



“Capital Structure” Determinants: A Conceptual and Empirical Review

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Article History	Abstract
Received: 06 June 2023 Revised: 05 Sept 2023 Accepted: 29 Nov 2023	Choosing the right kind of financing is considered essential and critical in the world of business finance. It is the combination of debt and equity financing that a company uses to sustain its funding patterns that is referred to as the “capital structure” of a company. For this project, we will examine theoretical and empirical research on capital structure, as well as the primary elements that influence how organisations choose their capital structure. The present study looks at the main competing “capital structure” theories, as well as the assumptions that drive each of them. The examination highlights the factors that impact a company's “capital structure” decision. Factors of “capital structure” determinants discovered via empirical study on “capital structure” determinants so far. Research Methodology: The nature of Present Research study is descriptive based and conceptual, Empirical review paper. The data has been collected from various reputed journals such as Elsevier Science direct, articles published in peer-reviewed journals, textbooks etc. The review is based on various research works that were selected through well defined inclusion and exclusion criteria. Results: Many research studies on large organisations have been done using secondary data and regression models, and many of these studies have been conducted on large organisations utilising primary data. It was discovered that the impact of leverage differs by industry, which should be examined further in future study. The present research examines “capital structure” theories and factors that impact “capital structure” selection in the financial industry. When it comes to “capital structure” choices, firms have been demonstrated to follow the pecking order theory. Keywords: Financing decision, Capital Structure, Empirical, global factors, inclusion and exclusion criteria
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1. Introduction

The decision on how to fund a firm is viewed as a crucial and essential issue in the area of corporate finance. The mix of debt and equity used to finance investments should be established in such a manner that the value of the investments made is maximised, depending on the financing objective. The “debt-to-equity ratio” should be as low as feasible since it allows the firm to invest more in new ventures while also enhancing the value of existing assets. When it comes to financing options for a business, the most significant concerns are the acquisition of funds and their right use in order to meet the company's financial objectives and ensure that working capital is successfully managed. When financing long- and short-term assets and obligations, companies should keep this important factor in mind. When financing long-term assets, long-term debt should be employed, but short-term debt should be used when financing short-term assets. The decision of a company to seek cash on hand is a stage in the financing process. The formation of the company's “capital structure” takes up a significant portion of the company's time and resources. When referring to a company's overall capital structure, the proportion of debt and equity is referred to as the company's “capital structure” in general. The ideal “capital structure” contributes to lowering the overall cost of capital while simultaneously increasing the value of the firm; the best “capital structure” contributes to lowering the

overall cost of capital while simultaneously increasing the value of the company. The optimal “capital structure” contributes to the reduction of total capital costs while simultaneously increasing the value of the firm. Because interest on debt is tax deductible, using borrowed money in a “capital structure” increases earnings per share, which in turn increases the value of a company's stock market shares because interest on debt is deductible. When the proportion of debt financing in a company's “capital structure” is raised, the increased financial risk results in a greater cost of capital and a decline in the value of the company's stock price over time. The establishment and maintenance of a good “capital structure” is therefore crucial to the organization's performance, while keeping the firm's value maximisation goal in mind.

In the present study the author's has made an attempt to look over the theories and empirical works done so far on “capital structure” and factors affecting “capital structure” decisions of firm at global level. The objectives of the present study were presented below:

1. To review the “capital structure” theories.
2. To look over the empirical research on the elements that influence a firm's “capital structure” choices.
3. To identify the elements that influence “capital structure” at the company level as well as in the global environment.

Review of Literature

Modigliani and Miller released the fundamental work in 1958, in which they built a theoretical model to explain finance executives' judgments on “capital structure” design and highlighted some of the probable elements affecting a corporation's “capital structure” choices. A company's market value is not impacted by its capital structure, and the needed rate of return increases in proportion to the company's debt-to-equity ratio, according to the idea. Regardless of the kind of security used to fund the investments, the average cost of capital will always equal the investment cut-off rate, unless otherwise specified. Modigliani Miller's initial hypothesis disregarded the impact of corporate and personal taxes; but, later in his career, Miller revised his theory to include tax advantages for geared businesses.

