Effect of Capital Structure on Firms Performance in Nigeria

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Abstract The lack of precise methodology to determine the capital structure mix on firm performance has generated a lot of mixed results. Empirical studies from emerging nations revealed a scarcity of empirical findings on the measures with a significant impact on firm performance. This paper examines capital structure measures on manufacturing firm’s performance in Nigeria. Using annualized panel data for a sample of 15 quoted firms from diverse sectoral classifications from 1999-2018. Excluding the financial firms due to the uniqueness of their capital structure and the strict legal requirements for their financing choices. This study focus on non-financial firms. Capital structure measures book value and market value of the firm. Results indicate that performance proxy by ROE, and Tobin’s Q, significantly influence SDTA, SIZE, LDTA, and TDTA while ROA negatively influences LDTA, D_E, and TDTA. Findings revealed a robust relationship between Tobin’s Q and financial performance compared to other book value. Tobin’s Q is a better measure of performance within the period under review. The study reveals that Nigerian firms are keenly financed by short-term debt supporting the Pecking Order Theory. It’s vital to note that no single theory can sufficiently explain the capital structure effect on firm performance.

Keywords Capital Structure, Performance, Manufacturing Companies, Debt, Equity

JEL Classification numbers: G32, L25, L6, N67, G 23, M41

1. Introduction

The financial decision of a firm is vital in determining the optimal capital structure mix. Measuring the firm managerial and financial prowess to adjust and direct its numerous leverages to maximize its value, growth, and generate optimum returns. Firms have a diverse level of leverage, the determination of the best mix to enhance performance by managers remains a puzzle to be solved in corporate finance theory and finance literature. The capital structure comprises long-term debt, specific short-term debt, common equity, preferred equity, and retained earnings. Firm performance is calculated by its capacity to generate optimum returns from its assets, maximize the value and wealth of the shareholders. The financing decisions of firms vary according to the rate of risk related to each financing option as well as the relationship between risk and return (Abu-Rub, [1]). Capital structure effect on firm performance varies proportionately in two ways; according to Desai, ([2]) highly leverage firms with similar risk level might have a higher cost of capital and leverage.

Similarly, high financial leverage stirs volatility and
lower firm values than others as a result of valuation in
the capital structure. Modigliani, and Miller, ([3]) assert
the irrelevance of the debt-to-equity ratio effect on firm
value. The MM model considered the Arrow-Debreu
environment of the perfect market condition of no taxes,
rational investors, perfect competition, free economy, no
bankruptcy costs among others (Hartono, and Utami [4]).
According to Modigliani and Miller ([3]), firm’s
performance is independent of their capital structure; and
their financing strategies “equity and debt” are
“irrelevant” to the firm’s value.

They further upheld that firms at all capital structure
levels should maintain the same market value and
Weighted Average Cost of Capital (WACC). Empirical
findings, on the contrary, argued that the idealistic
assumptions are unrealistic and impossible in reality
where government taxes are inevitable. Ahmad, Salman,
and Shamsi ([5]) observed that imperfect market condition
factors group under firm-specific, industry-specific, and
country-specific such as firm size, profitability, corporate
tax, bankruptcy costs, industry type, and internal policies
influences the capital structure decision of a firm (Akeem,
In conceding the tax shield advantage on debt, under
imperfect market conditions, Modigliani and Miller ([8])
upheld that a unit increase in firm value increases debt in
the capital structure mix where interest payments are
tax-deductible to maximize performance and minimizes
borrowing cost. Firms enjoy tax shields using more debt
under an imperfect market condition. The interest tax
shields proposed by Modigliani and Miller, ([8]) are
considered irrelevant to the firms with other tax shields,
such as depreciation (DeAngelo, Harry, Ronald and
Masulis. [9]).

