

## **Capital Structure and Survival Dynamic of Business Organisation: The Earning Approach**

**James Sunday Kehinde**

(Corresponding Author)

Department of Accounting and Finance  
Faculty of Management Science  
Lagos State University, Ojo  
Nigeria (+234)  
E-mail: pastorkehindebox@yahoo.com

**Roseline Oluitan**

Department of Accounting and Finance  
Faculty of Management Science  
Lagos State University, Ojo  
Nigeria (+234)  
E-mail: roselinetoyin@yahoo.com

**Ojo A Agbodu**

Department of Accounting and Finance  
Faculty of Management Science  
Lagos State University, Ojo  
Nigeria (+234)  
E-mail: ojoagbodu@yahoo.com

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### **Abstract**

The determination of the financial risk of the firm is a function of the capital structure of the firm, a firm might be making good net profit before tax but might have less to distribute to the shareholders after the payment of tax when compared with a similar firm in the same industries due to poor capital structure arrangement, thus, payment of low return to shareholders most times is due to poor capital structure rather than to poor business return. In this study the return is the earning made before tax. Secondary data was used for the study, collected from the financial report of the firm. The simple multiple linear regressions was used in the study and the asymptotic probability and the t-statistic were adopted for the study. The result of the study revealed that capital structure of the firm do not satisfied the optimal capital structure status of the Modigliani and Milan, the firm for the period covered is mostly financed by equity and have a near zero debt finance a low relationship also exist between equity-debt finance of the firm however a strong relationship exist between the earning of the firm and the capital structure of the firm. It was recommended that the firm should introduce debt finance to the capital structure of the firm to enjoy the tax advantage of debt finance.

**Keywords:** Earning, Capital structure, Debt, Equity.

## Introduction

The operation of the firm is always influenced by the business risk and the recovery risk of industry, some of the risks are diversified and the others are not, the diversified risks are called the unsystematic risk while the non-diversifiable are called systematic risk. The business risks are due to factors within the framework of the firm while the financing risk is the whole capital structure of the firm. The business risk is sometimes a function of the culture, leadership, product and market structure of the firm and the industries, while the finance risk if not well decomposed and managed will fall in the systematic risk framework of the firm. It can bring growth to the firm and increase the wealth of the organization, Kehinde (2011), stated that the basic goal of the firm is to maximize the wealth of the firm. However, today the primary goal of the firm is to survive and not to make wealth, wealth will only come to focus after survival of the firm is assured.

Thus, the study attempts to study the capital structure of Cadbury Nigeria Ltd and the survival ability of the firm in line of ever dynamic environment of the nation, the earning approach was used as the study for effective measure of the scenario.

The study is an attempt to measure the relationship between the capital structure of the firm and the earning structure of the firm. Many firms in the industry do not match the capital structure advantage against the earning structure of the firm. The capital structure of most firms in Nigeria is not composed to give effective earnings and revenue generation structure for the firm. The capital structure relevant theory by Modigliani and Miller (1960) is not followed by several firms. Several firms possess heavy capital structure with lean earning structure which sometimes is not good enough for firms with the basic goal of profit and wealth maximization objective.

## Conceptual Frame Work

Capital structure in finance, refers to the way a corporation finances its assets through the combination of equity, debt, or hybrid securities. It is the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure of a firm describes the combination of both debt and equity finance structure of the firm. A firm's capital structure is therefore the composition or 'structure' of its liabilities. The relative ratio of securities can be determined by process of capital gearing. On this basis, the companies are divided into two namely highly geared companies: these are firms whose proportion of equity capitalization is small. Low geared companies: these are firms whose equity capital dominates total capitalization (Wikipedia, 2012, MSG, 2012)

The Modigliani and Miller (M&M) capital structure relevant and irrelevant theorems posit that in the absence of company taxes, there are no benefits, in terms of value creation, to increasing leverage and on the other hand in the presence of taxes, such benefits, by way of interest tax shield, do accrue when leverage is introduced and/or increased. The capital structure theory by Modigliani and Miller are three types' namely static trade-off theory, agency theory and theories based on information asymmetries (Cohen, 2004)

## Trade-off Theory of Capital Structure

In the trade-off theory of capital structure the bankruptcy cost is allowed to exist. It states that there is an advantage to financing with debt (namely, the tax benefits of debt) and that there is a cost of financing with debt (the bankruptcy costs and the financial distress costs of debt). The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm that is optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. Empirically, this

theory may explain differences in D/E ratios between industries, but it doesn't explain differences within the same industry.

