance in developed economies has been greatly researched. In an emerging economy like Kenya there is a scarcity of literature on the relationship between capital structure and firm financial performance. There are few studies on developing economies and most have yielded conflicting results. It is therefore important to document the available literature on this subject with special focus on emerging economies like Kenya where there is little literature. In addition, the different studies that have been done so far needs to be interrogated in order to establish the possible reasons as to why they have yielded conflicting results.

Capital Structure

In economics, capital or capital goods or real capital refers to factors of production used to create goods or services that are not themselves significantly consumed in the production process. Capital goods may be acquired with money or financial capital. In finance and accounting, capital generally refers to financial wealth especially that used to start or maintain a business. Financial capital which is required by entrepreneurs can be obtained through various sources. There are long term sources like share capital, debenture capital, venture capital, retained profit, etc. Financial capital can also be obtained through medium term sources like term loans, leasing, etc. and through short term sources like bank overdraft, trade credit, factoring, etc. Capital contributed by the owner of a business, obtained by means of saving or inheritance, is known as own capital or equity. The capital provided by owners of business can

be in the form of preference shares, ordinary shares or retained earnings. That capital which is granted by another person or institution is called borrowed capital or debt (Parab, 2013).

While some authors have restricted the meaning of capital structure to only the mixture of long-term sources of financing, others have defined capital structure as to include both short-term and long-term sources of financing. Brealey and Myers (2003) defined capital structure as the firm's mix of different securities used in financing its investments. They noted that a firm can issue dozens of distinct securities in countless combinations. They categorise these securities as debt and equity securities. Debt securities are used to raise funds from lenders while equity securities are used to raise funds from owners of the firm (shareholders).

Firm Financial Performance

The construct of firm performance is of central importance to management research because explaining variation in performance is an enduring theme in the study of organizations (Gentry and Shen, 2010). These authors also added that, although firm performance has been recently proposed as a multi-dimensional construct that consists of many different aspects such as operational effectiveness, corporate reputation, and organizational survival, one of the most extensively studied areas is its financial component and fulfilment of the economic goals of the firm. Organisational researchers generally use either accounting based measures of profitability such as return on assets (ROA), return on sales (ROS), and return on equity (ROE), or stock market-based measures such as Tobin's Q and market return.

Worthington (2001) wrote that an accepted financial axiom is that the role of managers is to maximise the wealth of shareholders by the efficient allocation of resources. In order to operationalize this objective, shareholder wealth is traditionally proxied by either standard accounting magnitudes (such as profit, earnings and cash flows from operations) or financial statement ratios (including earnings per share and the returns on assets, investment and equity). This financial statement information is then used by managers, shareholders and other interested parties to assess current firm performance, and is also used by these same stakeholders to predict future performance.

Stewart (1994) suggested that Economic Value Added (EVA) stands well out from the crowd as the single best measure of wealth creation on a contemporaneous basis and is almost 50% better than its closed accounting-based competitors (including EPS, ROE and ROA) in explaining changes in shareholder wealth. EVA is a measure that enables managers to see whether they are earning an adequate return. Where returns are lower than might reasonably be expected for investments of similar risk (i.e., they are below the cost of capital), EVA is negative, and the firm faces the flight of capital and a lower stock price. Quite simply, EVA is a

measure of profit less the cost of all capital employed. It is the one measure that properly accounts for all the complex trade-offs, often between the income statement and balance sheet, involved in creating value. EVA is also the spread between a company's return on and cost of capital, multiplied by the invested capital: $EVA = (\text{Rate of Return} - \text{Cost of Capital}) \times \text{capital}$

The balanced scorecard as popularised by Kaplan and Norton (1992) examines firm performance from the perspective of finance, customers, innovation and learning, and internal efficiency. In advocating for the Scorecard, the two authors argued: "senior executives understand that their organization's measurement system strongly affects the behaviour of managers and employees. Executives also understand that traditional financial accounting measures like return on investment (ROI) and earnings per share (EPS) can give misleading signals for continuous improvement and innovation. The traditional financial performance measures worked well for the industrial era, but they are out of step with the skills and competencies companies are trying to master today"

Relationship between Capital Structure and Firm Financial Performance

Studies have been carried out in different contexts to establish the relationship between firm's performance and capital structure. In India, Sai *et al* (2011) found out that firms that were moderately geared were able to generate a better return on equity. A study in France by Carpentier (2006) concluded that with all things being equal, changes in capital structure do not explain changes in the value of the firms. Zaher (2010) carried out a research involving US publicly traded Corporations. The study found out that investments in portfolios of debt free firms tend to generate higher returns than investments in their peers of portfolios of leveraged firms over long and short periods. Luo (2012) carried a research in Australia and found out a significant and robust quadratic relationship between capital structure and firm performance. Abor (2005) did a study seeking to investigate the relationship between capital structure and profitability of listed firms on Ghana Stock Exchange (GSE). The results revealed a significantly positive relationship between ratio of short-term debt to total assets and ROE. Coleman (2007) carried out a research in Ghana involving MFIs. The results revealed that highly leveraged MFIs performed better. Onaolapo and Kajola (2010) embarked on a study to examine the impact of capital structure on firm's financial performance in Nigeria. The results showed that a firm's capital structure surrogated by Debt ratio has a significantly negative impact on the firm's financial measures.

The studies carried out in different contexts have returned conflicting outcomes. In addition, most of the studies have been carried out in developed countries. It is therefore,

important to find out from the available literature the likely reasons as to why there has not been a consensus with more focus on emerging economies like Kenya.

Kenya

Kenya is an emerging economy. The Nairobi securities exchange (NSE) could be regarded as the barometer that indicates the financial performance of Kenyan firms. Ngugi *et al.* (2009) wrote that the Nairobi Securities Exchange (NSE) has been performing poorly in the recent years. While there were about 58 companies listed at NSE, not all of them were in a financially sound position. Although at the point of listing, these listed companies must meet the listing requirements of NSE, given time, the company's financial position can change for better or worse. The researchers noted that there are many reasons for these changes and that one of them could be capital structure decisions. According to Maina and Sakwa (2010), there is an increasing trend of failure among Kenyan firms as a result of financial distress. They gave a few examples of KCC, Uchumi Supermarkets, A Baumann and Company, Bulk Medical Limited, and said that the list could be longer. Kwama (2010) noted that the Kenya National Transport Company (Kenatco) Ltd was probably the first prominent Kenyan firm to show the impact of high debt on companies' fortunes. The company was placed in receivership in 1996 due to inability to meet repayment obligations to the National Bank of Kenya. Okuttah (2012) narrated how Telekom Kenya was on the verge of collapse due to high debt levels. The Kenyan government converted its Ksh 4 billion shareholder loan into shares as France Telecom swapped its Ksh 15 billion debt into equity. This trend raises the question as to whether capital structure choice has a bearing on firm's financial performance in Kenya.

A country's extent of financial markets development is likely to determine the level of debt and equity firms employ in their capital structure. According to Beck and Fuchs (2004) by regional standards, Kenya's financial system is relatively well developed and diversified. The system enjoys higher levels of credit channeled to the private sector and higher deposits in financial institutions than other Sub-Saharan African and low income countries. However, Mbewa *et al.* (2007) noted that by developed world standards, the level of development of Kenya's debt market indicates that the country is very far from developing this market.

The capital structure theory has identified taxation and interest rates as important determinants of how capital structure complexion is likely to affect the financial performance of a firm. Moyi and Ronge (2006) contend that over time, Kenya has moved from being a low tax burden country to a high tax burden country. According to Karingi *et al.* (2005) Kenya is a high tax yield country with a tax to GDP ratio of over 20 percent. In addition, the real interest rate spread in Kenya is among the highest in the world (Institute of Economic Affairs, 2000).The

Parliamentary Budget Office (2011) summed up the Kenyan interest rate regime as being highly volatile. For instance, Treasury bills interest rates at one time reached 84.67% in July 1993. The lending rate also rose steadily, exceeding 30 percent for the period October 1993 to October 1994. Lending rates remained above or close to 30 percent through September 1998. But the year 1999 ushered in a decade of declining and stable interest rates. However, towards the end of 2011 the increase in Central Bank Rate (CBR) caused banks to adjust their rates from an average of 15 percent to about 24 percent. Beck and Fuch (ibid) adds that while Kenya has high interest rate spreads and margins as other countries in the region. It has substantially higher spreads and margins than OECD countries.

