

Effect of Capital Structure on Financial Performance of Quoted Non-Financial Companies in Nigeria

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Abstract

A great dilemma for management and investors alike is whether there exists an optimal capital structure and how various capital structure decisions, both short-term and long-term, influence business performance. This paper therefore investigates the effect of capital structure decisions on financial performance using a sample of 10 quoted Non-financial companies on the Nigerian Stock Exchange for a period of five years (2016–2020). The study used secondary panel data contained in the annual reports and financial statements of the quoted non-financial companies. The study examined the effect of debt equity (being the explanatory variable) on return on equity (ROE) and return on assets (ROA) which represents the dependent variables. The panel dataset were analysed using pooled, fixed effect and random effect models while Hausman's test were used to select the appropriate model. Correlation and regression analysis were employed in the statistical analysis that was carried out with the aid of STATA version 13. On both the ROE and ROA models, there is a positive relationship with debt equity ratio. The results showed that the financial performance of firms increases with the increase in the changes in debt in the capital structure. This implies that, the inclusion of debt in the capital structure of a firm positively affect the equity shareholders in terms of firm performance; and this thus supports debt financing in running the firms. The study recommended that firms should increase debt financing in their capital structure in order to enhance financial performance and increase value to the companies' stakeholders.

Keywords: Capital Structure, Financial Performance, ROE, Non-financial, Agency Cost Theory

INTRODUCTION

The quest for firms to expand their activities, maximise their shareholders' wealth and compete effectively in the industry where they operate cannot be over-emphasised. It is an undeniable fact that the going concern and the performance of a firm hinge on some important factors such as: qualified management board, pragmatic strategies, availability of finance, among others. Therefore, for firms to achieve their goals and objectives, taking into cognisance their limited resources, they necessarily need to strategize on how to finance their activities. Basically, the sources of finance available to an entity include: equity, debt, and earnings. Equity refers to the fund invested into a firm by its shareholders. Equity includes paid-up share capital, sharepremium and reserve and surplus (retained earnings) (Pandey, 2010). While debt is the fund sourced from other capital providers, which crystallised at a specified date. Earnings on the other hand, refer to the profit generated by a company in its business activities. However, since earnings may not always be sufficient for an organisation to run its activities due to tax and dividend dependability on it, hence, the major sources of fund available to a firm is equity and debt. The choice of a company's capital structure helps in determining how the operating cash flows can be allocated for every period between the shareholders and debt holders. There has been an unresolved debate over the significance of the choice of capital structure for a company that has been on-going for quite some time. However, in essence, it is about the effect on the total market value of the firm, (the combined value of its equity and debt) of dividing the cash flow stream between debt and equity components. In the past, financial and economic experts believed that increasing leverage of a firm would increase the value up to a certain point. However, beyond that point, any other increases in leverage would also increase the overall cost of capital and decreases its total value in the market, Abor (2007; as cited in Muyundo et al., 2020).

Capital structure refers to the mix of long-term sources of funds, such as debentures, long-term debt, preference share capital and equity share capital including retained earnings. Capital structure is one of the most complex areas of financial decision making because of its interrelationship with other financial

decision variables. Effective capital structure decisions can lower the cost of capital, resulting in higher net present value and more projects that are acceptable and thereby, increasing the value of the firm (Abdur, 2015). Empirical evidences assert that firms will select the mix of debt and equity that maximises the value of the firm (Modigliani & Miller, 1958). When an organisation intends to expand its investments, the need to raise funds is inevitable, which may alter its capital structure. An appropriate capital structure is a critical decision for any business organisation. The decision is important not only because of the need to maximise returns to various organisational stakeholders, but also because of the impact such decision has on the survival of the business (Mykhailo, 2013).

LITERATURE REVIEW

Conceptual Framework

Strength of financial position of an organization is called financial performance. Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account. In financial analysis a ratio is used as a benchmark for evaluating the financial position and performance of a firm. Ratio is defined as “The indicated quotient of two mathematical expression” and as “The relationship between two or more things”. Ratios help to summarize large quantities of financial data and to make qualitative judgment about the firm’s financial performance (Jude, 2013). Capital structure is the mixture of debt and equity that a firm uses in financing its business. It is also regarded as a very significant financial variable because it is highly linked to the capacity of the firm to meet its obligations to stakeholders such as shareholders, community, employees and others. Equity finance is the finance that is contributed by the owners of the business towards the capital. It is the one with the most risk. Shareholders are entitled to the shares of the company’s profit, referred to as dividend, and this is following the number of shares held. It is not compulsory, however, to carry dividend payments every time because the company can at times hold part of the profits to support future expansion or use of its business activities. Besides, shareholders also share business risks that may occur and are also the last ones to benefit in the case of company liquidation after settling all debts (Mutegi, 2016).