Assumptions of Modigliani Miller theory

The financial markets are assumed to be without flaws. In this situation, there are no transaction costs. There is no interest rate difference between borrowing and lending. There are no personal or corporate taxes in this nation. The investors are rational and reasonable, and they anticipate similar behaviour from other investors. There are no withheld earnings to disperse, thus the dividend payment ratio is 100 percent. There is no benefit to debt financing unless you include in the lower corporate tax rates that arise from interest payments on borrowed money being tax-deductible.

Static trade of theory

According to the static trade theory, a company's worth is defined by interest tax savings, which incentivize enterprises to borrow until the present value of interest tax shielding just balances the present value of debt agency expenses and the risk of financial crisis. According to the static trade-off hypothesis of value creation, profitability and financial leverage have a considerable negative connection. Despite the fact that “static trade-off theory” predicts the opposite relationship, which means that higher profits translate into more money available for debt payment and more taxable income to be protected, high profits are often linked with low debt. In an ideal case, businesses, on the other hand, would want to avoid financial issues and insolvency.

Pecking order theory

It was 1961 when Davidson first presented the pecking order concept. In 1984, Myers suggested the idea, which has subsequently received universal support. According to the concept, the company has no clear goals or an optimal “capital structure” in place. A firm's capital structure, according to the idea, is more dependent on internal cash flows than on external cash flows. A company's dividend policy, according to this idea, is connected to its capital gearing and investment decisions, among other factors. The primary focus of the theory is on the costs associated with getting cash for investment.

The assumptions of the theory are stated below

Utilizing domestically produced cash is theoretically costless since there are no issue fees when using retained revenue. The theory also claims that obtaining external money is costly since debt is less expensive than equity, and that the issuance of equity capital has comparatively high issue costs due to the absence of issue costs associated with using retained revenue.

When it comes to the sources of money that a business chooses to use to support its long-term investments, it's normal for it to have a set of preferences. To fund its activities, the business will prefer to use funds generated inside the company rather than outside money at first. Dividend policy is sticky, according to the “capital structure” pecking order theory, and corporations prefer internal funds to external funds, as well as the fact that businesses prefer internal resources to external resources, all of which are consistent with the theory. When a firm seeks more external capital, the pecking order theory of security advocates proceeding from the greatest degree of safety to riskier debt, maybe convertibles and quasi-equity instruments, and eventually stock at the bottom of the list, starting with the most secure debt.

The Signaling theory

The optimum “capital structure” is decided by signalling theory, which holds that insiders, like as managers and executives, possess information that the market lacks. The “capital structure” chosen by insiders may therefore serve as a signal to external users and have an influence on the company's worth. The signalling theory draws attention to the underlying value of a firm and has a substantial influence on the cash flows of the organisation.

Agency Cost theory

The agency costs connected with stock and debt issuance are essential concerns when it comes to capital structure. Maintenance of issue expenses, for example, is one of the costs associated with equity issuance. Principal, agent expenses, and debt issuance increase the owners' capital available for investment in high-risk ventures that generate large profits for the owners and management, however, loan investors will bear a greater portion of the risk of failure if the project does not meet its goals and is not completed. If debt holders anticipate this, a significant premium will be required, raising the cost of borrowing money even higher. As a result of disagreements between the principle and the agents, agency fees are owed to the principal and agents. A trade-off between two types of expenditures is necessitated when finding an ideal debt to equity ratio due to the fact that agency fees are relevant to both equity and debt financing.