Research Problem

The debate on whether or not capital structure affects a firm's financial performance (and how) has raged on since the landmark publication on the subject by Modigliani and Miller (1958). Studies have been carried out in different contexts to establish the relationship between firm's performance and capital structure. What motivated the current study was the fact that there seems never to be a consensus among the different studies that have been done. The range of different results obtained from different studies include: (i) Changes in capital structure does not explain changes in the value of the firms; (ii) Investments in portfolios of debt free firms tend to generate higher returns than investments in their peers of portfolios of leveraged firms; (iii) Highly leveraged firms perform better; (iv) and firm's capital structure surrogated by debt ratio has a significantly negative impact on the firm's financial measures.

Majority of these studies have been carried out in the developed world. The available research work that has been done in emerging economies has also yielded conflicting outcomes. The main objective of this study was to document literature on the subject of capital structure and firm financial performance with specific focus on the developing economies for which Kenya is a good representative. As indicated earlier Kenya as a representation of developing economies has her unique peculiarities especially in relation to interest rate regime, taxation, and equity and debt markets. There has also been an increasing trend of failure among Kenyan firms as a result of financial distress. Therefore, it was necessary to document the existing literature on this subject and try to establish the possible reason(s) as to why different studies in both developed and developing countries have been yielding conflicting results. In summary, the desire of the current study was to carry out a critical literature review that was hoped to give a definite and conclusive answer as to where gaps in the previous studies exist that led to yielding of varied and conflicting results.

The study established that there exist gaps in the current studies. Firstly, some studies used measures of performance that did not seem to capture the consequences of capital structure choice, hence making it not possible to clearly bring out the likely difference in financial performance among firms that employed different levels of leverage. Secondly, most studies did not comprehensively operationalize the study variables with some ignoring the role of control variables in the moderation of relationship between the independent and dependent variables. Thirdly and most importantly, an overwhelming majority of the studies lacked in the area of modeling the relationship between the studies variables. While majority of the studies made use of regression analysis, unfortunately some important OLS mandatory diagnostic tests (e.g. normality, heteroscedasticity, multicollinearity, and autocorrelation tests), stationarity test, co integration test, and reverse causality tests which are very crucial in financial time series modeling were glaringly missing. This puts to question the reliability of the models so developed.

The outcome of this study would be very helpful in detailing the contributions that have been made so far by different researches on the subject of capital structure and firm financial performance. But most importantly, the study would help in establishing research gaps that exist on the subject and hence suggest possible research areas. The different capital structure theories have never been in consensus on whether there is any relationship between capital structure and firm performance and what the direction of the relationship is if at all it exists. This study is expected to introduce new insights into this theoretical debate. The study will bring out the important variables that each theory must not ignore in order for the validity of its argument to remain tenable. In addition, the future researchers in the discipline of finance would benefit by been able to identify possible shortcomings in theory and previous empirical studies in order for them to be able to undertake more defensible studies on this particular subject.

THEORETICAL PERSPECTIVE

According to Myers (2001) there is no universal theory of the debt-equity choice, and no reason to expect it. The various theories on capital structure are discussed below:

Modigliani and Miller theory of capital structure

The modern theory of capital structure began with the celebrated seminal paper of Modigliani and Miller (1958). They demonstrated that if a company's investment policy is taken as given, then in a perfect world where there is no tax and transaction cost associated with raising money or going bankrupt, and the disclosure of all information is credible, capital structure does not affect a firm's value. They christened it "irrelevance theory of capital structure".

The authors assumed that firms can be divided into “equivalent return” classes such that the return on the shares issued by any firm in any given class is proportional to (and hence perfectly correlated with) the return on the shares issued by any other firm in the same class. This assumption implies that the various shares within the same class differ, at most, by a “scale factor”. Accordingly, if we adjust for the difference in scale, by taking the ratio of the return to the expected return, the probability distribution of that ratio is identical for all shares in class. It follows that all relevant properties of a share are uniquely characterised by specifying (1) the class to which it belongs and (2) its expected return. The significance of this assumption is that it permits us to classify firms into groups within which the shares of different firms are “homogeneous”, that is, perfect substitutes for one another.

They developed two basic propositions with respect to the valuation of securities in companies with different capital structures:

Proposition I

Consider any company j and let X_j stand for the expected return on the assets owned by the company (that is, its expected profit before deduction of interest). Denote by D_j the market value of the debts of the company; by S_j the market value of its common shares; and by $V_j \equiv S_j + D_j$ the market value of all its securities or, the market value of the firm. Then, Proposition I asserts that we have in equilibrium:

$$(1) V_j \equiv (S_j + D_j) = X_j / \rho k, \text{ for any firm } j \text{ in class } \xi.$$

That is, the market value of any firm is independent of its capital structure and is given by capitalising its expected return at the rate ρk appropriate to its class. This proposition can be stated in an equivalent way in terms of the firm’s “average cost of capital”, X_j / V_j , which is the ratio of its expected return to the market value of all its securities. The proposition then is: (2) $X_j / (S_j + D_j) \equiv X_j / V_j = \rho k$, for any firm j , in class ξ . That is, the average cost of capital to any firm is completely independent of its capital structure and is equal to the capitalisation rate of a pure equity stream of its class.

As long as the relations (1) or (2) do not hold between any pair of firms in a class, arbitrage will take place and restore the stated equalities. If proposition 1 did not hold, an investor could buy and sell stocks and bonds in such a way as to exchange one income stream for another stream, identical in all relevant respects but selling at a lower price. The exchange would therefore be advantageous to the investor quite independently of his attitudes towards risk. As investors exploit these arbitrage opportunities, the value of the overpriced shares will fall and that of the underpriced shares will rise, thereby tending to eliminate the discrepancy between the market values of the firms.

Consider two firms in the same class and assume that the expected return, X , is the same for both firms. Let company 1 be financed entirely with common stock while company 2 has some debt in its capital structure. Suppose first the value of the levered firm, V_2 , to be larger than that of the unlevered one V_1 . Consider an investor holding S_2 dollars' worth of the shares of company 2, representing a fraction α of the total outstanding stock, S_2 . The return from this portfolio, denoted by Y_2 , will be a fraction α of the income available for the stockholders of company 2, which is equal to the total return X_2 less the interest charge, rD_2 . Since under our assumption of homogeneity, the anticipated total return of company 2, X_2 , is, under all circumstances, the same as the anticipated total return of company 1, X_1 , we can hereafter replace X_2 and X_1 by a common symbol X . Hence, the return from the initial portfolio can be written as: (3) $Y_2 = \alpha(X-rD_2)$

Now suppose the investor sold his αS_2 worth of company 2 shares and acquired instead an amount $s_1 = \alpha (S_2+D_2)$ of the shares of company 1. He could do so by utilizing the amount αS_2 realised from the sale of his initial holding and borrowing an additional amount αD_2 on his own credit, pledging his new holdings in company 1 as collateral. He would thus secure for himself a fraction $s_1/S_1 = \alpha (S_2+D_2)/S_1$ of the shares and earnings of company 1. Making proper allowance for the interest payments on his personal debt αD_2 , the return from the new portfolio, Y_1 , is given by:

$$(4) \quad Y_1 = \left\{ \alpha (S_2+D_2)/S_1 \right\} X - r\alpha D_2 = \alpha (V_2/V_1) X - r\alpha D_2$$

Comparing (3) with (4) we see that as long as $V_2 > V_1$ we must have $Y_1 > Y_2$, so that it pays owners of company 2's shares to sell their holdings, thereby depressing S_2 and hence V_2 ; and to acquire shares of company 1, thereby raising S_1 and thus V_1 . We conclude therefore that levered companies cannot command a premium over unlevered companies because investors have the opportunity of putting the equivalent leverage into their portfolio directly by borrowing on personal account.

