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A Theoretical Review of Capital Structure of Quoted Companies in Nigeria

Lawal Suleiman Gbenga[1], Nkamare Stephen Ekpo[1], Bassey Gift Eja[2], Eno Omini Ojah[2] & Obioke Esedu Anthony[1]

[1] Department of Banking and Finance, University of Calabar, Nigeria

[2] Department of Accounting, University of Calabar, Nigeria

Correspondence: Nkamare Stephen Ekpo, Department of Banking and Finance, University of Calabar, Nigeria.

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Abstract

Capital structure is a significant managerial decision because it influences the shareholders' returns and risk as the market value of the share and may be affected by the capital structure decisions. The theory maintained that financing adapts to mitigate problems created by differences in information between insiders (managers) and outside investors. The company turns first to the financing sources where differences in information matter least. A company's capital structure shows all the sources of finance a company is utilizing to finance its operations. The study was undertaken to review capital structure of quoted companies in Nigeria. So many theories of capital structure have been developed over the years. These theories have directly and indirectly affected the ways companies in Nigeria raise their capital. From the review obtained, it was revealed that capital structure of quoted companies in Nigeria is a significant measure of their performance. In view of the findings, it was concluded that capital structure of quoted companies in Nigeria is a significant measure of their performance and should be effectively and efficiently managed at all time. The study recommended that quoted companies in Nigeria should invest their profits when there are good investment opportunities and pay cash dividend as soon as enough income is generated.

Keywords: capital structure, quoted companies, pecking order theory, traditional view, Irrelevance of capital structure theory, trade-off theory

1. Introduction

Financial policy relates to two key choices that firms make namely: how much of their capital structure is supported by debt, rather than equity; and how much of their earnings to retain as internal equity finance, rather than distributing dividends and raising new equity in the market. In other words, financial policy decisions often amount to choosing the optimal trade-off between debt financing and equity financing. Capital structure is one of the most important decisions by finance managers. Capital structure relates to the various means of financing a firm; that is the proportionate relationship between debt and equity.

Capital structure has been found to have impact on firm performance. Pandey (2010) maintained that capital is a significant managerial decision because it influences the shareholders' returns and risk as the market value of the share and may be affected by the capital structure decisions. It therefore goes to say that while making capital structure decisions, corporate managers are expected to seek answers to how the investment project be financed, the way in which the investment projects are financed, how financing affect the shareholders risk, return and value, the exist of an optimum financing mix in terms of the maximum value to the firm's shareholders, the determination of optimum financing mix in practice for a company, and the factors company considers in designing its financing policy.

Aiming at maximizing firm's value, financial managers both of small and medium enterprises as of multinational enterprises try to optimize their company's tax liabilities. Tax considerations regarding location, organizational form, type and timing of transactions enhance the risk that financial decisions are guided by tax purposes rather than management objectives. This is especially true for multinational companies. Although value maximization is the leading principle of financial management, the use of tax planning strategies has a distorting impact on a company's financing and investment decisions. A distortion of corporate financing and investment decisions is related to the different taxation of debt and equity, impacting the capital structure of companies.

Most national tax systems favor the use of debt over equity thus, attributing a different tax treatment to the cost related to each of those financing modes. On the one hand, interest paid, i.e., the return to creditors, is a tax deductible expense, lowering the taxable base of the company. On the other hand, retained earnings or dividends paid, i.e., return to shareholders are not tax deductible. As a result, companies could trade- off between sources of financing based on their tax differential. This study is supported by pioneering work of Modigliani and Miller in their two landmark papers of 1958 and 1963. In the first seminar work published in 1958, they proved that, under certain assumptions (existence of perfect market and the absence of taxes and transaction costs), costs of capital does not affect capital structure. That is, debt in a firm's capital does not affect the firm's value. This theory is normally referred to as irrelevant theory. Later in their second paper published in 1963, they modified the irrelevant theory by presenting proof that cost of capital affect capital structure and thus the value of the firm when the assumptions that there are no taxes or transaction cost were removed.

1.1 The Pecking Order Theory

The theory of Myers and Majluf (1984) maintained that financing adapts to mitigate problems created by differences in information between insiders (managers) and outside investors. The firm turns first to the financing sources where differences in information matter least. It begins with a company with assets-in-place and a growth opportunity requiring additional equity financing. 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 companies have more internal financing available. Less profitable firms require more external financing, and consequently accumulate more debts. Myers and Majluf (1984) assumed perfect financial markets, except for asymmetric information. Investors do not know the true value of either the existing assets or the new opportunity, so they cannot exactly value the shares issued to finance the new investment.