The empirical literature suggests an optimal capital
structure that maximizes firm value and simultaneously
minimizes the cost of capital, to balance risk and return
without a specific methodology to achieve the best mix
(Dada, and Ghazali, [7]). Financial theorists, over the
decade, tried to provide possible explanations on the
financing decisions of firms with diverse and unrealistic
assumptions such as the Net Operating Income Approach
and the traditional theory. The agency cost theory and
pecking order theory among other theories provided a rich
understanding of the effect. According to the agency
theoretical model popularized by Jensen, and Meckling,
([10]), the capital structure level of a firm minimizes the
agency cost and maximizes firm values by trading off
agency cost of debt against debt benefit (Riahi - Belkaoui
[11] cited in Pirzada, and Bin Mustapha, and
Wickramasinghe [12]).

The lack of a precise methodology to determine a
firm’s optimal capital structure, boost productivity,
profitability, growth, stakeholder satisfaction, firm value,
minimizes cost, and strike a balance between risk and
return is the major problem of this study. Earlier studies
are in advanced countries with functional stock markets.
In Nigeria and other emerging countries, contemporary
studies reveal diverse results on firm Performance as
presented in table (1) below. In Palestine [13], India
Kannadhasan, ([14]), Pakistan Umar, Tanveer, Aslam, and
Sajid, [15], Nigeria Aransiola, and Aransiola ([16]),
Nigeria Nwachukwu and Akpeghughe [17] Oil and Gas
Companies in Pakistan Raheel, and Shah, F.M [18]
Bangladesh Hossain, Imran, and Hossain [19] also
observed diverse results as a result of methodology,
variable measurement, scope of study, method of data
collection among others.

This study differs from previous studies to employ
Tobin’s Q a measure of market value and accounting
value, along with other book value, to examine capital
structure on non-financial firm performance which most
studies ignored in Nigeria to focus on quoted Banks
Nwachukwu and Akpeghughe [17]; Adesina, Nwidobie,
and Adesina [20]; Olaniyan, Soetan, and Simon- Oke [21]
among others. The contemporary econometric technique
(panel data analysis) was also adopted to extend and
improve on the other empirical, analysis conducted so far
in Nigeria.

The panel data methodology allows for an unbiased and
efficient estimation which most studies in Nigeria use the
linear regression model predominantly.

2. Literature Review

The firm’s performance is sizably affected by various
factors and capital structure is key among them. Numerous
theoretical, and empirical studies conducted to explore possible “positive, negative, or no relationship”
between capital structure and firm performance reported
mixed results and findings. Similarly, financial theorists
tried to propose possible explanations on capital structure
effect on firm performance, presenting idealistic
assumptions. The Net Income Approach Theory
Modigliani and Miller, [8] proposed a positive effect of
debt on the firm value. This theory assumes that the cost
of debt is less than the cost of equity and that corporate
income tax exists. The theory supports 100% debt finance.

The Net Operating Income Approach assumes that
the common stock price is not affected by modest or
excessive use of debt financing in the operational and
business activities of the firm. The firm's value is
independent of the weighted average cost of capital and
total firm value (Pandey [22]). The assumptions of the Net
Income and Net Operating, Income Approach were
criticized on the ground of impractictability, artificial, and
inadequate (Rezaei, and Ortt, [23]).

The traditional theory hypothesizes that at a minimum
level the weighted average cost of capital; a firm optimal
capital structure and shareholders’ wealth are maximized
and achieved. Kraus, and Litzenberger, [24] proposed the
trade-off theory of optimal capital structure to maximizes firms' value through debt financing to the extent where tax shield is higher than the bankruptcy cost. The trade-off theory allows firms to adopt both debt and equity financing sources notwithstanding their operational cost implication on their operational and business activities. The pecking order theory proposed by Myers, and Majluf, [25], envisages, no optimal leverage due to asymmetric information and transactions costs.

Firms adopt a hierarchical order of available and accessible financing preferences from the least sensitive (least risky) to the most sensitive (most-risky). Thus, firms preferred internal funding over external funding except where internal funds are inadequate or unavailable.

Debt funding is required where external financing is desirable and equity finance becomes the last resort where the desirable is unavailable and inaccessible. The hierarchical order was initiated by Myers, and Majluf, [25] regarding the adverse selection problem of information asymmetric between the managers and outsiders (investors). Information asymmetry also occurs when external financing signals a problem that may affect the share price (Frank and Goyal, 26; Kumar, Colombage, and Rao, 27]). The pecking order theory does not envisage the debt ratio (a mix of debt and equity) because of internal and external capital.