Consider now the other possibility, namely that the market value of the levered company V_2 is less than V_1 . Suppose an investor holds initially an amount S_1 of shares of company 1, representing a fraction α of the total outstanding stock, S_1 . His return from this holding is:

$$Y_1 = (s_1/S_1) X = \alpha X$$

Suppose he were to exchange this initial holding for another portfolio, also worth s_1 , but consisting of s_2 dollars of stock of company 2 and of d dollars of bonds, where s_2 and d are given by

$$(5) \quad s_2 = (S_2/V_2)s_1, \quad d = (D_2/V_2)s_1$$

In other words the new portfolio is to consist of stock of company 2 and of bonds in the proportions S_2/V_2 and D_2/V_2 of the total return to stockholders of company 2, which is $(X-rD_2)$,

and the return from the bonds will be r_d . Making use of (5), the total return from the portfolio, Y_2 , can be expressed as follows:

$$Y_2 = s_2/S_2(X-rD_2) + r_d = s_1/V_2(X-rD_2) + r (D_2/V_2) \quad s_1 = (s_1/V_2) X = \alpha (S_1/V_2) X$$

(Since $s_1 = \alpha S_1$). Comparing Y_2 with Y_1 we see that, if $V_2 < S_1 \equiv V_1$, then Y_2 will exceed Y_1 . Hence it pays the holders of company 1's shares to sell these holdings and replace them with a mixed portfolio containing an appropriate fraction of the shares of company 2.

The acquisition of a mixed portfolio of stock of a levered company j and of bonds in the proportion S_j/V_j and D_j/V_j respectively, may be regarded as an operation which "undoes" the leverage, giving access to an appropriate fraction of the unlevered return X_j . It is this possibility of undoing leverage which prevents the value of levered firms from being consistently less than those of unlevered firms, or more generally prevents the average cost of capital X_j/V_j from being systematically higher for levered than for non levered companies in the same class. Since we have already shown that arbitrage will also prevent V_2 from being larger than V_1 , we can conclude that in equilibrium we must have $V_2 = V_1$, as stated in proposition 1

Proposition II:

From proposition 1 we can derive the following proposition concerning the rate of return on common stock in companies whose capital structure includes some debt: the expected rate of return or yield, i , on the stock of any company j belonging to the g th class is a linear function of leverage as follows:

$$(6) \quad i_j = \rho k + (\rho k - r) D_j / S_j$$

That is, the expected yield of a share of stock is equal to the appropriate capitalization rate ρk for a pure equity stream in the class, plus a premium related to financial risk equal to the debt-to-equity ratio times the spread between ρk and r . Or equivalently, the market price of any share of stock is given by capitalizing its expected return at the continuously variable rate of i_j (6)

Revised Modigliani and Miller theory

The original Modigliani and Miller theory was based on a set of restrictive assumptions which lack practicality in the real world. Therefore, later in 1963 Modigliani and Miller revised their position by incorporating tax benefits as determinants of capital structure. They argued that since interest is a tax deductible expense, tax-shield advantage is afforded to those firms that employ debt in their capital structure. Thus, they state that firms are able to maximize their value by employing more debt due to the tax shield benefits associated with debt use.

Relevance and Critique of the theory

The 1963 revised Modigliani and Miller position is likely to be of great relevance to firms that operate in emerging economies where the tax levels are very high; the interest rates are also equally high and highly volatile. It would be important to establish if these play any role in influencing a firm's financial performance. But concerning the original Modigliani and Miller "irrelevance theory of capital structure", it was based on highly simplified assumptions that lack practicality in real world. Some of these unrealistic assumptions include: capital markets are frictionless and hence there are no transaction costs, firms can be categorized into "equivalent return" classes and that all firms within a class have the same degree of business risk, corporate taxes are also ignored.

The Pecking order theory

The pecking order theory as popularized by Myers and Majluf (1984), argue that firms follow a financing hierarchy to minimize the problem of information asymmetry between the firm's managers (insiders) and the shareholders (outsiders). These authors assumed that managers act in the interest of existing shareholders, and refuse to issue undervalued shares unless the transfer from "old" to new stockholders is more than offset by the net present value of the growth opportunity.

Issuing debt minimises the information advantage of the corporate managers. Optimistic managers, who believe the shares of their companies are undervalued, will jump at the chance to issue debt rather than equity. If debt is an open alternative, then any attempt to sell shares will reveal that the shares are not a good buy. Equity issues will occur only when debt is costly- for example, because the firm is already at a dangerously high debt ratio. In this case, even optimistic managers may turn to the stock market for financing. This leads to the pecking order theory of capital structure: Firms prefer internal to external finance (information asymmetries are assumed relevant only for external financing); Dividends are "sticky", so that dividend cuts are not used to finance capital expenditure, and so that changes in cash requirements are not soaked up in short-run dividend changes, In other words, changes in net cash show up as changes in external financing; If external funds are required for capital investment, firms will issue the safest security first, that is, debt before equity. If internally generated cash flow exceeds capital investment, the surplus is used to pay down debt rather than repurchasing and retiring equity. As the requirement for external financing increases, the firm will work down the pecking order, from safe to riskier debt, perhaps to convertible securities or preferred stock, and finally to equity as a last resort; and each firm's debt ratio therefore reflects its cumulative requirement for external financing

The preference of public corporations for internal financing, and the relative infrequency of stock issues by established firms, has long been attributed to the separation of ownership and control, and the desire of managers to avoid the “discipline of capital markets”.

Relevance and Critique of the theory

The pecking order theory explains why the bulk of external financing comes from debt. It also explains why more profitable firms borrow less: not because their target debt ratio is low- in the pecking order they don't have a target- but because profitable firms have more internal financing available. Less profitable firms require external financing, and consequently accumulate debt. Therefore, this theory is important in helping us to determine whether it is the firm's financial performance that influences the capital structure or it is the capital structure which influences the firm's financial performance. In addition, the debt markets are not well developed in emerging markets and the cost of debt is also expensive, hence it would be important to establish what informs choice of debt capital in these markets. The biggest weakness of this theory is because it does not specify whether there is an optimal capital structure.

The Agency theory of capital structure

Jensen and Meckling (1976) argued on the basis of agency theory. They said that using debt is beneficial to the firm because it has an effect of “disciplining” managers. According to this theory, generally managers have an incentive to misuse the firm's cash. But when a firm finances with debt, the firm is obligated to make periodic interest payments. This reduces the cash balance the firm holds, reducing the incentive to misuse the firm's cash.

They define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interest of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and incurring monitoring costs designed to limit the aberrant activities of the agent.

Since the relationship between the stockholders and the managers of a corporation fits the definition of a pure agency relationship, it should come as no surprise to discover that the issues associated with the “separation of ownership and control” in the modern diffuse ownership corporation are intimately associated with the general problem of agency. If a wholly-owned firm is managed by the owner, he will make operating decisions that maximize his utility. If the owner-manager sell equity claims on the corporation which are identical to his own (i.e.,

which share proportionately in the profits of the firms and have limited liability), agency costs will be generated by the divergence between his interest and those of the outside shareholders, since he will then bear only a fraction of the costs of any non-pecuniary benefits he takes out in maximizing his own utility. If the manager owns 95 per cent of the stock, he will expend resources to the point where the marginal utility derived from a dollar's expenditure of the firm's resources on such items equals the marginal utility of an additional 95 cents in general purchasing power (i.e., his share of the wealth reduction) and not one dollar.

Relevance and Critique of the theory

According to this theory, when a firm finances with debt, it is obligated to make periodic interest payments. This reduces the cash balance the firm holds, reducing the incentive to misuse the firm's cash. Hence, the theory anticipates that firms with more debt perform better. However, it is a would not be defensible to assume that employing high debt levels would necessarily deter managers from misusing funds and also motivate them towards working harder to honor the debt obligations. In fact, on many occasions firms have gone under because of carrying unsustainably high debt levels. The theory needs to advice on the optimal debt level. Nevertheless, this theory would be helpful in helping establish whether managers of more leveraged firms tend to post better financial performance.

The Static trade-off theory of capital structure

The static trade-off theory focuses on the benefits and costs of issuing debt. It predicts that an optimal target financial debt ratio exists, which maximizes the value of the firm. The optimal point can be attained when the marginal value of the benefits associated with debt issues exactly offsets the increase in the present value of the costs associated with issuing more debt (Myers, 2001). The benefits of debt are the tax deductibility of interest payments. The tax deductibility of corporate interest payments favours the use of debt. Another benefit of debt is that it mitigates the manager-shareholder agency conflict. Corporate managers have the incentive to waste free cash flow on perquisites and bad investment. Debt financing limits the free cash flow available to managers and thereby helps to control agency problem (Jensen and Meckling, 1976). The costs associated with issuing more debt are the costs of financial distress (Modigliani and Miller, 1963) and the agency costs triggered by conflicts between shareholders and debtors (Meckling, 1976). Costs of financial distress are likely to arise when a firm uses excessive debt and is unable to meet the interest and principal payments.