1.2 The Traditional View

The traditional theory believes that capital structure matters. It states that debt capital is cheaper than equity capital and as such, a company can increase its value by borrowing up to a reasonable limit (optimal level of gearing). The traditional view has emerged as a compromise to the extreme position taken by the net income approach. The theory does not assume constant cost of equity with financial leverage and continuously declining weighted average cost of capital (WACC). Accordingly, a judicious mix of debt and equity capital can increase the value of the firm by reducing the weighted average cost of capital up to certain level of debt. By implication, WACC decreases only with the reasonable limit of financial leverage and after reaching the minimum level, it starts increasing with financial leverage. Hence, a firm has an optimum capital structure that occurs when WACC is minimum, and thereby maximizing the value of the firm.

The traditionalists maintained that financial leverage, resulting in the risk to shareholders, will cause the cost of equity to increase. However, it is assumed that at a moderate level of leverage, the increase in the cost of equity is more than offset by the lower cost of debt. The assertion that debt funds are cheaper than equity funds implies that the cost of debt in addition to the increased cost of equity, together on a weighted basis, will be less than the cost of equity that existed on equity before debt financing (Pandy, 2010).

1.3 Irrelevance of Capital Structure Theory

Modigliani and Miller (1958) argued that in perfect capital markets without taxes and transaction costs, a firm's market value and the cost of capital remain invariant to the capital structure changes. They believe that the value of the firm depends on the earnings and risk of its assets rather than the way in which assets have been financed. To justify their case, they demonstrated that if two companies have the same annual earnings and are also subject to the same business risk but they do not have the same market values purely because of the difference in their capital structure, then investors could make profit by selling their shares in the company that has the higher market value and buy shares in the company with lower market value. This process is known as arbitrage. The theory concludes that in a world without taxes, where the levels of business risk and earnings of two companies are equal, their total market values and their weighted average cost of capital must also be equal. If this were not the case, then arbitrage transactions would soon bring the companies back to the equilibrium position.

1.4 The Trade-off Theory

This theory is of the view that firms should choose their mix of debt and equity financing to balance the costs and benefits of debt. It is worthy of note however, that a company cannot continuously minimize its overall cost of capital by employing debt. This is because a point is reached beyond which additional debt becomes more expensive due to increased risk (financial distress) of excessive debt to creditors. As the degree of leverage rises, the risk of creditors rises causing them to demand for a higher interest rate and or can decide not to grant loan to the firm at all, once its debt has reached a given level. In addition, the excessive amount of debt makes the common stock holders' position to be very risky. This has the effect of increasing the cost of equity. In other words, up to a certain point, the overall cost of capital decreases with debt, but beyond that point the cost of capital would start increasing and, therefore it would not be advantageous to employ debt further. So, there is a combination of debt and equity which minimizes the firm's average cost of capital and maximizes the market value per share. The trade-off between cost of capital and earnings per share set the maximum limit to the use of debt.

1.5 Conceptual Review

A company's capital structure shows all the sources of finance a company is utilizing to finance its operations. It refers to how a company finances its operations and it is usually made up of ordinary share capital, preference share capital, debt capital, retained earnings, etc. If a company maintains the right proportion of these sources of finance, the weighted average cost of capital will remain unchanged (Auerbach, 2001). According to Pindado and Torre (2014), a good capital structure must not just contain equity, debt and preference stocks but these securities must be held in such a way that they maximize the earnings of the firm. A proper mix has to be ensured or else the firm will find itself in a serious difficulty. He maintains that when the gear is high it means the proportion of debt compared to the entire capital is high. Similarly, when the gear is low, it means that the proportion of debt to the entire capital is low. From the foregoing, it becomes obvious that the higher the gear, the more speculative the venture and hence the higher the risk exposure and vice-versa.