Table 1 presents empirical review of studies conducted locally and internationally on capital structure effect on firm performance.

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>Objective</th>
<th>Methodology</th>
<th>Findings/Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yinusa, Ismail, Yulia, and Olawale [34]</td>
<td>Capital structure on firm performance</td>
<td>GMM model</td>
<td>Positive effect on performance where debt financing is moderately employed in Nigeria</td>
</tr>
<tr>
<td>Negative Results</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aransiola and Aransiola [16]</td>
<td>Capital structure on the performance of manufacturing firms in Nigeria</td>
<td>Panel Regression</td>
<td>Negative effect on performance</td>
</tr>
<tr>
<td>Raluca, [37]</td>
<td>Capital structure on Corporate performance of listed Romanian firms</td>
<td>Regression</td>
<td>Negative effect on performance</td>
</tr>
<tr>
<td>Mixed Results</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nwachukwu and Akpegbrugu [17]</td>
<td>Capital structure and firms performance in the Nigerian banking sector</td>
<td>Regression</td>
<td>A positive relationship with equity capital and a negative relationship with debt capital and return on investment. Negative effect on Chinese firms and a positive on Germany and Sweden, firms before the 2008 financial crisis.</td>
</tr>
<tr>
<td>Tianyu, [38]</td>
<td>Capital structure on performance in both developed and developing markets</td>
<td>Regression</td>
<td>Capital structure shows a weak-to-no impact on performance.</td>
</tr>
<tr>
<td>Inconclusive Results</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raheel, and Shah [18]</td>
<td>Financial leverage on firms’ profitability in Oil and Gas Companies of Pakistan Listed in KSE</td>
<td>Regression Analysis</td>
<td>The non-significant effect between financial leverage and earnings per share.</td>
</tr>
</tbody>
</table>

Source: Authors Computation (2020).
The debt ratio represents the accumulated external financial needs of the firm. The theory concentrates on the cost of capital reduction and ongoing performance ignoring the firm’s long-term reputation of reliability (regular debt payments), profitability (stable or increasing dividends), and performance. The underpinning theory of this study is the pecking order theory given its relevance in literature. Capital structure effect on firm performance under the perfect market conditions in the United States Petroleum, oil, and electricity industries was examined using the two-stage instrumental variable approach. Findings revealed a non-significant influence on the firm’s value. Singh, and Hamid [28] and Singh [29] examined the Western models of capital structure theories in developing nations results revealed a mismatch of funding where long term investments are financed by short term debt. Most firms in developing countries finance their business and operational activities inversely, from the pecking order theorem relying heavily on external financing, the bulk of which is short-term finance (Singh [29]). On the other hand, firms in developing countries rely more heavily on equity issues than those in the developed business climate. Empirical literature acknowledged the long and short-term debt ratio as the best-fit measure of leverage ratios in developing countries like Nigeria. Salawu [30] observed that 60% of Nigerian firm’s capital structure is short - term debt. Myers [31] observed that only a small proportion of capital formation of US quoted firms are finance externally, equity issues represent a minor percentage while the bulk of external finance is debt. The findings and results vary with publicly quoted firms in Nigeria. The theory of capital structure is closely related to the firm’s cost of capital (Nwude, Itiri, Agbadua, and Udeh [32]).

2.1. Knowledge Gap

The lack of precise methodology on the determination of the capital structure mix on firm performance has generated a lot of mixed results. Most contemporary empirical studies in Nigeria employed divers leverage measures excluding others; Salawu [30], adopted the short term debt, and excluding total debt to total assets, reporting a negative result. Dada, and Ghazali [7] employed total debt to equity excluding, short term debt to total assets, and long term debt to total assets, short-term debt, long-term debt, and total debt observing a mixed result of a positive and negative relationship while DeAngelo, Harry, Ronald and Masulis [9] employed total debt to equity and long term debt to total assets, excluding short-term debt, and total debt. This study employed Tobin’s Q to proxy market value and growth, a leverage ratio of Long Term Debt to total asset, Total Debt to total asset, Short Term Debt to total asset, and Debt equity ratio to cover and expand the frontiers of other empirical analysis in Nigeria. Tobin’s Q is a combination of market value and accounting value measuring the firm’s value. This study adopts a contemporary econometric technique of (panel data analysis), by using fixed - effect estimation, random - effect estimation, and a pooled regression model with an array of pre-test and diagnostic tests.