The theory never the less, states that with no taxes, there are no debt-related tax benefits, and with no such benefits [assuming everything else remains constant] there is no optimal capital structure. With no optimal capital structure, therefore, one could only conclude that the whole notion [based on the contention that  $E + D = \text{constant}$ ] of trying to locate the optimal capital structure becomes self-contradictory and, thus, meaningless (Cohen, 2003)

In another study by Cohen(2004) on determination of weighted average cost of capital and firms value in relation to capital structure with intent to locate the optimal capital structure, taking into consideration the relationship between debt, equity and taxes, and placing emphasis on the effects of default risk, as well as on the assumptions that underlie the curves discovered that the conventional optimal capital structure theory by Modigliani and Millan is flawed as is not commonly used in practice,

Cohen also in the study of the difference in the capital structure of depository institutions(banks) and that of the corporate firms .using the basic Modigliani-Miller [M&M] methodology, but instead of using a constant EBIT as stated by (M &M), as classically done for corporate firms used a variable EBIT, which hinges on the interest earnings from the asset-based loans made to the borrower discovered that the optimal capital structure of a depository institution is not as easily identifiable as that of a corporate firms. The reasons for this include, among others, (i) the existence of regulatory capital restrictions, (ii) an inter-dependence between the borrower and the lender and (iii) a dramatic change in the behaviour of the return on equity with respect to leverage when risks and credit spreads of both, lender and borrower, are accounted for. The study also highlighted some of the main differences that exist between the treatment of the capital structure of corporate firms and depository institutions.

Mac an Bhaird (2010) In a study of samples of the capital structure of 299 Irish small and medium sized firms (SMEs) Using hypotheses formulated from pecking order and agency theories and also incorporating a financial growth life cycle approach discovered that the age, size, level of intangible activity, ownership structure and the provision of collateral are important determinants of the capital structure in SMEs.

Zellner (1962) also in a study of the capital structure in several firms discovered that the influence of age, size, ownership structure and provision of collateral is similar across industry sectors, indicating the universal effect of information asymmetries and also discovered that firms overcome the lack of adequate collateral security by providing personal assets as collateral for business debt, and by employing additional external equity.

Murphy, Ofer and Satterthwaite (2009) stated that Modigliani and Miller in their 1958 article showed that if firms are in the same risk class and in an economy with a perfect capital market having no transaction costs, taxes, or no bankruptcy costs, then their relative market values are independent of their capital structures however where they are in a taxable situation then their capital; structure counts in determination of their net return

## **Pecking Order Theory**

Pecking Order theory tries to capture the costs of asymmetric information. It states that companies prioritize their sources of financing (from internal financing to equity) according to the law of least effort, or of least resistance, preferring to raise equity as a financing means "of last resort". Hence: internal financing is used first; when that is depleted, then debt is issued; and when it is no longer sensible to issue any more debt, equity is issued. This theory

maintains that businesses adhere to a hierarchy of financing sources and prefer internal financing when available, and debt is preferred over equity if external financing is required (equity would mean issuing shares which meant 'bringing external ownership' into the company). Thus, the form of debt a firm chooses can act as a signal of its need for external finance. The pecking order theory is popularized by Myers (1984) when he argues that equity is a less preferred means to raise capital because when managers (who are assumed to know better about true condition of the firm than investors) issue new equity, investors believe that managers think that the firm is overvalued and managers are taking advantage of this overvaluation. As a result, investors will place a lower value to the new equity issuance. (Myers, 1984, Mac an Bhaird, 2011)

Strebulaev (2012) study the capital structure theory using the calibrated dynamic trade-off model to simulate firms' capital structure path and stated that in the presence of frictions, firms adjust their capital structure infrequently. As a consequence, in a dynamic economy the leverage of most firms is likely to differ from the "optimum" leverage at the time of readjustment. It also noted from the results of standard cross-sectional tests on selected data a consistency between the practice and theory of capital structure with a little difference and thus suggests a rethinking of the way capital structure tests are conducted.