2. Classification of Corporate Securities

2.1 Common Stocks

Olukoya (2013) posited that the common stock is the most important source of corporate funds. It is a universal source of corporate assets. It is the first source of funds to a new business and the base of support for borrowing by existing firms. Some corporation can afford not to issue other securities such as bonds but the issuing of common stock is indispensable. This means that common stocks are universally issued by every corporation whereas bonds may not be issued by firms. The ordinary share of a company does not carry any fixed interest or dividend rates. The holders are the owners of the business and are entitled to the remaining profits of the business after all fixed interest and dividend charges have been satisfied. Ordinary shares usually carry voting rights and are known as equity capital of the business. The holders of this class of share are actually the risk bearers of the business because they are not entitled to a repayment of their investment until all others have been satisfied if the business winds up.

2.2 Bond Stocks

A bond is a long-term debt instrument with which firms raise funds for their various expansion programmes. This debt instrument is accompanied by a piece of document called indenture which stipulates the terms of the contract between the parties. Because of the complex nature of the contractual obligation, a bond may not be able to contain all the stipulated provisions and so this indenture gives detailed account of the various obligations contained in the contract (Oladele, 2013). Generally, bonds contain two promises. These are promises of periodic interest payments as they fall due and the redemption of the bond at the stipulated dates. These two promises are unconditional and so the payment stipulations must be adhered to or the firm will be declared insolvent.

Bonds can be denominated to any amount, but the general practice is to have low denominations for the bond which enhances the market potential of the bond as diverse investors can afford to hold the bond. Some of the specifications that would be found in a typical bond indenture will include: the term of the bond issue, description of the property pledged, interest rates, call price, maturity date, and specification of principal amount, conversion features, and protective clauses such as limits on indebtedness, sinking fund provision and dividend restrictions.

3. Capital Structure Planning and Policy

Some firms do not plan their capital structure; it develops as a result of the financial decisions taken by the financial managers without any formal policy and planning. Financial decisions are reactive and they evolve in response to the operating decisions. These firms may prosper in the short-run, but ultimately they may face considerable difficulties in raising funds to finance their activities. With unplanned capital structure, these firms may also fail to economize the use of their funds. Consequently, it is being increasingly realized that a firm should plan its capital structure to maximize the use of the funds and to be able to adapt more easily to the

changing conditions.

The board of directors or the chief financial officer of a firm should develop an appropriate or target capital structure, which is most advantageous to the company. This can be done only when all those factors, which are relevant to the firm's capital structure decision, are properly analyzed and balanced. The capital structure should be planned generally, keeping in view the interest of the equity shareholders and the financial requirements of the company. The equity shareholders being the owners of the company and the providers of risk capital (equity), would be concerned about the ways of financing a firm's operations. However, the interest of other groups, such as employees, customers, creditors, society and government, should also be given reasonable consideration. Thus, while developing an appropriate capital structure for its company, the financial manager should aim at maximizing the long-term market price per share.

Theoretically, there may be precise point or range within which the market value per share is maximized. In practice, for most companies within an industry there may be a range of an appropriate capital structure within which there would not be great differences in the market value per share. One way to get an idea of this range is to observe the capital structure patterns of firms vis-à-vis their market prices of shares. It may be found empirically that there are not significant differences in the share values within a given range. The management of a firm may fix its capital structure near the top of this range in other to make maximum use of favorable leverage, subject to other requirements such as flexibility, solvency, control and norms set by the financial institutions, the security and exchange commission and the Nigerian stock exchange.

3.1 Objectives of Firms

A profit seeking business enterprise often uses a goal-oriented financial structure. The financial manager performs certain tasks or functions that help to achieve the goals of the finance department. These goals in turn help the firm achieve its overall operating objectives. Of course, the firm needs to ensure that the actions of all operating units, including finance, are helping it to achieve its stated objectives (Cassar & Holmes, 2003). There is a little disagreement in the literature of economics and finance as to what the objectives of firms are or even what they ought to be. However, most writers on financial management make the assumption that the primary objective of a firm is to maximize the wealth of its shareholders. Although it is generally agreed that the financial objective of a firm should be the maximization of owners' economic welfare, there is a disagreement as to how the economic welfare of owners can be maximized (Chandrasekharan, 2012). In the light of the above, two key known objectives of firms (profit maximization and shareholders' wealth maximization) each with its pros and cons are hereby considered.