Relevance and Critique of the theory

This theory is strong because it takes into account the arguments advanced by all the other theories. It suggests that there is an optimal capital structure which maximizes value of the firm; the point where the marginal value of the benefits associated with debt issues exactly offsets the increase in the present value of the costs associated with issuing more debt. This theory would be helpful in bringing out the difference in financial performance among the firms that employ different debt levels while taking into account the costs and benefits associated with debt especially in emerging markets.

Firm performance theories

The several theories on firm performance are discussed as follows:

Stakeholder theory

Cyert and March (1959) have argued that the firm is a coalition of various different groups- shareholders, employees, customers, suppliers and the government- each of whom must be paid a minimum to participate in the coalition. Corporations have stakeholders, that is, groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions. The concept of stakeholders is a generalisation of the notion of stockholders, who themselves have some special claim on the firm. Just as stockholders have a right to demand certain actions by management, so do other stakeholders have a right to make claims. Corporations shall be managed in the interests of its stakeholders, defined as employees, financiers, customers, employees, and communities.

The Central premise of much of the literature on stakeholder theory is that focusing on stakeholders, specifically treating them well and managing for their interests, helps a firm create value along a number of dimensions (Free Man, 1984). Financial performance is important to many of a firm's stakeholders, but it is not the only aspect of value that is important to stakeholders. Firm performance might be defined as the total value created by the firm through its activities which is the sum of the utility created for each of a firm's legitimate stakeholders. From a stakeholder perspective, financial performance metrics are important because they are important to all the firm's core stakeholders, but they are incomplete and oversimplify the roles of, and utility received by, the various stakeholders involved in firm success (Barney, 2011). Firm performance for much of the business and economics literature is focused on providing financial returns, variously referred to as profits, return on investment (ROI), economic rents, or shareholder returns.

Relevance and Critique of the theory

The theory makes an important contribution by emphasising that while evaluating a firm's performance, the focus should not be just on how it affects a single participant- the shareholder. Therefore, the measures of performance should be comprehensive enough to rope in the interest of all the stakeholders. However, the current study intended to focus only on the financial performance with special focus being on the interest of shareholders. This theory would be very helpful in broadening the measures of financial performance and in identifying other important influencing factors.

Balanced score card theory

The need to link financial and non-financial measures of performance and identify key performance measures led to the emergence of the balanced scorecard- a set of measures that give top management a fast but comprehensive view of the organizational unit (i.e. a division/strategic business unit). The balanced scorecard was devised by Kaplan and Norton (1992). Balanced scorecard examines firm performance from the perspective of finance, customers, innovation and learning, and internal efficiency. In advocating for the Scorecard, the two authors argue: "senior executives understand that their organization's measurement system strongly affects the behaviour of managers and employees. Executives also understand that traditional financial accounting measures like return on investment (ROI) and earnings per share (EPS) can give misleading signals for continuous improvement and innovation....The traditional financial performance measures worked well for the industrial era, but they are out of step with the skills and competencies companies are trying to master today"

Relevance and Critique of the theory

This theory helped in bringing into fore the fact that a firm's performance should not be judged solely from the financial performance perspective. There are other important dimensions of performance that also have a bearing on financial performance that should never be ignored. However, as far as this study is concerned, the theory is important to the extent that it recognises financial performance as one of the most important measures of a firm's performance.

Economic value added theory

This theory was popularised by Stewart (1994). Economic Value Added, or EVA, is a measure that enables managers to see whether they are earning an adequate return. Where returns are lower than might reasonably be expected for investments of similar risk (i.e., they are below the

cost of capital), EVA is negative, and the firm faces the flight of capital and a lower stock price. Quite simply, EVA is a measure of profit less the cost of all capital employed. EVA is also the spread between a company's return on and cost of capital, multiplied by the invested capital:

$$\text{EVA} = (\text{Rate of Return} - \text{Cost of Capital}) \times \text{capital}$$

Although in any given business there are countless individual operating actions that can create value, eventually they must fall into one of four categories measured by an increase in EVA. Specifically, EVA can be increased through the following four means: Improving the returns on existing capital: this might be achieved through higher prices or margins, more volume, or lower costs; Profitable growth: This might be achieved through investing capital where increased profits will adequately cost of additional capital. Investments in working capital and production capacity may be required to facilitate increased sales, new products or new markets; Harvest: this might be achieved through rationalizing, liquidating, or curtailing investments in operations that cannot generate returns greater than the cost of capital. This might be through divestitures or through withdrawing from unprofitable markets; And optimize cost of capital: this might be achieved through reducing the cost of capital but maintaining the financial flexibility necessary to support the business strategy through the prudent use of debt, risk management, and other financial products

Stewart further suggested that EVA stands well out from the crowd as the single best measure of wealth creation on a contemporaneous basis and is almost 50% better than its closed accounting- based competitor (including EPS, ROE and ROA) in explaining changes in shareholder wealth.

Relevance and Critique of the theory

Quite simply, EVA is a measure of profit less the cost of all capital employed. It is the one measure that properly accounts for all the complex trade-offs, often between the income statement and balance sheet, involved in creating value. This theory is very important for this study because EVA evaluates financial performance both from the perspective of profitability and also value maximization (stock price) unlike some measures that focus on either profitability or value.

Knowledge Gaps in the theories

The following is a summary of knowledge gaps identified in the various theories

Modigliani and Miller theory

The original Modigliani and Miller "irrelevance theory of capital structure", was based on highly simplified assumptions that lack practicality in real world. Some of these unrealistic assumptions

include: capital markets are frictionless and hence there are no transaction costs, firms can be categorized into "equivalent return" classes and that all firms within a class have the same degree of business risk, corporate taxes are also ignored. However, most of these gaps were addressed by some subsequent theories.

Pecking order theory

The key element of pecking order theory is the asymmetric information between firm's insiders and outsiders. The theory ignores the fact that information asymmetry may also exist with the regard to a firm's risk. Generally, a firm should issue more equity and less debt if risk plays a larger role in the adverse selection problem of external financing. This might help to explain why large mature firms tend to issue debt and young small firms tend to issue equity. Outside investors presumably know less about the risk of an investment for a small, young, non-dividend paying firm than for a large, mature, dividend-paying firm.

Agency theory

The attractive aspect of agency theory of capital structure is that it contains a large number of intuitive ideas and it can explain (mostly qualitatively) the usage of different financing strategies and existing phenomenon. The overall effect of agency problems on debt level however is difficult to quantify. In the future, one should expect more research aiming at creating practical recommendations regarding the usage of agency theory by managers.

Static trade off theory

The theory ignores retained earnings and transaction costs, these factors are important in a dynamic setting. For example, profitable firms may prefer to retain earnings in order to reduce the cost of raising funds in the future. This may lead to lower leverage as compared to static theory.

EMPIRICAL EVIDENCE

This section gives a summary of different empirical studies, contributions made by different studies and knowledge gaps.

Studies done in Kenya

Several studies have been done in Kenya to investigate the determinants and state of capital structure among Kenyan firms, the factors that influence financial performance of firms, and the relationship between capital structure and firm financial performance.

Capital structure of the Kenyan Firms

According to Mantilla *et al.* (2009) Kenyan firms have difficulties accessing finance from banks and must revert to alternative financing sources. For instance, the authors noted that manufacturing firms in Kenya finance 51% of working capital and 59% of new investments with retained earnings. However, according to them, this is considerably lower than in most African countries, indicating that Kenyan firms have greater access to external sources of finance at least by African standards. Bank financing covers only 14% of working capital, with 31% of the working capital needs of Kenyan firms being financed by trade credit, the leading source of working capital. The share of working capital financed by trade credit in Kenya is higher than in most African countries.