Factors affecting “capital structure” and Empirical evidences

The researcher identified six significant components that impact a corporation's “capital structure” based on an analysis of “capital structure” theories. With the help of Modigliani and Miller, the researcher found the following components: Some of the economic theories explored are “picking order theory, static trade-off theory, agency cost theory, and “capital structure” signalling theory”. Profitability, business size, growth potential, taxation, non-debt protection, tangibility, and financial crises all influence “capital structure” decisions.

According to Harris and Raviv (1991), the use of fixed assets, tax debt shields, investment opportunities, and business size all led to increasing leverage, but the use of variable earnings resulted in lower leverage. He observed an erroneous and inconsistent relationship between the variables and the capital structure, which he questioned. Empirical study has resulted in results that are diametrically opposite to one another. Businesses tend to acquire cash from internal sources first, with riskier capital coming in last, according to the concept of "pecking order." Profitable organisations should be able to fund their operations with internal cash, and they should have a low “debt-to-equity ratio” (Myers and Majluf 1984). Experts say that to be successful, companies should leverage internal resources and have a low debt-to-equity ratio. According to the results, “capital structure” and the other elements studied by the researchers have a positive association. According to Jensen (1986), debt should be used as a lever to compel management to allocate profits to shareholders. Profitability and dividend showed an unfavourable relationship, according to a signalling architecture research. As a consequence of this insight, it is projected that successful businesses would increasingly utilise debt as a predictor of their capacity to succeed in the marketplace. According to the theory, the two variables will have a positive association. Although empirical studies establishing a positive correlation was few and far between, Titman and Wessels 1988, Rajan and Jingles 1995, Wald (1999), and others have revealed a negative link between profitability and leverage (Titman and Wessels 1988, Rajan and Jingles 1995, Wald (1999), et al. Chen (2004) revealed that long-term leverage was statistically significant when profitability, growth potential, size, and tangibility were all included while investigating the drivers of “capital structure” for 88 Chinese public-listed enterprises from 1995 to 2000. Baral (2004) investigated the variables that impacted the “capital structure” of 40 firms that were listed on the Nepal stock market on July 16, 2003. Long-term leverage was shown to be statistically significant when the company's size, growth rate, and profits rate were all considered. The researchers observed that tangibility, as well as size, profitability, and income unpredictability, as well

