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PERFORMANCE OF CORPORATE CAPITAL STRUCTURE APPROACH

Commerce

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ABSTRACT

This study is to investigate the effect which capital structure has had on corporate performance using a panel data sample representing of Indian companies. The results showed that a firm's capital structure had a significantly negative impact on the firm's performance measures, in both the accounting and market's measures. We also found that the short-term debt to total assets (STDTA) level has a significantly positive effect on the market performance measure Indian corporate performance negative impact on corporate performance.

KEYWORDS

Corporate Performance And Failure, Capital Structure

1. INTRODUCTION

In practice, firm managers who are able to identify the optimal capital structure are rewarded by minimising a firm's cost of finance thereby maximising the firm's revenue. If a firm's capital structure influences a firm's performance, then it is reasonable to expect that the firm's capital structure would affect the firm's health and its likelihood of default. From a creditor's point view, it is possible that the debt to equity ratio aids in understanding banks' risk management strategies and how banks determine the likelihood of default associated with financially distressed firms. In short, the issue regarding the capital structure and firm performance are important for both academics and practitioners. The objective of the current paper is to examine the effect which capital structure has on corporate performance in Jordan. There is a lack of empirical evidence about the effect of capital structure on the performance of firms in both developed and developing countries. Most of the previous evidence on capital structure comes from the determinants of corporate debt ratio. To the best of the authors' knowledge, this research provides the first attempt to investigate the effect of capital structure on corporate performance in Indian. Our reason for choosing Jordan as a case for this topic is its uniqueness, which we discuss below.

2. LITERATURE REVIEW

Harris and Raviv (1991) argued that capital structure is related to the trade-off between costs of liquidation and the gain from liquidation to both shareholders and managers. So firms may have more debt in their capital structure than is suitable as it gains benefits for both shareholders and managers.

Krishnan and Moyer, (1997) found a negative and significant impact of total debt to total equity on return on equity.

Mathur and Mathur, (2000) found that firms capital structure has a negative and significant impact on firms performance measures return on assets (ROA), growth in sales, and pre tax income. Therefore, high levels of debt in the capital structure would decrease the firm's performance.

3. RESEARCH METHODOLOGY

Descriptive Statistics

The average return to assets for the sample as a whole is 1.2%, while the average return to equity is about - 14.2%. The two accounting measures of performance show that Jordanian companies have a very low accounting performance. The four measures of market performance show a high percentage of performance compared with the accounting measures. For example, the average values of Tobin's Q and MBVR are 170% and 195%, respectively. The high ratios for the market performance measures could be as a result of the increase in firms' share price and equity without any increase in the real activities performance of the firms.

Result Discussion

The results of the estimation of the panel data models with each of the performance measures and for the full sample of observations for the period 1989-2003 are displayed in Tables 3 to 6. The regression model using price per share to earnings per share (P/E)[10] is not significant using any measure of capital structure and, hence, is not reported. The regression model using return on equity (ROE) is excluded from the analysis because the ROE measure does not have any significant variable in the estimation and the R-squared value using this measure in most cases was less than 0.1%[11]. The market value of equity to book value of equity (MBVE) is also excluded from the analysis as the R-squared is very small and the result is very similar to Tobin's Q[12]. These results make the ROA and Tobin's Q the most powerful measures of performance in the Jordan case. Therefore, our discussion will concentrate on these two measures of performance beside the MBVR and PROF measures.

4. CONCLUSIONS

There is no single study formulated in the Middle East that investigates the impact of capital structure on a firm's performance. This study tried to fill the gap in this field by investigating the effect of capital structure on corporate performance by taking Jordan as a case study. Furthermore, this paper employed different measures of capital structure such as short- term debt, long-term debt, and total debt to total assets in order to investigate the effect of the debt structure on corporate performance. Investigating the effect of capital structure on corporate performance using market and accounting measures could be valuable as it provides evidence about whether the stock market is efficient or not.

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