For quite a long time, financial performance is a measure of how best a company uses the resources available in the generation of revenue. In most cases, it provides the guidelines that direct how decisions will be made in future as far as business development, managerial control and asset acquisition are concerned. It also assists in reflecting on what the management has achieved in monetary terms over a certain period. Such achievements can also be used in carrying out comparisons of similar firms. In addition, financial performance provides a way for the evaluation of business activities in monetary terms that are objective. It helps in showing how well shareholders are at the end of an accounting period as compared to the beginning. This can be well realized through clear analysis of market data or financial ratios taken from financial statements (Zeitun, & Tian, 2007). There are various ways of measuring financial performance. There are therefore many varying absolute and relative indicators that include expenses, revenues, and earnings before interest and tax, net income levels, return on equity and return on assets among many others. In most studies, the frequently used measures of performance are ROA and ROE. ROA explains the return on assets of the company. Firms majorly use it as the overall indicator of financial performance. ROA is arrived at through computation whereby Net Income after Taxes is divided by Total Assets. ROA is, therefore, used in measuring the financial performance of companies. On the other hand, ROE indicates a return on shareholders capital and is arrived at by dividing Net profit after Taxes by Total Equity capital. Furthermore, it explains the level of profitability of companies considering the total sum of invested shareholder capital (Saeedi & Mahmoodi, 2011). Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested (Khatab, Masood, Zaman, Saleem, & Saeed, 2011). It is often viewed as a hybrid measure of firm performance because it incorporates profit which is accounting based and equity which is market based.

Empirical Framework

Several authors across the globe have made attempt to ascertain the impact of capital structure on firms' performance. Lucy et al. (2014) investigates the relationship between capital structure on the performance of non-financial companies listed in the Nairobi Securities Exchange (NSE), Kenya. The study employed an explanatory non-experimental research design, using a census of 42 non-financial companies listed in the Nairobi Securities Exchange. The study used secondary panel data contained in the annual reports and financial statements of listed non-financial companies with data extracted from the hand books for the period 2006-2012. The study applied panel data models (random effects). The regression results from the study revealed that financial leverage had a statistically significant negative association with performance as measured by return on assets (ROA) and return on equity (ROE). The study recommended that managers of listed non-financial companies should reduce the reliance on long term debt as a source of finance. Similarly in Nigeria, Osuji and Odita (2012) examines the impact of capital structure on financial performance of Nigerian firms using a sample of thirty (30) non-financial firms listed on the Nigerian Stock Exchange during the seven (7) year period, from 2004 to 2014. Panel data for the selected firms were compiled and analysed using the ordinary least squares as a method of estimation. The result of their study showed that a firm's capital structure has a significantly negative impact on the firm's financial performance. Lawal *et al.* (2014) in their study of the effect of capital structure on firm's performance among sampled firms in the Nigerian manufacturing industry, observed that capital structure variables are negatively related to firms performance they however recommend that firms should use more of equity than debt in financing their operation.

Jude (2013) also provides evidence in his investigation of the relationship between capital structure and the financial performance of listed manufacturing firms in Sri Lanka from 2008 to 2012. Financial performance was measured in terms of accounting profitability by Return on Equity (ROE) and Return on Assets (ROA). 30 listed manufacturing firms were selected as sample. The data were analyzed and hypotheses were tested through correlation and regression analysis by using SPSS. The findings revealed that, there was a significant negative relationship between leverage and return on equity. And there was no significance relationship between leverage and return on assets. In addition to the foregoing, divers authors, Mustafa and Osama (2013), Bokhtiar et al. (2014), Varun (2014), Onaolapo and Kajola (2010), Ebaid (2009), Shan and Khan (2007), Zeitan and Tian (2007), and Haung and Song (2006) have all concluded that capital structure statistically and negatively impact firm's performance, using the different methodologies and country data. Contrariwise in Pakistan, Mubeen and Kalsoom (2014) in their investigation of the impact of capital structure on financial performance and shareholders' wealth sampling 155 firms in the Pakistan Textile Sector concluded that capital structure positively impact firms financial performance and shareholders' wealth. Other authors have also concluded that capital structure has a mixed effect on firms performance. (Zeitan & Tian, 2007), Berger and Bonaccorsi (2006), in their study of the impact of capital structure on firm's performance concluded that neither higher leverage nor lower equity capital ratio are connected with higher profit efficiency for all range of data. Also, Phillips and Sipahioglu (2004) in their study of the impact of capital structure on firm's performance using the UK lodging firms as sample concluded that there is no significant link between capital structure and firm's performance.