as non-debt tax shields, were essential in the design of capital structures for 6000 Swedish businesses from 1992 to 2000. Growth, on the other hand, had no discernible influence on “capital structure” design, according to the study. Frank and Goyal (2007) looked at the influence of “capital structure” on leverage in publicly listed American corporations using data from 1950 to 2003. They observed that the market to book assets ratio is inversely associated to profits, but the log of assets, as well as inflation, industry leverage, and tangibility, is favourably related to profits. Age, profitability, and taxes have all been proven to be unfavourable traits. Bas and colleagues (2009) found that tangibility, profitability, and size were the most important factors in small and private firm “capital structure” decisions when they used data from World Development Indicators to examine 11,125 small and private firms in 25 developed nations. Between 1996 and 2007, Ramakrishnan (2012) evaluated the basic determinants on Malaysian firms. According to the author, risk, tax debt protection, the size of the business, and its tangibility all played a role in determining a company's capital structure. Several “capital structure” variables were found to have a positive and significant impact on the “capital structure” of 110 Nigerian companies that were listed on the stock exchange between 2000 and 2005, but the impact of age was found to have a negative and significant impact on the “capital structure” of the same 110 companies. Since the first day of January 2005, a research undertaken by Kedzior has shown many elements that have had a major 1063 firms from European Union member states. (2012). The research found that variables including size, profitability, economic growth, inflation rates, and income taxes have an influence on how a company's “capital structure” is designed. Chandrashekharan (2012) studied the variables that impact the “capital structure” of Nigerian enterprises between 2007 and 2011. He observed that the most essential “capital structure” elements of Nigerian enterprises are their size, age, growth, tangibility, and profitability. Fauzi and colleagues (2013) studied the variables that impact corporate “capital structure” for 79 businesses that were publicly listed on the New Zealand stock market between 2007 and 2011. Growth, asset tangibility, signalling, management ownership, and business size are all linked to overall debt, according to the study's results. The determinants of “capital structure” between 2006 and 2011 revealed that firms with lower profitability are negatively related, according to Fernandez et al. (2013), who studied the “capital structure” of 82 publicly traded companies in Oman between 2006 and 2011. Between 2000 and 2011, Thippayana (2014) looked at the variables that impacted the “capital structure” of Thai companies that were listed on the stock exchange. A total of 144 businesses were examined between 2000 and 2011. It has been shown that a corporation's size and profitability have an influence on the “capital structure” of that firm. Masoud (2014) used data from eight firms that were publicly listed on the Libyan stock exchange between 2008 and 2013 to study the variables that influence companies' choices to invest in equity rather than debt. According to the author, Libyan businesses prefer equity financing over loan financing due to high price earnings ratios and interest rates. Cekrezi (2015) used data from 70 non-listed businesses over the course of five years to investigate the determinants of “capital structure” in Albanian enterprises between 2008 and 2011. According to the authors' findings, a number of critical characteristics such as return on assets (ROA), return on equity (ROE), liquidity (liquidity ratio), and tangibility affect capital structure, with long-term debt having a significant impact. Larger-scale considerations like size, risk, and non-debt tax sheltering, which are all evaluated in the near term, have little bearing on long-term debt. A range of factors, including business-specific features like financing issues and capital market evaluation, company size, leverage, and profitability, as well as macroeconomic variables like GDP growth, have been shown to influence the pace at which leverage is adjusted. Risk is the most important factor affecting the pace at which leverage adjusts, according to Baum et al. (2017), while Al-Zoubi and colleagues (2018) revealed that “capital structure” decisions have an influence on the persistence of leverage and the development of cyclicity. From 1975 through 2016, the study was restricted to businesses in the United States. According to the authors, there have been six economic cycles and five financial crises over the time period under consideration. “capital structure” is both cyclical and long-lasting, according to the results of the study. The authors claim that leverage does not follow the mean reversion strategy as a consequence of their rationale. Despite the notion that this is similar to a business cycle, rising leverage happens when profits are high and lowering leverage occurs when earnings are low. Ramli and colleagues (2019) investigated the influence of “capital structure” factors on firm financial performance, with a particular emphasis on the mediation effect of leverage, in Malaysian and Indonesian companies between 1990 and 2010. They found that the influence of “capital structure” factors on firm financial performance was mediated by leverage. As a result of the study, the authors observed that “capital structure” elements had a direct impact on company performance, and that there was a positive significant link between leverage and the financial performance of Malaysian listed businesses. According to the results of a recent survey, Malaysian businesses seem to prefer foreign cash over the local currency they are currently utilising. If you're thinking about your company's

financial structure, leverage is an important element to consider. The capital structures of Indonesian corporations, on the other hand, are not considerably altered by the usage of leverage. It is believed by the authors that the asset structure of enterprises and non-debt tax sheltering have an indirect influence on their financial performance. A number of aspects of the company's liquidity, growth potential, and asset structure, as well as non-debt tax protection and interest rates, were all made public.

Determinants of “capital structure” and predicted signs summarized below:

