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CONTENT

	<i>Page</i>
1. The Impact of Corporate Social Responsibility Expenditure on Firm Performance and Firm Value of Nigerian Banks — Abogun, S., Fagbemi, T.O., Uwuigbe, O.R.	1
2. Effects of Formal Skill Acquisition on Entrepreneurial Performance of Two Selected Local Government Areas in Oyo State — Dairo, A.O., Alo, E.A.	13
3. Effect of Compensation on Employee Performance in Nigerian Banking Industry — Imouokhome, E., Dr. Aun, I.I., Oladipo, G.T.	28
4. The Impact of Budget Participation on Information Manipulation Via Environmental Uncertainty: A Study of Quoted Companies in Nigeria — Fagbemi, T.O., Ajibolade, S.O., Akinniyi, K.O., Abogun, S.	42
5. Essentials of Non-oil Exports in Economic Development of Nigeria: A Descriptive Approach — Balogun, W.O., Akinjole, A.	55
6. Inter-Industry Linkage of Small and Medium Scale Enterprises as a Mechanism of Small Scale Business Development and Poverty Reduction: Empirical Evidence from Nigeria — Abu Z., Olowu, A. U.	66
7. Impact of Environmental Accounting Disclosure Practices on Financial Reporting and Performance of Selected Commercial Banks in Nigeria — Dr. (Mrs.) Yahaya K.A., Dr. Sanni M., Omede I.L., Oni M.O.	80
8. Post Consolidation Assessment of the Effect of Capital Structure on Banks' Performance in Nigeria — Olaniyi, T.A., Adeyemi, A.Z., Oloyin-AbdulHakeem, B.O.	99
9. Total Quality Management and Organisational Performance: A Survey of Selected Hospitality Industry in Ilorin Metropolis, Nigeria — Ijaiya M.A., Sanni, M., Shorun, C.Y., Abdulmumin, B.A.	111

POST CONSOLIDATION ASSESSMENT OF THE EFFECT OF CAPITAL STRUCTURE ON BANKS' PERFORMANCE IN NIGERIA

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Abstract

This study examines the effect of capital structure on bank performance in the post-consolidation era in Nigeria with a view to validate or refute the long standing Modigliani and Miller theory of irrelevance or the Traditional relevance theory. The secondary data used were obtained from annual financial statements over a period of seven (7) years from 2005 to 2011 of the stratified sampled fifteen (15) banks listed on the Nigerian Stock Exchange. A panel regression analysis was applied on Return on Assets (ROA) as performance indicator as well as short term debt ratio (STDTA) and total debt ratio (TDTA) as proxies for capital structure while a 2-tailed t test was used to test the formulated hypotheses at 5% significance level. The study finds an insignificant negative impact of capital structure (STDTA and TDTA) on bank performance (ROA), a compliance with MM irrelevance theory leading to the acceptance of null hypotheses; that no significant relationship exist between capital structure and bank performance in Nigeria. The study recommends that instead of

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emphasizing capital structure composition, managerial efficiency must be sought instead, with a view to enhance bank performance/profitability, achieve all-round stake holders satisfaction and engender a more viable and reliable banking sector in the country.

Keywords: Capital structure, Return on assets, Debt ratio, Consolidation.

1.0 Introduction

The fact that the magnitude of the risk a firm is exposed to depends on the mix of the various sources of finance (debt and equity) adopted by the firm brings out the relevance of capital structure in enterprise's financing policy. The capital structure of an enterprise according to Watson and Head (2007) is the mix of debt including preference stock and equity often referred to as the firm's long term financing mix. While Debts can be acquired in the form of bonds and long term credit and equity can be acquired through the participation of stakeholders or common stocks and retained earnings. An optimal capital structure determination is one of the most important and complex issues in the corporate finance.

The banking sector in most economies is so critical that it attracts much attention and demands from the domestic and international financial institutions, regulatory agencies and multivarious demands of the different stakeholders. A high percentage of equity places a higher contribution demand on the shareholders while debt financing is tax deductible but exposes shareholders to high risk. This scenario can be likened to a situation where you can't eat your cake and have it. What then is the best option and what impact specifically does capital structure have on bank performance.