Theoretical Framework

The theory of corporate capital structure has been a study of interest to finance economists since the publication of the Modigliani and Miller's (1958) work on the irrelevance of capital structure. Over the years, different theories of capital structure have been propounded which diverge from the assumption of perfect capital markets under which the "irrelevance model" is working. However, the commonest among these theories include; agency cost theory, static trade-off theory, and pecking order theory.

Static Trade-off Theory

Static trade-off theory asserts that there is a trade-off between the benefits of taking on more debt and the costs of higher indebtedness. The benefits of taking on debt (rather than equity) are mainly in the tax relief while the marginal costs of extra debt relate to the greater risks from financial distress. The theory therefore postulate that companies should have an optimal level of gearing and that the optimal gearing level for a company is reached at a point where the marginal benefits of taking on additional debt capital equals the marginal costs of taking on the extra debt.

Pecking Order Theory

This theory attempts to criticise the static trade-off theory. The pecking order theory says the most preferred source of finance for firms is retained earnings follow by debt capital and lastly equity capital (Myers, 1984). The rationale behind this order is that, using retained earnings to finance investment is convenient and cheaper than any other sources of finance. However if retained earnings is unavailable or inadequate, debt capital will be used because of its relative tax advantage. The less preferred source of finance in this theory is equity capital due to the high cost of raising such capital.

Agency Cost Theory

Agency Cost theory which was propounded by Jensen and Meckling (1976) discussed the conflict of interest between principals (shareholders) and decision makers (agents) of firms (managers, board members, etc.), this conflict stems from the differences in behavior or decisions by point out that the parties (agents and shareholders) often have different goals, and different tolerances toward risk. In this case, the managers whom are responsible of guiding the firm toward to achieve them personal goals rather than maximizing benefits to the shareholders. Hence, the main conflict that shareholders face is to ensure that managers (agents) do not invest the free cash flow in unprofitable projects. In another hand, increasing the debt to equity ratio would assist firms to make sure that managers are running the firm more efficiently. The agency cost theory only buttress the submission of the static trade-off theory by submitting that optimal capital structure for a company is obtained by trading off not just the marginal benefits and costs of extra debt but also the agency costs of additional debt and/or that of additional equity.

METHODOLOGY

The population of this study encompasses some of the quoted non-financial firms on the Nigerian Stock Exchange (NSE) market. A sample of 10 quoted companies was randomly selected for this study. The companies are spread across conglomerates, consumer goods, oil & gas, manufacturing and trading industries. Data were extracted from audited annual reports and accounts of these companies, which spanned between 2016 and 2020. Evaluation captured the global pandemic period in which data was available. The collected data was sorted, edited and verified for accuracy while preparing it for analysis. STATA version 13 was used in analysing the data. This was through the use of descriptive statistics to show the measures of tendencies that include means, tables, standard deviations and percentages. Correlation and regression analyses were also carried out to find out the relationship between debt capital and financial performance. In order to capture the impact of capital structure on firm performance, we specify a model conforming to the agency theory. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. For the most part, the higher a company's return on equity compared to its industry, the better. The formulated hypothesis is as follows:

H₀: Capital Structure has no significant effect on Financial Performance of Non-financial companies in Nigeria.

The variables that will be used in the analysis are as follows:

Dependent variables:

- Return on Equity (ROE) = $(\text{Profit After Tax} \div \text{Shareholders Fund}) \times 100$
- Return on Assets (ROA) = $(\text{Profit Before Tax} \div \text{Total Assets}) \times 100$

Independent variable:

- Debt to Equity Ratio (DER) = Ratio of Total Debt to Shareholders Fund

The hypothesis is divided into two models represented by the dependent variables as stated above.