Leary and Roberts (2012) empirically examine whether firms engage in a dynamic rebalancing of their capital structures while allowing for costly adjustment. They begin by showing that the presence of adjustment costs has significant implications for corporate financial policy and the interpretation of previous empirical results. It confirms that financing behavior is consistent with the presence of adjustment costs and that firms actively rebalance their leverage to stay within an optimal range. Our evidence suggests that the persistent effect of shocks on leverage observed in previous studies is more likely due to adjustment costs than indifference toward capital structure

## The Research Method

The research work made use of secondary data obtained from the financial report of the firm. It also made use of personal interview selectively conducted. The study covered a period of 2001 to 2010. The simple linear regression was used and the f-statistic and Mackinnon, one field, p. value was used for the test; the correlation coefficient and the coefficient of determination were also used for the study. The study is an attempt to measure the effect of the capital structure of the firm on earning. The Earning of the firm is the total earning after tax of the firm for the period covered.

## Model Specification

Earning=f (equity, debt)

Earning=  $a_0 + a_1 \text{ equity} + a_2 \text{ debt} + C$

Equity: is the total shareholders fund of the firm.

Debt: this refers to both the current and long term liability of the firm.

**Table 1.0**

	<b>Coefficient</b>	<b>Probability</b>
Constant	1313169	0.1233
Equity	0.151539	0.1900
Debt	0.034999	0.638705
R		0.638705
R <sup>2</sup>		0.407945

Adjusted R <sup>2</sup>		0.171124
Prob(F-statistic )		0.269715

Source: the researcher's analysis

## Interpretation

The relationship between earning, equity and debt obtained from the financial report of the firm was tested. The earning of the firm as a dependent variable was regressed against the equity (shareholders fund) and the debt (total debenture and loan) of the firm. The correlation coefficient (R) was 0.638705, that is, the relationship between the earning of the firm and the independent variable is 64%, this is very high, however, the adjusted R<sup>2</sup> is 0.17 that is, 17% which shows that earning by the firm is only determined by the equity and debt portfolio to the tune of 17% Other factors are responsible for the rest 83% change in earning. Since the coefficient of determination is 17%, this revealed a very weak deterministic relationship between the variables tested. The slope are 0.15 and -0.035 for equity and debt respectively which shows that every one naira of equity will generate a 15k of earning and every one naira of debt will generate 3.5k of earning. It is also interesting to note that the firm is mostly financed by equity in recent times. The relationship between the debt portfolio and the earning is negative. The debt portfolio as regarding long term debt is near zero while only short-term or current liability remains.

The significance test was done with the asymptotic probability (Mackinnon one sided p value) which revealed that there is no significant relationship between equity and earning on one hand and debt and earning on the other hand, at both 10% and 5% significant level respectively, since the p-value are 0.1233 and 0.1900 for the constant and equity and that of debt was also 0.269, thus there exist no significant relationship between the dependent variable and the independent variables.

The result from this study corroborate the assertion of Nwachukwu (2012) in a recent finding by the world bank who said that firms operating in Nigeria are less productive when measured by their output in relation to the amount of labour and capital they put into the business and also when compared to firms in kenya who are 40% efficient more than those in Nigeria

## Findings

1. There capital structure of the firm is not a good mixture of both debt and equity, significantly the firm is an all equity financed firm according to Modigliani and Millian () an all equity finance firm will have a lower earning after tax when compared with a well leveraged firm.
2. The firm is zero geared in recent times and since the firm is in a taxable position it will return less dividend per time to the shareholders than other firms in the same industry that is highly geared.
3. There exist no significant relationships between the capital structure of the firm and the earning structure, this suggest a poorly managed firm, since other factors apart from the capital structure influenced the earning.
4. Generally speaking a poor relationship and deterministic factor exist between the capital structure and the earning structure of the firm. This revealed that the firm is not maximizing it market potentials in revenue generation and it is poorly utilizing it equity fund.
5. The management of the firm is very unconscious of series of financial opportunities neither are they availing themselves of finance in the money market.

6. The personal interview carried out revealed that the product of the firm is in high demand and good quality, however, the interrelationship working of the firm has not made it possible for the firm to take advantage of the market opportunities.

## Conclusion and Recommendation

The firm is not maximizing its market opportunities, the financing structure does not take into recognition the tax advantage of debt and the money market potentials of the firm is not exploited. The firm also operates all equity finance which dis-possesses it of the depth of non-interest advantage of current liability, thus it has a weak current asset to current liability ratio, and this may also affect the liquidity of the firm.

It is recommended that the organization should exploit series of money market finance to take tax advantage of debt finance the management should also avail itself of the robust market opportunities enjoyed by the firm since it is operating in the food industries with a strong sales potentials. The firm should also restructure its finance composition to be mixture of debt and equity. The sales frontier should also be expanded.

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