Financial performance according to Barbosa and Louri (2005) as reflected in profit maximization, maximizing return on assets and maximizing shareholder return based on firm's efficiency is based on return on investment, residual income, earnings per share, dividend yield, price/earnings ratio, growth in sales, market capitalization etc.

The issue of capitalization came up in Nigeria in 2004 as a policy to raise the capital base of banking sector to a minimum of N25 billion with a view to raise the standard and strength of the sector and possibly forestall liquidity susceptibility. Hence, the important question facing banks in need of new/ additional finance is whether to raise debt or equity capital, the issue of finance has been identified as an immediate reason for business failing to start or to progress.

It is imperative for banks in Nigeria to be able to finance their activities and grow over time in order to minimize the pain of global financial crisis biting hard on

the economy if they are to play an increasing and predominant role in creating value-added, providing employment as well as income in terms of expanding the size of the directly productive sector in the economy. This helps in generating tax revenue for the government and facilitating poverty reduction through fiscal transfers and income from employment and firm ownership. This is the pattern found in developing and developed countries (La-portal, Lopez-Ze-Silanes, Shleifer and Vishny (1999).

Since every investment decision taken by the manager affects the performance of the banks, the percentage of equity and debt in the capital structure of the bank to maximize profitability of the bank given that each source of finance has a cost benefit attach to it, is a major managerial decision that deserve adequate attention. The difficulties associated with designing such optimum capital structure policies (which Modigliani and Miller 1958; believe not to exist) to enhance profitability is an arduous task and is characterized by lack of consensus. Thus, examining the relationship between the two is not an academic waste but a justifiable effort. This was pursued by concentrating on the fifteen (15) selected banks out of all the twenty one (21) banks listed on Nigerian Stock Exchange over a period of seven (7) years spanning from 2005 to 2011. This feature make this study unique and different from others as it evaluate financial performance of Nigerian banks in the post consolidation era as it is affected by the capital structure decisions.

This study, therefore, address the capital structure puzzle using data from the Nigerian quoted banks with a view to address the following questions:

- (i) To what extent is the profitability of Nigeria banks influenced by total debt ratio?
- (ii) To what extent is the profitability of Nigerian banks influenced by short-term debt ratio

These research questions are transformed into the following study hypotheses:

- (i) Profitability of Nigerian banks is not significantly influenced by total debt ratio.
- (ii) Profitability of Nigerian banks is not significantly influenced by short- term debt ratio.

1.2 Objectives of the Study

This study examines the relationship between capital structure and financial performance of Nigeria banks. However, it clusters around two specific objectives:

- i) To examine the effect of total debt ratio on the profitability of Nigerian

banks.

- ii) To examine the effect of short-term debt ratio on the profitability of Nigeria banks.

Literature Review

2.0 Conceptual Clarification

2.1 Capital Structure and Performance

In reality, capital structure of a firm is difficult to determine but it refers to the firm's financial framework of debt and equity use to finance the firm. In financial parlance; Saad (2010) defined capital structure as the way in which firm finances their assets through the combination of equity, debt, or hybrid securities. A debt entitles the holder to a fixed interest rate and this is deductible before profit determination while equity is owners contribution. It only entitles the holder to right to dividend which is not certain. This is because it is not compulsory for any firm to pay dividend. Retained earnings is a profit set aside for further growth from the annual profit. As such, it has the same characteristic as equity except that it has no issue cost.

Performance is controversial in the literature due to its multidimensional meanings/usage. Precisely, although the two are interconnected, it may be interpreted from the perspective of organizational and financial performance. While organizational performance is anchored on corporate achievements in terms of productivity, return, growth and customer satisfaction, financial performance is on the other hand is related to profit maximization, maximizing return on assets and maximizing shareholders return based on efficiency (Chakravarthy, 1986).

Other performance measure is the market performance such as price per share to the earnings per share (Abdel -Shahid, 2003), market value of equity to book value of equity and Tobin's Q. The most widely used measures of performance are Return on Equity (ROE) and Return on Investment (ROI) which are accounting measures but Tobin's Q mixes accounting and market measures.

2.2 Theoretical Background

A number of theories have been found in the literature to explain the capital structure and its relationship with performance including the irrelevance /MM Theory, Static Trade -off Theory in the 1960s- 1970s, Agency Cost Theory in the mid-1970s and Pecking Order Theory in the 1980s.