Authors	“capital structure” determinants	Predicted signs
Myers and Majluf (1984)	Growth opportunities, debt	+/-
Jensen (1986)	Profitability, dividend signaling	+
Titman and wessels (1988) Rajan and Jingles (1995) Wald (1999)	Profitability and leverage	-
Huang and Song	Firm size, non-debt tax shields, Profitability, leverage	+ -
Cheng (2004)	Profitability, growth opportunities, size, tangibility Long term leverage	+
Baral (2004)	Firm size, Growth, Business risk Dividend payout ratio, leverage	+ -
Song (2005)	Tangibility, size, profitability, income variability, Non-debt tax shields	+
Frank and Goyal (2007)	“Market to book ratios, profits Log of assets, inflation, leverage, Tangibility”	- +
Abor (2008)	“Long term debt Age, profitability, Tax”	+ -
Bas et.al (2009)	“Tangibility, profitability, size”	+
Ramakrishnan (2012)	“Size, Non-debt tax shields and Tangibility”	+
Ogubulu and Kehinde (2012)	Firm Size and other variables Age.	+ -
Kedzior (2012)	Size, profitability, economic growth, inflation rates, income taxes, legal legislations.	+
Chandrashekar (2012)	Size, Age, growth, profitability and Tangibility.	+
Fauzi et,al (2013)	Growth, tangibility, Managerial ownership, firm size, signals.	+
Fernandez et.al (2013)	Leverage Profitability	+ -
Thippayana (2014) Masoud (2014)	Size, profitability. Equity finance Debt finance	+ + -
Cekrezi (2015)	“ROA, ROE, Liquidity, Tangibility, long term debt, short term debt”. Size, risk and Non-debt tax shields	+ -
Baum et.al (2017)	Firm size, leverage, profitability. GDP Growth, risk at global factors	+ +
Al-Zoubiet.al (2018)	Profitability, leverage	+
Ramli,et.al (2019)	“Leverage, liquidity, growth, asset structure, non-debt tax shields, interest rates”. Asset structure	+ -

4. Conclusion

Specifically, the writers of this research study conducted a thorough examination of the literature on “capital structure” theories” and determinants in order to identify the elements that influence a corporation's “capital structure” and financing choices. MM irrelevance hypothesis, which has been shown to be incorrect in the corporate world due to frictions such as corporation taxes and transaction costs, which impact “capital structure” choice and company value, is discussed first. The authors first selected the most dependable key company variables that impact capital choice, such as profitability, growth prospects, business size, tax shields, tangibility, and age, as well as financial distress costs, and showed how these qualities affect firm leverage. The authors next attempted to trace significant “capital structure” theories' predictions back to their original roots. Those theories are in direct opposition to one another. In understanding company funding choices, it was observed that the theories' assumptions act in collaboration rather than in opposition to one another.

The authors' goal in writing this work was to examine empirical research that has been done to investigate the factors that impact business “capital structure” decisions. The authors of this research assessed work that was done in both developed and underdeveloped countries. When it comes to describing the company's financing decisions, it was revealed that the trade-off theory beat the pecking order hypothesis. It has been observed that businesses in impoverished countries rely on foreign capital more than those in wealthy countries. Given the disparities in empirical data, institutional variations seem to have a role in the “capital structure” decision of the company. This study concludes with theoretical and empirical evaluations of “capital structure” choices in businesses.

Findings of the study

It has been shown that analysing the trade-off between tax benefits, bankruptcy costs, and agency difficulties using trade-off theory may help businesses choose the best “capital structure” for their operations. In contrast to the conventional method, the “debt-to-equity ratio” shows a company's overall cumulative requirement for external money, and this theory explains “capital structure” choices by concentrating on internal financing sources rather than external financing sources. It implies that companies should not set leverage objectives and should only utilise debt financing when their retained profits are inadequate. Insiders' “capital structure” choices, according to the signalling theory, may broadcast information to other parties, resulting in a change in the company's value.

Profitability, firm size, growth potential, tax benefits such as non-debt tax shields, the cost of the financial crisis, and tangibility have all been found to have a significant impact on “capital structure” decisions. There is a relationship between these parameters and the degree of leverage, as illustrated in the table, according to “capital structure” theories. The findings of some studies found a statistically significant relationship between determinants, whereas the findings of others revealed a statistically insignificant relationship between determinants. Researchers may use the disagreement in the links between determinants and “capital structure” theories” to help them perform new research investigations. These statistically insignificant relationships among elements impact “capital structure” selection.

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