3.2 Profit Maximization Objective

Traditionally, business firms have been considered as economic institutions. As such, they develop a common and unique measurement of efficiency vis-à-vis profit. It is therefore rational to assume profit maximization as a natural business objective. Adeyemi and Oboh (2011), defined profits as the money that a business makes when it sells something for more than it paid for it. It is the income from an investment or transaction. According to Ahmed (2015), profit is the excess of income over expenditure being referred to as financial gain. Profit maximization is the most important objective of a business. Every business, in addition to striving for the attainment of other objectives, does its best to make profit. Profit is regarded as a yardstick against which the quality, value and the success of a business are measured. Furthermore, in the economic theory, the behavior of a firm is analyzed in terms of profit maximization. Profit maximization implies that a firm either produces maximum output for a given level of input, or uses minimum input for producing a given output. It is assumed that profit maximization causes the efficient allocation of resources under the competitive market condition, and profit is considered as the most appropriate measure of a firm's performance (Beneto, 2015).

However, the microeconomic model of profit maximization is static; that is, it lacks time dimension. Specifically, it does not provide any explicit basis for comparing long-term and short-term profits. Bello (2011) argues that profit maximization objective is a consequence of perfect competition and in the face of imperfect modern markets today, it cannot be a legitimate objective of the firm. According to Pandy (2010), profit maximization as a business objective was developed in the early 19th century, when the characteristics features of the business structure were self-financing, private property and single entrepreneurship. The only aim of the single owner then was to enhance his individual wealth and personal power, which could easily be satisfied by the profit maximization objective.

However, in the contemporary placing of things, ownership and management are separated. In other words, the owner manager of the 19th century has been replaced by professional manager who has to reconcile the conflicting objectives of the parties connected with the business firm. In this new business environment, profit maximization is regarded as narrow, unrealistic, difficult, inappropriate and immoral. More so, accounting profits are not the same as economic profits. Accounting profits can be manipulated to some extent by choices of

accounting policies. A company might make an accounting profit without having used its resources in the most profitable way possible. There is, therefore, a difference between the accounting concepts of historical cost and economic concept of opportunity cost which is the value that should have been obtained by using resources in their most profitable alternative way (Kajananthan & Nimalthasan, 2013). Hence, the profit maximization objective fails to serve as an operational criterion for maximizing the owners' economic welfare as it fails to provide an operationally feasible measure for ranking alternative courses of action in terms of their economic efficiency.

3.3 Shareholders' Wealth Maximization Objective

The shareholders' wealth maximization objective maintains that the immediate operating goal and the ultimate purpose of a firm is and should be to maximize return on equity capital. It stresses the maximization of the present value of all the future benefits to the owners. That is, reward shareholders of a company can expect to receive. This is the second frequently encountered objective and it has two components: risk and return (Pandy, 2010). Positive returns to common shareholders in form of increases in their share value can occur in two ways: dividends can be paid and the market price of common shares can increase. On the one hand, negative return can result from decreases in the resale price of the common share. The fact that future returns are unknown is the risk that shareholders accept in purchasing common stocks. Investors are generally assumed to buy and sell common stocks on the basis of the impact of the stock's risk and return component on their wealth. Purchasing the shares of a given corporation implies that investors rightly or wrongly decide that expected returns justify the risk that actual return may turn out to be less than expected or may even be negative (Ishaya & Abduljellel, 2014). These changes in shareholders' wealth are frequently measured as a rate of return per time period. This provides a common denominator for measuring returns over successive periods of time and facilitates the comparison of the desirability of alternative investments.

However, in an attempt to make the greatest possible contribution to the wealth of its owners, it becomes incumbent on firms to seek to provide the largest attainable combination of dividends per share and stock price appreciation. While a corporation may have considerable latitude in setting its dividend policy, it will have much less influence over its stock's price, that is, the corporation can adopt a dividend policy that sets the size and frequency of dividend payments, but the resale price of its common stock is set by the interaction of buyers and sellers in the securities markets. Most often, stock prices are merely a reflection of the market's perception of the corporation's ability to earn profits and the degree of risk it assumes in earning its expected future profits. Given the limitation of profit maximization as a corporate goal, stockholder wealth maximization has received greater emphasis as the primary corporate goal. This of course, does not suggest that stockholder wealth maximization is a perfect goal.

3.4 Capital Structure Decisions

Capital structure decisions are so important and sensitive that it is of necessity that firms should know this before deciding its mix. Heaton (2012) posited that the capital structure decisions of firms have serious implications on both the micro and macro-levels of the economy. On the micro level, the capital structure decisions of companies cost them a lot of time and money in searching out and ascertaining the best capital structure policy to adopt and this has been evidenced amongst firms. Similarly, at the macroeconomic level, the capital structure decisions have great implications. A rise in corporate debts tends to increase the vulnerability of an economy to a downturn.