The MM theory of capital structure as propounded by Modigliani and Miller (1958) argued that the value of the firm should not depend on its capital structure under the assumption of perfect market where information id freely available. no

transaction or bankruptcy cost as well as no taxation. Thus, equity and debt choice become irrelevant and internal and external funds can be perfectly substituted.

The static trade off theory believe there is a positive relationship between the firm's leverage and performance such that firms manage to balance the bankruptcy cost with the benefits of tax shields (Kraus and Litzenberger, 1973; Scott, (1977).

On the other hand, the pecking order theory according to Myers (1984), and Myers and Majluf (1984) argues that there exist a negative relationship between the debt level and firm performance. Hence, more profitable firms generate higher earnings that can serve for self financing, enabling them to opt less for debt financing while less profitable firms are compelled to take on debt in order to finance their ongoing activity.

The traditional theory on its own proposes a relevance of optimal capital structure wherein debt capital is cheaper than equity and thus a company can increase its value by borrowing up to a reasonable limit. Hence, there is an optimal capital structure that maximizes the firm's value and minimizes the firm's cost of capital which means that different levels of capital structure yields different values for the firm. Summarily, this study is anchored on all the theories reviewed in this study as they directly relate capital structure to performance.

2.3 Empirical studies

The relationship between capital structure and bank performance have been addressed in the literature. For instance, Desai (2007) pointed out that capital structure could have two effects: one, firms of the same risk class could possibly have higher cost of capital with higher leverage. Second, capital structure may affect the valuation of the firm, with more leverage firms being riskier and consequently valued lower than the less leveraged firms. However, pursuing the objective of shareholders wealth maximization by a firm makes capital structure decisions relevant and indeed an important managerial decision.

Following the pioneer study of Modigliani and Miller (1958, 1963) a substantial amount of effort has been put forward in corporate finance theory to determine the factors that influence a firm's choice of capital structure and its impact on performance. Such categories of determinants identified by Haris and Raviv (1991) include the desire to:

Ameliorate conflicts of interest among various groups with claims to the firm's resources, including managers (the agency approach),

Convey private information to capital markets or mitigate adverse selection effects (the asymmetric information approach),

Influence the nature of products or competition in the product/input market, or Affect the outcome of corporate control contests.

Deciding on the combination of debt and equity that will minimize the firms cost of capital and hence maximizes the firms profitability and market values (optimal capital structure) is affected by conflict between shareholders and managers and between debt holders and equity holders as identified by Jensen and Meckling (1976). These conflicts have remained unresolved ever since and worse still, there exists no manual to consult when taking decisions relating to optimal capital structure.

Following the pioneer study of Modigliani and Miller (1958, 1963), Myers (1977), Williamson (1988) and Stulz (1990) a substantial amount of effort has been put forward in corporate finance theory to determine the factors that influence a firm's choice of capital structure and its impact on performance. While Modigliani and Miller (1958) assume that under conditions of no bankruptcy cost and frictionless capital markets without taxes, firm's values is independent of its capital structure, Watson and Head (2007) believed that the choice of debt and equity results in the growth in the value of investment made by various categories of investors particularly equity investors. This debt-equity mix was adjudged very crucial by Barclays and Smith (2005) as they pointed out that if too much debt can destroy firm's value by causing financial distress and underinvestment, then, too little debt can also lead to overinvestment and negatively affect returns.

Gleason *et al* ((2000) evaluated the relationship between culture, capital structure and performance using data from retailers in 14 European countries. The result shows that capital structure differs by cultural classification of retailers and that capital structure will influence performance.

Abor (2005) examines the influence of capital structure on profitability of listed companies in Ghana Stock Exchange over a five year period and found a positive relationship between debt financing and Profitability. Zeitun and Tian (2007) look into the capital structure and profitability relationship on 167 listed companies in Jordan using a panel data model and finds a significant negative impact of capital structure on firm's performance.

Pratomo and Ismail (2006) examine Islamic bank performance and capital structure in 15 Malaysia Islamic banks between 1997 and 2004. Their results show a higher leverage or lower equity capital ratio is associated with higher profit efficiency. It also confirms the agency theory hypothesis

Omorogie and Erah (2010) investigate capital structure and corporate performance in Nigeria between 1995 and 2009 and finds capital structure is positively related to performance. None of these studies however coincide with the post capitalization policy in Nigeria which is the period when the issue of

capitalization was properly addressed in the country and that gap was filled in this study.