Gathogo and Ragui (2014) sought to find what determines the capital structure of publicly quoted firms, unquoted firms and small and medium enterprises (SMEs) in Kenya. More specifically, the study aimed to assess whether the size of the firm, asset growth, profitability, liquidity, cost of debt, risk of the business, and industry type were crucial in influencing the capital structure decisions of Kenyan firms. The study employed descriptive design. Stratified sampling technique was used to select 200 firms which included 22 quoted firms, 25 unquoted firms and 153 SMEs. The data for the empirical analysis were derived from the financial statements of these firms over the period 2000- 2010. Information on the heterodox factors was obtained through a questionnaire survey. The size of the firm, asset growth of the firm, profitability, liquidity, cost of debt were found to have a positive effect on the capital structure of a firm. On the other hand, risk of business and industry type were not very strongly correlated to the capital structure of the firm. Modified Pecking Order theory was confirmed by the study.

Muthama *et al.* (2013) analysed the influence of the macro economic factors on the capital structure of selected listed companies in Kenya. The population of study consisted of all firms listed at the Nairobi Securities Exchange (NSE). The sample size was made up of 39 firms which had a “clear capital structure”. Secondary data from financial statements and Kenya Bureau of Statistics was analysed over the period 2004- 2008. An econometric model of linear regressions was used where leverage (debt ratios) was regressed against GDP growth rate, inflation and interest rate. GDP was found to have a positive influence on long-term debt ratio and a negative influence on total debt ratio and short term debt ratio. Inflation had a negative influence on short-term debt ratio while interest rates as measured by the treasury bills have a positive influence on the long-term debt ratio and total debt ratio and a negative influence on the short-term debt ratio.

Capital structure and Firm financial performance in Kenya

In Kenya, some studies about the relationship between capital structure and firm financial performance have been undertaken. Yegon *et al.* (2014) did a research on the effect of capital structure on firm's profitability in the Kenyan Banking sector. Multiple regression analysis was used to evaluate relationship between the variables. Profitability was measured using return on equity (ROE), while ratio of short-term debt to total assets, ratio of long-term debt to total assets, and ratio of total debt to total assets were the indicators of capital structure. The study found a positive relationship between short-term debt and profitability, and a negative relationship between long-term debt and profitability. The study did not perform important diagnostic tests to validate the ordinary least squares (OLS) model that was employed for the analysis. In addition, the time series data was not tested for stationarity. A non-stationery time series is in the danger of giving spurious results. Therefore, there is a need to carry out a similar study that encompasses firms from all the sectors using robust modelling procedures.

Mule *et al.* (2013) sought to establish the effect of ownership concentration on financial performance of firms listed at NSE. Panel and OLS methods were employed in the analysis. The financial measures used in the study included return on equity (ROE), return on assets (ROA), and Tobin's Q. Ownership concentration was defined as the percentage of shares held by those classified as large shareholders. The study used the following as control variables: asset tangibility, size of the firm, age of the firm, profitability, and management efficiency. Ownership concentration was found to be negatively related to all the three measures of performance. This study measured the financial performance of Kenyan firms as determined by ownership concentration. There is a need to evaluate how capital structure affects firm's financial performance. Another similar study was carried out by Kiruri (2013). The researcher sought to investigate the effects of ownership structure on bank profitability in Kenya. Ownership concentration and state ownership were found to have a negative and significant effect on bank profitability while foreign ownership and domestic ownership had positive and significant effect on bank profitability.

Mwangi *et al.* (2014) investigated the effect of capital structure on the performance of non-financial companies listed on the NSE, Kenya. The study employed an explanatory non-experimental research design. Regression analysis was employed in the study. The measures of capital structure included financial leverage, ratio of current assets to total assets, and ratio of non-current assets to total assets. Firm financial performance was measured using ROA and ROE. The study used GDP growth rate as a control variable. Data was obtained from the firm's financial statements. A census of 42 non-financial companies was done. The results showed a statistically significant negative association with performance as measured by ROA and ROE.

The study focused only on non-financial firms. There is need for a study that focuses on all the firms. The use of GDP as a control variable was not defensible because it is expected to affect all the firms indiscriminately. Important moderating variables were not captured in the model. The study did not conduct causality test.

Maina and Ishmail (2014) investigated the effect of capital structure on the financial performance of firms in Kenya. Causal research design was employed in this study. The researchers used Panel regression analysis to estimate the relationship. Financial performance was measured using ROA, ROE, and Tobin's Q. on the other hand indicators of capital structure included: debt equity ratio, total debt to assets ratio, long-term debt to equity. Log of total assets, growth opportunity, asset tangibility ratio, and sales growth were used as control variables. A census of all the firms listed at NSE was done over the period 2002-2011. Secondary data from financial statements was the source of data. The study concluded that debt and equity are major determinants of financial performance of firms listed at the NSE. There was evidence of a negative and significant relationship between capital structure and all measures of performance. The firms that used more debt as a source of finance experienced lower performance. There was vagueness in how the stationerity test was conducted. The researchers did not specify the tools used to test stationerity and how it was conducted. In addition important OLS diagnostic test of normality was not conducted and industry sector as an important control variable was ignored. The researchers did not also conduct co-integration and causality tests.

Wabwile *et al.* (2014) sought to analyse and compare performance amongst tier 1 commercial banks listed on NSE in relation to their financial leverage. Indicators of performance used included Return on Assets (ROA), Return of Capital Employed (ROCE), growth of the firm EPS (Earnings per Share) and Dividend Yield (DY) and value of the firm Price Book Value (PBV). Pearson correlation analysis and regression analysis were used to test correlation of data. The study found a negative correlation between debt asset ratio and ROA and ROCE "though not significant". That is as the debt ratio increases, it means the banks' most assets are being financed by both long-term and short-term liabilities and hence the return on such assets as well as that on capital employed is reduced to cater for the outstanding liabilities. There was a positive correlation between the debt asset ratio and the EPS "though not significant". There was a negative correlation between debt ratio and the PBV "though not significant". It was not clear why Times Interest Earned (TIE) was used as an indicator of capital structure. The study ignored the influence of moderating variables on the financial performance of banks. The study made an assumption that the time series was stationery. This study focused only on banks,

there is a need to undertake a comprehensive study that captures organisations from all the sectors.

Maina and Kodongo (2013) sought to establish the effect of capital structure on financial performance of firms listed at the NSE. The study employed causal research design. The population of interest was the firms quoted at the NSE from year 2002-2011. Panel Regression analysis was conducted. Financial performance was measured using return on equity (ROE), return on assets (ROA), and Tobin's Q. The study concluded that debt and equity are major determinants of financial performance of firms listed at the NSE. The study provided evidence of a negative and significant relationship between capital structure and all measures of financial performance. This implies that the more debt the firms used as a source of finance they experienced low performance. This study assumed that the series was stationery. In addition, the OLS model was not validated through performance of different diagnostic tests. The study also ignored firm's industrial sector as an important moderating variable. It is necessary to undertake a study that comprehensively operationalizes the study variables and using robust fool proof modelling procedures.

Oluwagbemiga (2013) did a study entitled "perceived relationship between corporate capital structure and firm value among the Kenyan listed companies". The sample size was 35 firms excluding financial, investment and insurance companies due to the "peculiar" nature of their capital structure used. A regression analysis model was employed in this study. The study found a positive relationship between capital structure, firm size, liquidity, growth opportunity, and firm value. In other words, the higher the debt to equity ratio, the higher the firm's value. It is not convincing why the study used log of profitability as the measure of the firm's value. Many of the previous studies have justified Tobin's Q as the best measure of a firm's value. In addition, the study did not perform the diagnostic tests that are necessary when one uses an OLS model. Furthermore, the study did not test stationerity of the time series data that was used. There is need for a study that comprehensively measures the concept of financial performance as opposed to firm value alone. The study should also utilise fool proof statistical modelling procedures for establishing relationship between study variables.

Buigut *et al.* (2013) investigated the relationship between capital structure and share prices of the energy firms listed at the Nairobi Securities Exchange (NSE). The study assessed the effect of debt, equity, and gearing ratio on share price. A multiple regression model was employed in the analysis. Debt, equity, and gearing ratio were found to be significant determinants of share prices for the sector under consideration. Gearing ratio (equity/debt) and debt (debt/total assets) were found to positively affect share prices, while equity negatively affected share prices. This study focused only on one element of firm's financial performance

(the share price). There is need for a study that shows how capital structure broadly affects a firm's financial performance. In addition, the multiple regression models that were employed in this study were not subjected to important OLS diagnostic tests of autocorrelation, multicollinearity, and heteroscedasticity. The study also assumed the absence of moderating variables. Furthermore, the time series data was not subjected to stationerity test to ensure that the results obtained would not be spurious.