3. Methodology

The population of this study consists of 102 listed manufacturing firms in the Nigerian Stock Exchange (NSE) as in December 2018. To achieve the study objective, panel data gathered from the annual report of studied firms covering 19 years (1999-2018) of 15 listed firms in all the 7 sectors of Agriculture (FTN Cocoa Processors Plc), Oil and Gas (MRS Oil Nigeria), Basic Material (Meyer and Berger paint), Consumer Goods (Vita foam, Presco and Honey Well), Health Care (Juli Nigeria, Nigeria-German Chemicals), Information, Communication & Telecoms (Airtel Nigeria, MTN Nigeria) and Industrial Goods (Dangote Cement, Lafarge Africa and UAC of Nigeria) were selected. For this study, lots of factors were put into consideration in the selection of the sample firms. Such factors highlighted include: firms that were listed in NSE before the year of inception of the study, firms that ceased operation at any point during the period of the study and those that had problems with NSE and Securities and Exchange Commission (SEC) within the period under review were also excluded.

The study adopted the Panel Least Squares models of either the Random Effects Model (Error Component Model) or the Fixed Effect Model (Least Squares Dummy Variable Approach (LSDV) to analyse the effect of capital structure on firm performance in Nigeria. This study excluded the financial companies and the banking sector due to the uniqueness of their capital structure and the strict legal requirements for their financing choices. This study adopted the return on assets (ROA), return on equity (ROE), and Tobin’s Q to measure a firm’s performance and Long Term Debt to the total asset (LD/TA), Total Debt to total asset (TD/TA), Short Term Debt to total asset (SD/TA) and Debt equity ratio (D_E) as measures of leverages. Firm size is the controlled variable and is considered to be an important determinant of a firm’s profitability.

The functional relationship between firms’ performance and capital structure is shown below:

\[ Y_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 Z_{it} + \mu_{it} \]  

\[ Y_{it} = \beta_0 + \beta_1 (LDTA_{it}) + \beta_2 (TDTA_{it}) + \beta_3 (SDTA_{it}) + \beta_4 (DE_{it}) + \beta_5 (SIZE_{it}) + \mu_{it} \]  

\[ ROA_{it} = \beta_0 + \beta_1 (LDTA_{it}) + \beta_2 (TDTA_{it}) + \beta_3 (SDTA_{it}) + \beta_4 (DE_{it}) + \beta_5 (SIZE_{it}) + \mu_{it} \]  

*Model 1*
Model 2

\[ ROE_{it} = \beta_0 + \beta_1(LDTA_{it}) + \beta_2(TDTA_{it}) + \beta_3(SDTA_{it}) + \beta_4(D_E_{it}) + \beta_5(SIZE_{it}) + \mu_{it} \] (4)

Model 3

\[ Tobin's\ Q_{it} = \beta_0 + \beta_1(LDTA_{it}) + \beta_2(TDTA_{it}) + \beta_3(SDTA_{it}) + \beta_4(D_E_{it}) + \beta_5(SIZE_{it}) + \mu_{it} \] (5)

Where: \( Y_{it} = \) Dependent Variables.
\( \beta_0 = \) Intercept of the Equation,
\( \beta_1 = \) Coefficient of \( X_{it} \) Variable.
\( X_{it} = \) Independent Variable.
\( I = \) (Cross-Sectional Variables) Number of Manufacturing Firms
\( t = \) Time Period
\( \mu = \) Error terms

Estimation Procedure: The estimation processes follow an array of pre-estimation tests, Panel estimation, and diagnostic tests. The unit root test was conducted using the summary method to determine the dataset stationarity.