3.0 Research methodology

3.1 Data Type, Sources and Method of Analysis

The study made use of secondary data obtained from Nigerian Stock Exchange Fact Book and the financial reports of fifteen (15) out of the twenty-one (21) banks quoted on the Nigerian Stock Exchange. The data spans the years 2005 through 2011 which coincides with the post consolidation era in Nigeria. The banks are Skye bank, Diamond bank, Fidelity bank, First bank, First City Monument Bank, Guarantee Trust bank, sterling bank, union bank, UBA, Stanbic IBTC and Unity bank. Others are Wema Bank, Zenith Bank, Access bank and Ecobank. These banks were selected using stratified sampling after arranging them in alphabetical order. These data were analysed using panel regression while the study hypotheses were tested using 2-tailed sample t test.

3.2 Model Specification

The study co-opted the use of an adapted form of the regression model suggested by Onaolapo and Kajola (2010). To examine the relationship between capital structure and bank performance, capital structure was proxied by short term debt ratio and total debt ratio while the return on asset (ROA) was used to measure bank performance.

The functional equation for the model is based on the following equation:

$$Y = f(x_1, x_2) \dots\dots\dots (i)$$

Where Y = bank performance measured by the return on assets and;

x_1 and x_2 are the independent measures of capital structure: short term debt ratio (STDTA) and total debt (TDTA) ratio.

Thus,

$$ROA = f(STDTA, TD) \dots\dots\dots (ii)$$

The explicit form of the equation is presented as:

$$ROA = \beta_0 + \beta_1 STDTA + \beta_2 TDTA + e_i \dots\dots (iii)$$

Where:

ROA = Return On Asset

STDTA = short term debt ratio

TDTA = total debt ratio

β_0 = intercept of the relationship in the model/constant

β_1, β_2 = Coefficients of the independent variables

e_i = error term, representing factors other than those specified in the model.

The dependant variable for the study is Return on Assets (ROA) is measured by Earnings before tax (EBT) divided by total assets. The independent variables are short-term debts to total assets (STDTA) and total debts to total assets ratio (TDTA).

4.0 Data Analysis and Discussion of Result

In carrying out the analysis of data in order to establish the cause and effect relationship between the dependent variable, (ROA) and independent variables STDTA and TDTA, the Statistical Package for Social Sciences (SPSS) 16.0 was used to run the regression model.

Table 4.1: ANOVA Descriptive Statistics

	N	Minimum	Maximum	Mean	std. deviation
ROA	15	-.19	.04	.0087	.04627
TDTA	15	.79	1.12	.8413	.07150
STDTA	15	.78	1.11	.8280	.06992
Valid N (list wise)	15				

Sources: Researcher's Computation, 2014.

Table 4.1 presents the descriptive statistics of the dependents and independent variables which reveals the mean value of Return on Assets (ROA) of Nigerian banks during the research period to be 0.87 percent which means that Nigerian banks' ROA during the study period is one (1) percent. It also reveals the performance / profitability of sampled banks over the study period TDTA (measured as total debts divided by total assets) is 84.13 % This result shows that only 15.87 % of Nigerian banks capital is financed by sources other than debts (equity, retained earnings and others) during the study period.

Also, STDTA (measured by short term debts divided by total assets) averaged 82.80 percent over the study period. It also reveals that, of the 84.13 percent total debts ratio of Nigerian banks, 1.33 % is long-term debt during the period of this study. Return on Assets (ROA) of Nigerian banks during the period of study has a minimum of -.19 while the maximum is 4 percent. This result shows that some asset utilization is low, thus, the management team of these banks have not

been utilizing effectively the assets the owners entrusted to them. Total debts to total assets ratio (TDTA) of Nigerian Banks had the minimum value of 79 percent and the maximum value of 112 percent while short term debts to total assets ratio (STDTA) had a minimum value of 78 percent and a maximum value of 111 percent during the study period. By inference therefore, debt exceeds total assets of these banks.