Select Studies from Rest of the World

A lot of empirical evidence has been gathered regarding how or whether capital structure decision affects a firm's performance in diverse contexts outside Kenya. Some select studies representative of the different regions of the world are discussed below:

Studies from Africa

Iorpev and Kwanum (2012) examined the impact of capital structure on the performance of manufacturing companies in Nigeria. The annual financial statements of 15 manufacturing companies listed on the Nigerian Stock Exchange were used for the study which covered a period of 5 years from 2005-2009. Multiple regression analysis was applied on performance indicators namely return on assets (ROA) and profit margin (PM), as well as ratio of short-term debt to total assets (STDTA), ratio of long-term debt to total assets (LTDTA) and ratio of total debt to equity (TDE) as capital structure measures. The results showed that there is a negative but not significant relationship between STDTA and LTDTA, and ROA and PM; while TDE is positively related with ROA and negatively related with PM. STDTA is significant using ROA while LTDTA is significant using PM. The work concluded that statistically, capital structure is not a major determinant of firm performance. The researchers made a good attempt because they were able to operationalize capital structure into all its constituents. However, the following weaknesses were observed. Firstly, profit margin (PM) was used as a measure of firm performance. The computation of profit margin ignores interest on debt and taxation. Therefore, it cannot adequately capture capital structure choice consequences. Again, the moderating variables were also ignored. In addition, the two regression equations used assumed that the relationship between the variables is necessarily linear- but the relationship could as well be quadratic, cubic, etc. There was no assurance that the relationship between the study variables was spurious because stationerity test was not conducted on the time series data.

Abor (2005) sought to investigate the relationship between capital structure and profitability of listed firms on the Ghana Stock Exchange (GSE) during a five-year period. Profitability was measured using the ratio of earnings before interest and taxes (EBIT). The

following leverage ratios were used to measure capital structure: short-term debt to the total capital; long-term debt to total capital; and total debt to total capital. Firm size and sales growth were used as control variables. Regression analysis was used in the estimation of functions relating the return on equity (ROE) with measures of capital structure. The results revealed a significantly positive relation between the ratio of short-term debt to total assets and ROE. However, a negative relationship between the ratio of long-term debt to total assets and ROE was found. With regard to the relationship between total debt and return rates, the results showed a significantly positive association between the ratio of total debt to total assets and return on equity. The researcher observes EBIT was not the best measure of financial performance because it does not capture the interest on debt and taxation. These two are some of the consequences of capital structure choice. The author also assumed that the regression model would necessarily be linear without conducting preliminary tests. In addition, stationarity, diagnostic, and co integration tests were not done.

Onaolapo and Kajola (2010) examined the impact of capital structure on firm's financial performance using a sample of thirty non-financial firms listed on the Nigerian Stock Exchange during the seven-year period, 2001-2007. Panel data for the selected firms were generated and analysed using Ordinary Least Squares (OLS). The results showed that a firm's capital structure measured by debt ratio has a significantly negative impact on the firm's financial measures of ROA and ROE. The authors used the following control variables: Asset turnover was used to measure efficiency of management; Secondly, the size of a firm was considered to be an important determinant of firm's profitability. Large firms can enjoy economies of scale and these can favourably impact on profitability; thirdly, age of the firm was also considered an important contextual factor. It was argued that older firms can achieve experience based economies and can avoid the liabilities of newness as opposed to newer firms; fourthly, asset tangibility was also incorporated- A firm with high fraction of plant and equipment (tangible assets) in the asset base makes the debt choice more likely and influences the firm performance. A firm that retains large investments in tangible assets will have smaller costs of financial distress than a firm that relies on intangible assets; finally, industrial sector was also taken into account. This is because, capital structure for firms vary from one sector to another. This particular study was strong in the area of considering a variety of moderating variables in the modelling. However, the operationalization of capital structure was not comprehensive as the authors used debt ratio as the only indicator of capital structure. In addition, assumption of linearity was made without preliminary tests, and the crucial tests of stationarity, diagnostics, and co integration were not carried out.

Coleman (2007) examined the impact of capital structure on the performance of microfinance institutions (MFIs). Panel data covering the ten-year period 1995-2004 were analysed within the framework of fixed- and random-effects techniques. Panel data from 52 MFIs drawn from Ghana was used- The 52 institutions were purposely selected due to data availability and accessibility. Outreach and default rate were used as the indicators of performance, while short term debts, long term debts and total debts as a ratio of total assets were used as the measures of capital structure. Control variables used included firm size, risk level, and firm age. Highly leveraged microfinance institutions were found to perform better by reaching out to more clientele, enjoyed economies of scale, and therefore were better able to deal with moral hazard and adverse selection, enhancing their ability to deal with risk. But the author did not conduct stationarity, diagnostics, and co integration tests.

Studies from Asia

Khan (2012) carried out a study to find out the relationship of capital structure decision with the performance of the firms in the developing market economies. Pooled Ordinary least square regression was applied to 36 engineering sector firms in Pakistan market listed on the Karachi Stock Exchange (KSE) during the period 2003-2009. The engineering sector was chosen because it is capital intensive and requires large amount of capital investment and the business cycles are much larger and returns are witnessed over a longer time period compared to the other industries. The results showed that financial leverage measured by STDTA and TDTA has a significantly negative relationship with the firm performance measured by ROA, GM, and Tobin's Q. The relationship between financial leverage and firm performance measured by the ROE was negative but not significant. Asset size had no significant relationships with firm performance as measured by ROA and GM but a negative and significant relationship was found to exist with Tobin's Q. The researcher's regression model was a good one because he introduced a control variable, firm size. The argument was that large firms have more capabilities and resources, achieve economies of scale and are more diversified. However, there are more contextual factors that should have been incorporated into the model. But the model was not subjected to diagnostic, stationerity, and co integration tests.

In Pakistan, Hamidullah and Shah (2011) attempted to establish a joint determination of a firm's value through "ownership structure" and "capital structure", using a random sample of 80 firms listed on the Karachi Stock Exchange, Pakistan from 2003 to 2009. The study first used several variants of the panel data analysis such as "pooled OLS, fixed effects, and random effects" models to investigate the association between ownership variables and leverage. Then allowing for the possibility of endogeneity among ownership variables, leverage, and firm value,

the paper employed 3SLS regression models. Results of the panel data models signified the existence of negative association between the “institutional ownership and leverage” while managerial ownership did not show statistically significant association with leverage, possibly because of non-linear relationship between the two. Results of the 3SLS models showed that leverage and Tobin’s Q are negatively associated to “managerial share ownership”. Results of the second equation of the 3SLS model Tobin’s Q was positively related to managerial ownership at lower level and negatively related to it at higher levels. The third equations suggested that leverage was positively related with Tobin’s Q while negatively related with managerial share ownership. The simultaneous equations purported that ownership structure affects firm’s value through capital structure. The study made a good attempt but it was not comprehensive enough in terms of capturing several measures of performance and moderating variables.

In Malaysia a couple of studies have been done. Ahmad *et al.* (2012) sought to investigate the impact of capital structure on firm performance by analyzing the relationship between operating performance of Malaysian firms, measured by return on asset (ROA) and return on equity (ROE) with short-term debt (STD), long-term debt (LTD) and total debt (TD). The study covered two major sectors in Malaysian equity market which are the consumers and industrials sectors. Fifty eight (58) firms were identified as the sample firms and financial data from the year 2005 through 2010 were used as observations for this study, resulting in a total number of 358 observations. A series of regression analysis were executed for each model. Lag values for the proxies were also used to replace the non-lag values in order to ensure that any extended effect of capital structure on firm performance was also examined. The study found out that only STD and TD had significant relationship with ROA while ROE had significance on each of debt level. However, the analysis with lagged values showed that none of lagged values for STD, TD and LTD had significant relationship with performance. The study was a good attempt because unlike most previous studies it tested for co-integration. However, the study ignored the effect of moderating variables.