RESULT AND DISCUSSION

Table 1 Descriptive Statistics

Effect of Capital Structure on Financial Performance of Quoted Non-Financial Companies in Nigeria

Variable	Obs	Mean	Std. Dev.	Min	Max
Return on Equity (ROE)	50	0.156	0.1463	-0.13	0.62
Return on Asset (ROA)	50	0.095	0.1177	-0.15	0.57
Debt to Equity ratio(DER)	50	2.75	8.8214	-3.58	59.24

Source: STATA 13 Output Results based on study data

Table 1 presented the descriptive statistics for the dependent and independent variables (Return on Equity (ROE), Return on Assets (ROA), and Debt to Equity Ratio (DER). The standard deviation of the variables ranges from 0.1177 to 8.8214. Returns on Asset have the lowest standard deviation of 0.1177 followed by Return on Equity with a standard deviation of 0.1463 debts to equity ratio has the highest standard deviation of 8.8214. The relatively low standard deviation for all the study variables may be an indication that the sampled data for the study is normally distributed. The Table also indicated an average value of 0.156 for return on equity. The minimum and maximum values of return on equity during the study period are -0.13 and 0.62 respectively. These values implied that all the sampled companies actually have values for return on equity during the study period. The Table further revealed an average value of 0.095 for return on asset. The minimum and maximum values of return on asset during the study period were -0.15 and 0.57 respectively. Similarly, the Table showed that debt equity ratio had a mean value of 2.75, with minimum and maximum value of 59.24 and -3.58.

Table 2 Correlation Matrix of Dependent and Independent Variables

Variable	ROE	ROA	DER
Return on Equity (ROE)	1.0000		
Return on Asset (ROA)	0.6238	1.0000	
Debt to Equity (DER)	0.3886	0.5101	1.0000

Source: STATA 13 Output Results based on study data

From Table 2, it is observed that the independent variables of the study correlate well with the independent variables. There is no relationship among the variables that is large enough (greater than 0.7) to pose the problem of singularity of data. The extent of relationship among all the variables is therefore minimal and negligible. The Table revealed a positive correlation coefficient of (0.3886) between return on equity and debt equity ratio of the companies during the period under study. The positive correlation coefficient is an indication that debt equity ratio is associated with increase in return on equity of the sampled companies during the study period. Similarly, debt to equity ratio is positively associated with return on asset of the sampled companies (0.5101). The positive relationship showed that debt to equity ratio is associated with increase in return on asset of the companies.

Table 3 Breusch- Pagan/ Cook- Weisberg test for heteroskedasticity

Variable	Chi ²	Prob.> chi ²
Return on equity (ROE)	3.35	0.0674
Return on asset (ROA)	0.05	0.8185

Source: STATA 13 output Results based on study data

Heteroskedasticity Test–A pooled– OLS regression result was generated based on the dataset. After the OLS regression result, this test was conducted using Breusch–Pagan/Cook- Weisberg test of heteroskedasticity to check if the variability of error terms is constant. The presence of heteroskedasticity indicates that the variation of the residuals or error terms may not be constant and could affect inferences made from beta coefficients, coefficient of determination (R^2) and F-statistics of the study model. The result of the test showed that there is no presence of heteroskedasticity as the chi-square value of 3.35 and 0.05 with corresponding probability value of 0.0674 and 0.8185 for return on

Effect of Capital Structure on Financial Performance of Quoted Non-Financial Companies in Nigeria

equity and return on asset respectively are greater than 0.05. This was corrected by running a panel corrected standard error regression.

Table 4 Fixed effect, Random effect regression, Hausman test and Lanrangian multiplier test.

Model one	Chibar ²	Prob.> chi ²
Fixed effect	5.82	0.0206
Random effect	7.43	0.0064
Hausman test	0.52	0.4716
Breusch and Pagan Lanrangian multiplier	19.23	0.0000

Source: STATA 13 output Results based on study data

The result of the Hausman test showed a chi-square value of 0.52 and probability value of 0.4716 indicating that random effect regression model is most appropriate for the sampled data. However The Breusch and Pagan Lanrangian multiplier test for random effect was conducted to determine between the pooled OLS and random effect regression which is most appropriate. The results in table 4 above showed a Chibars² of 19.23 with a corresponding prob>chibar of 0.0000 therefore the study rejected the null hypothesis and accept the alternative hypothesis and conclude that random effect is the most appropriate model. Therefore the random effect regression results was used to analyse and interpret model one:

Model One

H0₁: Debt equity ratio has no significant effect on Return on Equity of quoted non-financial companies in Nigeria.