Table 4.2 Capital Structure and Performance Regression Results

Model	R	R-square	Adjusted R-square	Std. Error of the estimate	Change statistics					Durbin Watson
					R-square change	F change	df1	df2	Sig. f change	
1	.813a	.660	.604	.02913	.660	11.667	2	12	.002	2.101

Sources: Researcher's Computation, 2014.

Table 4.2 presents the summary of regression results of model 1 where Return on assets (which is measured by Earnings before Tax (EBT) divided by total assets of the firm) was regressed against two independent variables: total debts to total asset ratio (TDTA) and short term debts to total assets ratio (STDTA). This produced a coefficient of determination (R^2) of 66 percent which means that the identified variables in the model account for 66 percent of the variability of Return on assets while the remaining 34 percent is accounted for by other variables not included in the model. The f- statistics (11.67) signifies that the equation is significant at (0.002) percent (below 5%) level. The Durbin- Watson (DW) of 2.101 shows absence of auto-correlation problem in the residuals of regression analysis.

Table 4.3: Regression Coefficients

Model	Unstandardized Coefficient		Standard coefficient	t	Stg.	Collinearity Statistics
	B	Std.error	Beta			Tolerance
1(constant)	.455	.093		4.907	.000	
TDTA LEVI	-.146	.504	-.226	-.290	.777	.047
STDTA	.391	.516	-.591	-.758	.463	.047

Sources: Researcher's Computation, 2014.

4.3 Test of Research Hypotheses

The study hypotheses are tested using student t-statistics at a significance level of 5% for a two-tailed test (table 4.3). At that significance level, the critical value is -2.145 (using 14, for degree of freedom) while the computed t statistics values are -0.290 and -0.758 respectively for (TDTA) and (STDTA). These computed values lie within the acceptance region at 0.05 level of significance, thus, the null hypotheses was accepted while the alternative is rejected. It can thus be concluded that performance/Profitability of Nigeria banks is not significantly influenced by its capital structure as measured by total debt ratio (TDTA) and short-term debt ratio (STDTA).

These findings is partly in line and partly in disagreement with the study of Zeitun, and Tian (2007) who reported a mixed (both negative and positive) relationship between capital structure and performance. It is in total disagreement with the study of Omorogie and Erah (2010) but accords with the conclusion reached by Pratomo and Ismail (2006).

Going by these, it can be interpreted that capital structure has insignificant impact on the performance of Nigerian banks in the post consolidation era. This fact is supported by numerous initial public offers (IPOS) that was experienced during the consolidation period. It therefore means that no matter the capital structure composition bank performance is anchored upon the managerial skill and expertise of the management team in turning customer's deposits to profitable transactions that will ensure maximization of shareholders wealth objective.

Specifically, with respect to TDTA relationship, the result of the regression analysis indicates that total debts ratio (TDTA) has an insignificant negative impact (-2.90) on the performance of Nigerian banks (measured by ROA) during the period of study. More, so STDTA relationship also resulted into an insignificant negative (-0.758) impact of capital structure on bank performance (Table 4.3)

Theoretically, the finding of this study is in agreement with Modigliani and Miller (1958) theory of irrelevance which purports that the combination of debt and equity in the capital structure composition of a firm has no impact on the firm's value or performance. However, the results concurs with the traditional capital structure theory which supports the existence of an optimal capital structure that maximizes the firm's value and minimizes the firm's cost of capital .

5.0 Conclusions and Recommendations

This study examines the effect of capital structure on bank performance Nigeria in the post consolidation era. The study finds out that profitability is negatively related to capital structure and statistically not significant with short term

debts and total debts to total assets.

Although, the major objective of capital structure is to have an adequate mix of debt and equity that can maximize the shareholders wealth but regrettably, this objective is not always feasible as a result of some observed deficiencies like management inefficiency, inherent business risk, declining ethics and gross insider abuse. Thus, performance is tied to other factors like management efficiency and liquidity (irrespective of the capital structure mix).

In line with the findings, it is therefore recommended that managers should be careful while using debt as a source of finance since a negative relationship exists between the capital structure and performance variables used in this study. Efforts should be made to embrace other finance sources like equity and retained earnings that will minimize risk and reduce the overall cost of capital. This will facilitate the achievement of shareholders wealth maximization objective and a more strong, virile and reliable banking sector in Nigeria.

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