Yousefi *et al.* (2012) did yet another study in Iran. They examined the effect of industry on the relation between capital structure and profitability of Tehran Stock Exchange firms, using a comprehensive sample covering 136 firms in 6 industries over the period 2005- 2009. The study which was descriptive in nature argued that the relation between firms’ capital structure and profitability among different industries are diverse due to the effect of the specific sort of industry they belong to. The needed data were collected from the financial statements of the sample firms. First, firms’ debt ratio as the capital structure indicator and return on investment (ROI) as the profitability indicator were measured using collected data and then to examine the

hypothesis, Pearson correlation coefficient was used. The results revealed that this relation differs among diverse industries and that a particular components of capital structure can lead to either a significant positive or negative relation or even no relation with profitability regarding the influence of industry. Therefore, it was concluded that the kind of industry is the most important influential factor on firms' capital structure and also determines whether or not there is a significant relation between the capital structure and profitability and type of the relation as well.

Studies from Australia

Skopljak (2012) set out to find the effect of capital structure on the performance of Authorised Deposit-taking Institutions (ADIs) in Australia. The performance was measured using the ratio of inputs to outputs (efficiency). Inputs included three factors of production namely: the cost of loaned funds cost of labour, and cost of fixed assets. Outputs constituted of two measures of yields from using the factors of production: revenue from loans, and revenue from other activities. Capital structure was measured using ratio of equity divided by capital (ECAP). A low ECAP described a bank with relatively high leverage while a high ECAP described a bank with relatively low leverage. The control variables used included profit, asset and equity variable. The study found out that a significant and robust quadratic relationship existed between capital structure and firm performance. At relatively low levels of leverage an increase in debt leads to increased profit efficiency hence superior bank performance, at relatively high levels of leverage increased debt leads to decreased profit efficiency as well as bank performance. The author did a good work at not making an assumption that the relationship between the study variables was linear. Actually, he found that a quadratic relationship existed between the study variables. However, the study lacked stationarity, diagnostics, and co integration tests. In addition, the measures of capital structure, performance, and moderating factors were not exhaustive.

Luo (2012) carried a research in Australia to find out the relationship between the capital structure and performance of firms in the financial sector. The data consisted of a total 23 banks and financial institutions. The sample period spanned the period 2005 to 2007. ROE was chosen as a measure of performance due to its popular application in finance and accounting. Capital structure was measured using the ratio of equity to debt (ECAP). A low ECAP described a bank with relatively high leverage while a high ECAP described a bank with relatively low leverage. The study attempted to model a quadratic relationship between capital structure and performance using regression analysis. He found out a significant and robust quadratic relationship between capital structure and firm performance. At relatively low levels

of leverage an increase in debt led to increased profit efficiency hence superior bank performance. At relatively high levels of leverage, increased debt led to decreased profit efficiency as well as bank performance. He attributed this to financial distress outweighing any gains made from managerial performance improving and argued that a bank can help optimize the performance of management and general bank performance by choosing a capital structure which optimizes managerial incentives while keeping financial distress relatively low. The strongest point of this study is that it tested for reverse causality. But the biggest weakness was that they independent and dependent variables were not comprehensively operationalised. In addition the study did not perform diagnostic test, co integration and stationarity tests.

Studies from Europe

Kapopoulous and lazaretou (2006) tried to investigate whether there is strong evidence to support the notion that variations across firms in observed ownership structures result in systematic variations in observed firm performance. The study used data for 175 Greek listed firms. Accounting profit and Tobin's Q were used as the measures of performance. The ownership structure was first modelled as an endogenous variable and, secondly, two different measures of ownership structure reflecting different groups of shareholders with conflicting interests. Empirical findings suggested that a more concentrated ownership structure positively relates to higher firm profitability. The study used measures of performance that capture both profitability and wealth maximisation aspects of a firm. However, the study did not test the data for stationerity.

Karaca and Eksi (2012) investigated the relationship between ownership structure and corporate performance of 50 companies, listed in manufacturing industry on the Istanbul Stock Exchange during the 2005-2008 periods. The study used the share of the largest shareholder as ownership structure variables, Tobin's Q and profit before tax divided by total asset as performance variables, and leverage and firm size as control variables. Panel unit root and Hausman tests were made and then panel data analysis were applied. According to the result of analysis, while TLS were observed to have positive effect on PBT, no effects were observed on TOB. This study used measures of performance that capture both profitability and wealth maximisation aspects. In addition, the researchers conducted unit root test to ensure that the relationship established between study variables was not spurious. However, the period of analysis (four years) appeared too short to yield reliable results. Furthermore, the study ignored the influence of moderating variables.

Studies from America

Zaher (2010) set to find out whether investors tend to reward firms that resist the urge to borrow and operated with debt free balance sheet and penalize firms that have levels of debt. The data base constituted all publicly traded US Corporations that are available on the CRSP and COMPUSTAT data base from the period 1997-2007. Two samples of firms were extracted from the data bases, a debt free firm sample and a leveraged firm sample. Debt free firms were categorised as firms with a zero debt to total asset ratio, and leveraged firms as firms with a debt ratio that was equal or greater than 30 percent. Jensen's alpha and Sharpe information ratio were used as measures of performance. The performance of portfolios of debt free firms was compared to comparable portfolios of leveraged firms. The results showed that investments in portfolios of debt free firms tend to generate higher returns than investments in their peers of portfolios of leveraged firms over long and short periods. The study did not however capture the impact of control variables on the performance of firms. In addition, the regression model used to compute Jensen's alpha was not subjected to diagnostic tests and stationarity test.

Tailab (2014) analysed the effect of capital structure on financial performance. Two main sets of variables were used: For profitability, return on assets (ROA) as the ratio of net income to total assets, and return on equity (ROE) as the ratio of net income to shareholder's equity were adopted as a proxy for financial performance; and to indicate capital structure, short-term debt, long-term debt, total debt, debt to equity ratio, and firm's size were used. A sample of 30 Energy American firms for a period of nine years from 2005 – 2013 was considered. Secondary data were collected from financial statements which were taken from Mergent online. The data was analysed using PLS (Partial Least Square). The empirical findings showed that the total debt has a significant negative effect on ROE and ROA, while size in terms of sales has significantly negative effect on ROE. However, a short debt significantly has a positive influence on ROE. The researcher did not conduct stationarity, diagnostics, reverse causality and co integration tests. In addition, the study would have yielded more accurate results if it included more moderating variables like age of the firm, and asset turnover.

The table 1 presents the summary of contributions made by various studies and the knowledge gaps.

Table 1: Summary of research gaps in the various studies

Author(s)	Objective	Context	Methodology	Findings	Contribution	Gap
Yegon <i>et al.</i> (2014)	Effect of capital structure on firms' profitability in the Kenyan banking sector	Kenya	Causal research design; multiple regression analysis	Positive relationship between ratio of STD and profitability; Negative relationship between the ratio of LTD and profitability	Capital structure construct was comprehensively operationalised into the ratios of STD, LTD, and TD	OLS diagnostic tests not done; stationerity, co-integration, and reverse causality tests not conducted; ignored the effect of moderating variables
Mule <i>et al.</i> (2013)	Effect of ownership concentration on financial performance of firms listed on NSE	Kenya	Causal research design; multiple regression analysis	Ownership concentration negatively affects ROE, ROA, and Tobin's Q	Measures of financial performance well operationalised to include profitability and wealth maximisation; Used control variables in the model- Asset tangibility, firm size, age of firm, management efficiency	The study focused on ownership concentration as opposed to the conventional capital structure as articulated in the finance theory
Maina and Ishmail (2014)	Effect of capital structure on financial performance of firms in Kenya	Kenya	Causal research design; multiple regression analysis	Higher debt ratios negatively affects ROE, ROA, and Tobin's Q	Financial performance as a construct was comprehensively operationalised into the following indicators: ROE, ROA, and Tobin's Q	Industrial sectors as an important moderating variable was excluded; OLS diagnostic tests not done; stationerity, co-integration, and reverse causality tests not conducted