Table 5 Random Effect Regression Results

ROE	Coef.	Std. Err.	t-value	P-value
-Cons	0.1420	0.3463	4.10	0.000
Debt to Equity (DER)	0.0051	0.0019	2.73	0.006
R2				0.1510
Prob> chi2				0.0064

Source: STATA 13 Output Results based on study data

The F-statistics value of 0.0000 and a corresponding Prob.>F of 0.0001 indicated that the model is fit to explain the relationship expressed in the study and further suggests that the explanatory variable are properly selected, combined and used. The nature and extent of relationship between the dependent variable and each of the independent variables of the study in terms of coefficients, z-values and p-values are explained further:

The regression result for the sampled companies as presented in table 5 above showed that there is a positive relationship between return on equity (ROE) and Debt equity ratio (DER) as explained by a coefficient value of 0.0051 and a t- value of 2.73 with a corresponding P value of 0.006. This revealed that a one unit rise in debt equity ratio lead to 0.0051 unit increase in return on equity. The p-value of 0.006 is less than 0.05; therefore the study rejects the null hypothesis and accepts the alternative hypothesis that capital structure (proxy by debt equity ratio) has significant effect on financial performance (proxy by return on equity)

Model Two

H0₂: Debt equity ratio has no significant effect on Return on Asset of quoted non-financial companies in Nigeria.

Table 6 Fixed effect, Random effect regression, Hausman test and Lanrangian multiplier test.

Effect of Capital Structure on Financial Performance of Quoted Non-Financial Companies in Nigeria

Model Two	Chibar ²	Prob.> chi ²
Fixed effect	82.27	0.0000
Random effect	80.22	0.0000
Hausman test	2.12	0.1456
Breusch and Pagan Lanrangian multiplier	50.20	0.0000

Source: STATA 13 output Results based on study data

The result of the Hausman test showed a chi square value of 2.12 with a probability value of 0.1456 indicating that random effect regression model is most appropriate for the sampled data. However The Breusch and Pagan Lanrangian multiplier test for random effect was conducted to determine between the pooled OLS and random effect regression which is most appropriate. The results in table 6 above showed a chi bars² of 50.20 with a corresponding prob>chibar of 0.0000 therefore the study rejected the null hypothesis and accept the alternative hypothesis and conclude that random effect is the most appropriate model.

Table 7 Random Effect Regression Results

ROA	Coef.	Std. Err.	t-value	P-value
-Cons	0.0705	0.0009	8.96	0.000
Debt to Equity (DER)	0.0089	0.0300	2.35	0.019
R2				0.1510
Prob> chi2				0.0064

Source: STATA 13 Output Results based on study data

The results in table 7 revealed that there is a positive relationship between debt equity ratio (DER) and return on asset of the companies during the study period. This is explained by a coefficient value of 0.0089 and t-value of 2.35 with a corresponding P-Value of 0.019. This showed that a unit increase in debt equity ratio (DER), lead to 0.0089 unit increase in return on asset. The p-value of 0.019 is less than 0.05; therefore the study rejects the null hypothesis and accepts the alternative hypothesis that capital structure (proxy by debt equity ratio) has significant effect on financial performance (proxy by return on asset)

CONCLUSION AND RECOMMENDATIONS

This paper examines the effect of capital structure on financial performance using a sample of ten (10) quoted non-financial firms in Nigeria between 2016 and 2020. The study seeks to evaluate the validity of agency theory in the Nigeria context. The study therefore concluded that the Agency theory which postulates that financial leverage mitigates against the agency problem is applicable among non-financial companies quoted in Nigerian Stock Exchange. The study established that as a company increases financial leverage the performance as measured by ROE and ROA increases in agreement with the expectations based on the agency theory. The regression result for the sampled companies showed that there is a positive relationship between return on equity (ROE) and Debt equity ratio (DER) as explained by a coefficient value of 0.0051 and a t-value of 2.73 with a corresponding P value of 0.006. This revealed that a one unit rise in debt equity ratio lead to 0.0051 unit increase in return on equity.

Similarly, a coefficient value of 0.0089 and t-value of 2.35 with a corresponding P-Value of 0.019 showed that a unit increase in debt equity ratio (DER), lead to 0.0089 unit increase in return on asset, which revealed that there is a positive relationship between debt equity ratio (DER) and return on asset (ROA) of the sampled companies during the study period. The p-value of 0.006 and 0.019 for ROE and ROA respectively is less than 0.05, therefore the study rejects the null hypothesis and accept the alternative hypothesis that capital structure has significant effect on financial performance. These findings lend credence to the agency theory, but contrast the conclusion of Varun (2014) who studied the Indian firms

and concludes that leverage has negative impact on firms' performance, however, it is consistent with Mubeen and Kalsoom (2014) which indicated capital structure to positively impact both firm performance and shareholders wealth using Pakistan data. Considering that the research found a positive correlation between capital structure and financial performance, the research study recommends that financial managers and administrators should increase financial leverage (debt) they employ in their capital structure to increase the value of the firms.

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Effect of Capital Structure on Financial Performance of Quoted Non-Financial Companies in Nigeria

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