Estimation Technique: The choice of either pooled Ordinary Least Square (OLS), Fixed Effects, and Random Effects regression models is dependent on the Hausman Test conducted on the panel regression results.

\[ H_{stat} = (\beta_{FE} - \beta_{RE})[Var(\beta_{FE}) - Var(\beta_{RE})] - 1(\beta_{FE} - \beta_{RE}) \sim \chi^2(k) \]

Large statistic implies that the estimated p-value between the \( Ho \) Random Effects (ECM) Error Component Model and the \( H_1 \) the Fixed Effects (LSDV) Least Square Dummy Variable Approach is significant. The \( Ho \) is rejected and \( H_1 \) is accepted otherwise \( Ho \) is accepted and \( H_1 \) is rejected.

4. Data Analysis and Results:
Descriptive Statistic

Pre-Test

Figure 1 shows the mean, and median of the series. The standard deviation measures dispersion. Skewness shows the degree of or departure from symmetry and kurtosis the degree of peakedness and Jarque-Bera measure the normality. The results are largely Mesokurtic, the Kurtosis equal (3). By implication, the datasets are normally distributed.

<table>
<thead>
<tr>
<th>Series: Standardized Residuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sample 1999 2018</td>
</tr>
<tr>
<td>Observations 300</td>
</tr>
<tr>
<td>Mean                 -4.14e-16</td>
</tr>
<tr>
<td>Median               -0.917246</td>
</tr>
<tr>
<td>Maximum              6.447188</td>
</tr>
<tr>
<td>Minimum              -2.430557</td>
</tr>
<tr>
<td>Std. Dev.            2.126207</td>
</tr>
<tr>
<td>Skewness             1.528511</td>
</tr>
<tr>
<td>Kurtosis             3.955331</td>
</tr>
<tr>
<td>Jarque-Bera          128.2254</td>
</tr>
<tr>
<td>Probability          0.000000</td>
</tr>
</tbody>
</table>

Figure 1. Descriptive Statistics
null hypothesis is accepted (random effect). The Hausman test was adopted to select the best fit model to test the hypothesis; the Cross-Section chi-square statistic with 5 degrees of freedom is 2.80 and the p-value of 0.7305 is presented in Table 3 below. The P-value of (0.000). The result is reliable for a meaningful analysis. The Durbin Watson Statistics of 1.90 is approximately 2 ruling out all possible suspicion of first-order positive autocorrelation.

4.2. Panel Regression Analysis

Model 1: Capital structure correlates with return on assets of manufacturing firms in Nigeria

The Hausman test was adopted to select the best fit model to test the hypothesis; the Cross-Section chi-square statistic with 5 degrees of freedom is 2.80 and the p-value of 0.7305 is presented in Table 3 below. The P-value of the Hausmann Chi-square Statistic is greater than 5%. The null hypothesis is accepted (random effect).

Table 3: Capital Structure Versus Return on Assets of Manufacturing Firms in Nigeria

Table 4: Capital Structure Versus Return on Equity of Manufacturing Firms in Nigeria
Table (4): The $R^2$ of 87% shows, the goodness of the panel regression model. The exogenous variables are jointly responsible for an 87% variation in the endogenous variable with an unexplained variation of 13%. Firm performance proxy by return on equity showed a positive and significant relationship with firm size, LDTA, STDTA, and TDTA and a negative relationship with ROE under the measure of D_E. The overall panel regression results are significant. F-stat of (3.407) associated with the P-value of (0.000). The result is reliable for a meaningful analysis. The Durbin Watson Statistics of 2.161 rules out all possible suspicion of first-order positive autocorrelation.

Model 3: Capital structure correlates with a market value of manufacturing firms in Nigeria

The Hausman test was adopted to select the best fit model to test hypothesis three; the Cross-Section chi-square statistic with 5 degrees of freedom is 6.773 and the p-value of 0.238 is presented in Table 5 below. The P-value of the Hausmann Chi-square Statistic is greater than 5%. The null hypothesis accepted (random effect) is preferable over the fixed effect following the standard null hypothesis.