Frank and Goyal (2013) believe that it occurs due to the risk associated with corporate debt in terms of bankruptcy and liquidity caused by the inability to pay back debts and its accrued interest. They further noted that bankruptcy related problems become rampant when firms have a lot of debts in their capital structure. Eugene, Gapenski and Her-hardt (2010) also opines that debt has a great consequence on the macro economy of a society. He argues that when the debt burden in an economy is large enough, it will make the economy become vulnerable to downward revisions to expectations and such revisions will reduce effective demand in the domestic economy, hence could stimulate financial crisis. In deciding the capital structure of firms, Bello (2011) argued that firms should determine their capital structure based on applying the trade-off theory or the pecking order theory. He argues that in applying the trade-off theory, firms will settle for the capital structure at that margin where firms' trade-off the benefits of an additional debt against the costs. The benefits of additional debt include reduced agency cost of deriving the debt, tax cover as a result of interest payable on the debt; and the costs of debt include bankruptcy cost as a result of non-re-payment of debt.

4. Nigeria's Corporate Environment

Nigeria is a country blessed with abundant resources. It is expected that every necessary infrastructure needed to drive the economy are put in place to enable business and all other economic activities thrive accordingly. But unfortunately, in the contemporary Nigeria, the most critical infrastructure needed to drive the economy are

conspicuously absent. Power supply is poor, roads are bad, policies are unstable and insecurity unabated. This picture clearly depicts unfriendly business environment which directly or indirectly inhibits the performance of quoted companies in Nigeria.

Although, Nigeria has a population of over 120 million and present a wonderful climate for investment, there are 36 states, with federal capital territory, 744 local government headquarters as well as several other cities and big towns, each with substantial population, but, business opportunities, which serves as hallmark of big cities has remain precarious in most of these cities. The following factors shape business environment:

Technological factors: This includes research and development activity, technological incentives and the rate of technological change. They can determine barrier to entry, minimum efficient production level and influence outsourcing decisions. Technological shifts can affect costs, quality and stimulate further invention, innovation and competition.

Ecological factors: These include environmental aspect such as weather, climate, and climate change, which may affect industries like tourism farming and insurance. Growing awareness of the potential impacts of climate change is affecting how companies operate and the products they offer, both creating new markets and diminishing or destroying existing ones.

Legal factors: Included in this component are discriminatory law, consumer law, antitrust law, employment law, and health and safety law. These factors can affect how a company operates, its costs, and the demand for its products.

Political factors: This is described as the extent and level of government direct and indirect intervention and influence on businesses in an economy. In particular, political factors include the following areas; tax policy, labor law, environmental law, trade restrictions, tariffs, incentives and political stability. It may also involve goods and services which the government provide or has intention to provide or not to provide.

Economical factors: These are economic growth, interest rates, exchange rates and the inflation rate. These factors have influence on the operation and determination of businesses. For instance, interest rates affect the costs of exporting goods and the supply and price of imported goods in an economy.

Social factors: These aspects include health consciousness, population growth rate age distribution, career attitudes and emphasis on safety nets. According to them, trends in social factors affect the demand for a company's productions and how that company operates. Apart from these factors, other factors such as financial sources, image and reputation, information system, required skills etc., also affect business environment.

5. Conclusion

The study was undertaken to review capital structure of quoted companies in Nigeria. So many theories of capital structure have been developed over the years. These theories have directly and indirectly affected the ways companies in Nigeria raise their capital. From the conceptual review obtained, it was revealed that capital structure of quoted companies in Nigeria is a significant measure of their performance. In view of the findings, it was concluded that capital structure of quoted companies in Nigeria is a significant measure of their performance and should be effectively and efficiently managed at all time.

6. Recommendations

Based on the present study, the following recommendations were made:

1) Quoted companies in Nigeria should invest their profits when there are good investment opportunities and pay cash dividend as soon as enough income is generated.
2) Quoted companies in Nigeria should desist from the use of excessive debt during the period of harsh and unfavorable economic conditions but should use more of internal and equity funds in financing their assets in order to achieve a positive return on their assets.
3) Debt funds should only be used to finance assets that generate high returns so as to defray the cost of such debts and boost profitability.

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