Wabwile (2014)	Effect of financial leverage on the profitability of tier 1 commercial banks listed on the NSE	Kenya	Causal research design; multiple regression analysis and Pearson correlation	debt asset ratio negatively affects ROA and ROCE; There is positive correlation between debt asset ratio and EPS	Added growth as measured using EPS as a measure of performance, in addition to profitability and valuation measures	It was not clear why TIE was used as an indicator of capital structure; ignored the influence of moderating variables; Assumed that the time series was stationery
Maina and Kodongo (2013)	Effect of capital structure on the financial performance of firms listed at the NSE	Kenya	Causal research design; Panel regression analysis	Higher debt negatively affects ROE, ROA, and Tobin's Q	Financial performance as a construct was comprehensively operationalised into the following indicators: ROE, ROA, and Tobin's Q	Assumed that the series was stationery; No diagnostic tests conducted on the OLS model; Industrial Sector not included as an important moderating variable
Oluwagbemiga (2013)	Relationship between capital structure and firm value among Kenyan listed firms	Kenya	Descriptive design; Regression analysis	Higher debt positively affects firm size, liquidity, growth opportunity, and firm value	The study focused on measuring one important indicator of performance, that is, firm value	Log of profitability is not a tenable measure of firm value. Many previous studies have justified Tobin's Q as a superior measure of firm value; Diagnostic tests on the OLS model not conducted; Assumed the series was stationery; Reverse causality test not conducted

Buigut <i>et al.</i> (2013)	Relationship between capital structure and share prices of Energy firms listed at the NSE	Kenya	Causal research design; multiple regression analysis	Debt to equity ratio and debt to total assets ratio have a positive effect on share prices; While equity has a negative effect on share prices	The study focused on measuring one important indicator of performance, that is, firm value	OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted; ignored the effect of moderating variables
Iorpev and Kwanum (2012)	Impact of capital structure on the performance of manufacturing companies in Nigeria	Nigeria	Causal Research design; Multiple regression analysis	STD and LTD negatively affects Gross Profit margin (PM) and ROA; total debt to equity ratio positively affects ROA but negatively affects PM	Capital structure construct was comprehensively operationalised into the ratios of STD,LTD, and TD	Use of PM to compare performance of firms with different debt levels not tenable; OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted
Abor (2005)	Relationship between capital structure and performance of listed firms on the GSE	Ghana	Causal research design; multiple regression analysis	The ratio of STD affect ROE positively; the ratio of LTD affects ROE negatively; the ratio of TD affects ROE positively	Capital structure construct was comprehensively operationalised into the ratios of STD,LTD, and TD	EBIT as a measure of financial performance was not tenable; OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted

Onalapo and Kajola (2010)	Impact of capital structure on firms' financial performance	Nigeria	Causal research design; multiple regression analysis	Debt ratio has a negative effect on ROA and ROE	Comprehensive use of control variables: management efficiency, firm size, age of the firm, and asset tangibility	Used only a single indicator of capital structure i.e. debt ratio; OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted
Coleman (2007)	Impact of capital on the performance of micro-finance institutions (MFIs)	Ghana	Causal research design; multiple regression analysis; fixed and random effects techniques	Highly leveraged firms performed better	The study focused specifically on the MFIs	OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted
Khan (2012)	Relationship between capital structure and performance of firms in developing economies	Pakistan	Causal research design; multiple regression analysis	Financial leverage negatively affects ROA, gross profit margin; and Tobin's Q	Made use of a control variable i.e. firm size	OLS diagnostic tests not done; stationarity, co-integration, and reverse causality tests not conducted

Ahmed <i>et al.</i> (2012)	Impact of capital structure on the operating performance of Malaysian firms	Malaysia	Causal research design; multiple regression analysis	The ratios STD and TD affects ROA, while ROE has an effect on each debt level; Non-lagged values for STD, TD, and LTD have an effect on performance	The study conducted co-integration test	The study ignored the effect of moderating variables
Yousefi <i>et al.</i> (2012)	Effect of industry on the relationship between capital structure and profitability	Iran	Descriptive survey design; Pearson correlation	Profitability among firms in different industries were diverse due to the effect of the specific sort of industry they belong	The study evaluated the moderating effect of industrial sector on the relationship between capital structure and firm profitability	Pearson correlation is a weak statistic because it cannot measure causality
Luo(2012)	Relationship between capital structure and performance of firms in the financial sector	Australia	Causal research design; Regression analysis	There exists a significant and robust quadratic relationship between leverage and financial performance	The study tested for reverse causality; the research did not assume an existence of linear relationship between study variables	OLS diagnostic tests not done; stationerity test, and co-integration test not conducted; reverse causality test not conducted
Kapopoulous and Lazaretou (2006)	Effect of firm ownership structure on performance	Greece	Causal research design; Regression analysis	More concentrated ownership positively relates to higher performance	The study used measures of performance that capture both profitability and wealth maximization	OLS diagnostic tests not done; stationerity test, and co-integration test not conducted; reverse causality test not conducted

Karaca and Eksi (2012)	Relationship between ownership structure and corporate performance	Turkey	Causal research design; Regression analysis	Ownership structure has a relationship with profit before tax but no relationship with Tobin's Q	The study conducted stationerity test	A time series study covering only four years cannot give the most reliable results
Zaher (2010)	Effect of capital structure on financial performance	USA	Descriptive survey design; multiple regression	Debt free firms generated superior returns	The study juxtaposed the firms under study into the two extremes of capital structure characteristics i.e. debt free firms Vs leveraged firms	The study ignored the influence of moderating variables; OLS diagnostic tests not done; stationerity test, and co-integration test not conducted; reverse causality test not conducted
Tailab (2014)	Effect of capital structure on financial performance	USA	Causal Research Design; Partial Least Square	Total debt has a significant negative effect on ROE and ROA; Short-term debt has a positive effect on ROE	Conducted stationerity test	Ignored important moderating variables of managerial efficiency and age of the firm

Notes: ROE = Rate of Return on Equity; ROA= Rate of Return on Assets; LTD = Ratio of Long-term Debt to Total Assets; STD = Ratio of Short-term Debt to Total Assets; TD = Ratio of Total Debt to Total Assets; Earnings Per Share (EPS); Gross Profit Margin (PM); Return on Capital Employed (ROCE); Times Interest Earned (TIE); Earnings Before Interest and Tax (EBIT); Ordinary Least Squares; Nairobi Securities Exchange (NSE); Ghana Stock Exchange (GSE); Karachi Stock Exchange (KSE)

CONCLUSION AND RECOMMENDATIONS

The various researches that have been reviewed have made a fair attempt at explaining the relationship between capital structure and performance of firms. A summary of the contributions made by the various studies is captured in table 1. However, some studies used some measures of performance that did not seem to capture the consequences of capital structure choice. For instance, some studies used gross profit margin (GM) and Earnings before Interest and Tax (EBIT) as a measures of performance. GM and EBIT are not capable of showing the likely difference in financial performance between firms that employ different levels of debt. This is because the calculation of GM and EBIT does not capture interest on debt and taxation. This study suggests that the most tenable measures of financial performance would be return on equity (ROE), return on assets (ROA) and Tobin's Q, and Earnings per Share (EPS).

In addition, most studies did not adequately operationalise the study variables. For instance, financial performance indicators should capture all the dimensions of performance including profitability, efficiency, growth and wealth maximization (value of the firm). Similarly, capital structure should be comprehensively analysed into all its constituents of short-term and long-term debt. Finally, the studies should not ignore the role of control variables in the moderation of relationship between the independent and dependent variables.

But most importantly, an overwhelming majority of the studies lacked in the area of modeling the relationship between the study variables. While majority of the studies made use of regression analysis, unfortunately OLS mandatory diagnostic tests, stationarity test, co integration test, and reverse causality tests which are very crucial in financial time series modeling were glaringly missing. This puts to question the reliability of the models so developed. This study suggests that stationarity test must be performed to ensure that the relationships established from regression analysis are not spurious. Reverse causality should also be undertaken to show the direction of relationship among the study variables. In addition, co integration test should be done to verify if the relationships hold in the long-run. Finally, various diagnostic tests namely normality test, autocorrelation, heteroscedasticity, and multicollinearity must be done to ensure that the model(s) is validated. A comprehensive summary of research gaps in the specific studies is captured in the following table:

It is recommended that a study about the relationship between capital structure and firm financial performance should be conducted in Kenya using comprehensively operationalized study variables and the most robust and foolproof modeling procedures in order to give a conclusive answer to this important question. There is need for a study that shall act in future as the key reference material in relation to this subject in the Kenyan context.

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