Table 5. Capital Structure Versus Market Value of Manufacturing Firms in Nigeria

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>0.263</td>
<td>0.876</td>
<td>0.300</td>
<td>0.7639</td>
</tr>
<tr>
<td>TDTA</td>
<td>-0.027</td>
<td>0.022</td>
<td>-1.246</td>
<td>0.0011</td>
</tr>
<tr>
<td>SDTA</td>
<td>0.091</td>
<td>0.061</td>
<td>1.487</td>
<td>0.1380</td>
</tr>
<tr>
<td>LOGSIZE</td>
<td>0.087</td>
<td>0.058</td>
<td>1.505</td>
<td>0.1333</td>
</tr>
<tr>
<td>LDTA</td>
<td>-0.212</td>
<td>0.080</td>
<td>-2.647</td>
<td>0.0086</td>
</tr>
<tr>
<td>D_E</td>
<td>0.0056</td>
<td>0.057</td>
<td>0.098</td>
<td>0.9220</td>
</tr>
</tbody>
</table>

Effects Specification

| R²       | 0.68       | 6.773   |
| F.Stat.  | 12.925     | 0.238   |
| P-value  | 0.0000     | 2.108   |

Source: Authors’ Computation (2020)

Table (5): The $R^2$ of 68% shows, the goodness of the panel regression model. The exogenous variables are jointly responsible for a 68% variation in the endogenous variable with an unexplained variation of 32%. The overall panel regression model result is significant. F-stat of (12.925) is associated with the P-value of (0.000). The result is reliable for a meaningful analysis. The Durbin Watson Statistics of 2.108 rules out all possible suspicion of first-order positive autocorrelation.

5. Discussion

The results in model (1) of table (3) reveal a negative and significant relationship between LDTA, D_E, and TDTA on the performance level of studied firms by 17.46%, 29.67%, and 10.11% respectively. Supporting the pecking order theory hypothesizes a negative relationship between profitability and debt usage. [41;42] argued that long-term debt increases a firm’s value, due to a lower long-term debt ratio in the capital structure of companies. Highly profitable Nigerian firms require less debt finance. On the other hand, a positive and significant relationship was observed between short-term debt leverage ratio, ROA, and ROE supporting the agency cost model of debt ratios as a disciplinary device to reduce cash flow waste mitigating the opportunistic behaviours of shareholders-managers to generate sufficient cash flow to prevent liquidation. The result correlates with the true nature of the Nigerian business climate where the majority of firms depend on short-term financing from deposit money banks as a result of the high cost of raising equity from the stock market and debt market underdevelopment. The findings are consistent with the finding of (Nwachukwu and Akpeghugwu 17; Hossain, Imran, & Hossain 19]).

A positive and significant correlation was reported between TDTA, LTDTA, STDTA, and ROE. A unit increase influences manufacturing firm performance in model (2) of table (4). In model 3 of table (5) the results show a positive and significant relationship between market value measured by (Tobin Q) and SDTA, LDTA, D_E. A negative relationship with TDTA was also reported. The control variable of firm size reveals a strong significant effect on firm performance and market value measured by Tobin Q. The significance of a firm’s size on performance indicates that large firms earn higher returns compared to smaller firms, presumably as a result of diversification of investment and economies of scale. Total debt shows a negative and significant relationship with the firm market value. It can be inferred that a unit increase in total debt decreases the firm market value. The findings substantiate the findings and results of (Umar, Tanveer, Z., Aslam, S., and Sajid 15; Akguc, Choi,., Kim, and McKenzie, 43; Aransiola, and Aransiola 16; Ardalan,44) and others.

6. Conclusions

The results and findings of this study revealed a disparity between the capital structure of firms in an emerging business climate like Nigeria and those in the developed nations. Manufacturing firms in Nigeria prefer and rely heavily on short-term debt rather than long-term financing. Firm-specific factors that are relevant in the developed business climate are also relevant in Nigeria in explaining the capital structure and corporate performance. Overall, empirical results support the pecking order and agency cost theories of capital structure.
The findings limit the explanatory power of the capital structure theories in Nigeria showing that the theoretical underpinnings are still largely unresolved. It’s vital to note that no single theory can sufficiently explain the relationship between capital structure and firm performance. Theories are based on critical assumptions ignoring the extremely diversified and complex realities in the economic and business climate.

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The author confirms that the data do not contain any conflict of interest.

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