

Equity Financing and Financial performance of Listed Deposit Money Banks in Nigeria

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Abstract: The study examined the effect of equity financing on the financial performance of listed deposit money banks in Nigeria. Return on Assets was used as a measure of financial performance while share capital, retained earnings, and other reserves were used as independent variables. Data for the study was obtained from the audited annual reports of the 14 sampled deposit money banks for a period of 10 years covering 2009 to 2018. The study employed robust ordinary least square regression as a tool for analysis and testing of hypotheses based on the Hausman specification test. The result reveals that share capital has a positive and insignificant effect on return on assets while retained earnings and other reserves have a positive and significant effect on return on assets. The study concludes that retained earnings and other reserves improve the financial performance of listed deposit money banks in Nigeria, in line with pecking other theories. The study recommends, among others, that the board of directors should critically and closely monitor the financial structure decisions of the banks by closely ensuring that retained earnings and other reserves are ploughed back on profitable investments.

Keywords: Equity finance, Share Capital, Retained Earnings, Other Reserves, Financial Performance.

I. INTRODUCTION

The firm's financial structure consists of debt and equity capital, and the combination of both, which maximises shareholder wealth, is extremely important to management, the board of directors, investors, and so on. Equity finance is available finance for business operation and expansion; thus, it is regarded as the first choice of fund generation due to the flexibility involved, as it does not attract fixed interest payments that are applicable in financial leverage (Daniel Denis & Naveen, 2010). Pandey (1999) asserted that shareholders' claims on the firm increase when the firms increase their usage of equity finance (ordinary share capital or retained earnings). A typically firm equity finance choice consists of share-capital, share premium, retained earnings, and other reserves (Chadha & Sharma, 2015; Kongmanila & Kimbara, 2007). Equity finance in the form of share capital entitles the holders to ownership claims in the firms with other benefits such as dividends and share appreciation. Ayub (as cited in Achieng, Muturi & Wanjare, 2018) expressed that shareholder will strive to align their interests with those of the management in order to aid management in maximising the crucial value of the firm in the course of investment. Thus, equity finance is viewed as a better solution to business finance for firms, which will aid growth and improve financial performance (Achieng *et al.*, 2018). In general, firms finance

only a part of their assets with equity capital, which comprises ordinary shares, preference shares, and retained earnings, while the other part of their assets is financed by alternative capital resources such as bank loans, bonds, and other loans, which are referred to as long-term financial debt, and other short-term liabilities such as trade payables. This describes the behaviour of the financial structure (Moyer, McGiugan & Kretlow, 1997).

A sound financial sector is vital to the development of any nation. Deposit money banks play a pivotal role as they provide support to the government and the citizens. When deposit money banks are in poor health, it can have a negative impact on financial stability and business optimism. As deposit money banks are crucial to nations, especially Nigeria, there is a need to focus on the financial structure mix. This study has great significance due to the fact that limited studies of this nature have been carried out in Nigeria.

Furthermore, there is a dearth of studies that separate the total equity into different elements and evaluate their influence on the financial performance, especially in the Nigeria banking sector (Emenuga, 2019). The need for the study stems from the suggestion of capital structure theories. For instance, the pecking order theory suggests that retained earnings are the first choice of finance and share capital is the least. In essence, separating the components into internal and external sources of equity may help to identify the portion of equity that exerts more influence on financial performance. Also, findings from prior studies on share capital are inconclusive. While some studies found a positive influence of share capital on performance (Adera, Anyango & Rotich, 2015; Adesina, Nwidobie & Adesina, 2015), others found that share capital exerted a negative effect on financial performance (Achieng, *et al.*, 2018).

Owing to these identified gaps, the object of this study intends to examine the effect of equity finance on the financial performance of listed deposit money banks in Nigeria. A pertinent question guiding this research is: to what extent does equity mix affect the financial performance of listed deposit money banks in Nigeria?

II. LITERATURE REVIEW

This section discussed the conceptual, empirical, and theoretical review of the studies.

Financial performance

Financial performance is the extent to which a company's financial objectives will or have been met. Financial performance refers to the act of performing financial activity. In a wider sense, it is the degree to which the financial objectives of an organisation can be or have been accomplished. It is actually a way of ascertaining the outcome of the policies and operations of a corporate entity in monetary terms. It is used to measure a company's overall financial health over a slated period of time and can also be used to associate similar companies within the same industry or to compare industries or sectors in aggregation. Financial performance is a desirable goal for all profit-oriented companies. The absence of it can definitely spell failure. Classic measures of financial performance are profitability, leverage, liquidity, and growth (Yahaya and Lamidi, 2015).

Kajirwa (2015) deduced that the company's financial performance is subject to how successfully a company uses its assets from its main role of doing business and its subsequent generation of income. It also means the general well-being of a company as far as finance is concerned over a certain period of time. It can also be used to gauge or measure firms from one industry or across different industries for comparison purposes. It is, in summary, a crucial objective that firms, especially profit-oriented firms, desire or aim to achieve.

This term is also used as a general measure of a firm's overall financial fitness over a given time frame and can be used to match similar firms across the same industry or to compare industries or sectors in aggregation (Asutay, 2010). There are many different ways to assess financial performance, but all measures should be taken in aggregate. Line items such as advances and loans, deposits, total interest expense, total interest income, other costs, and other indicators are used in measuring the performance of a commercial bank. Moreover, an investor or analyst may like to look deeper into the annual financial statements of a company and seek to find out the margin growth rates or decline debt if any. According to Swain and Patnaik (2013), the term "financial performance" means explaining how efficiently and effectively a company utilises its limited economic resources to produce resources that yield maximum revenue. It reveals the extent to which the firm has realised its set vision, mission, as well as the core values. A firm's financial performance reveals the sustainability of the company; it is a symbol of whether the firm is a going concern or not; it is the main factor that guides the investors' decision of whether to invest in a company or not (Ayano, 2016). For the purpose of this study, I adopt Yahaya and Lamidi's definition of financial performance.

Equity

Equity capital is that part of capital which is debt-free and represents a shareholding in a company (Moyer *et al.*, 1999). It is therefore the amount contributed by the owners of the business and usually includes reserves, retained earnings, ordinary share capital, and preferential capital. As debt providers to the company, equity providers also earn returns on

investment in the form of dividends from the profits made by the company. Preference shareholders usually receive their dividends at a predetermined agreed rate before the ordinary shareholders of the company, and any un-appropriated profit is retained for the company's expansion programmes (Titman, *et al.* 2011). Unless the ratio of the dividend pay-out is high, when a company reports high net profits, it is expected to have high retained earnings. Suffice to say that good financial performance leads to a high retention of profits.

Pecking Order Theory Review

The Pecking Order Theory, originated by Myers and Majluf (1984), is the most pertinent theory explaining the company's optimal capital structure. (Myers, 1984). The Pecking Order Theory is based on the proclamation that managers have sufficient information about their companies compared to investors. It deals with the role of asymmetric knowledge and information in determining the level of equity and debt a company will issue. Companies should finance investments in the first place with internal resources, then the second option with safe debt, followed by risky debt, and finally with equity to reduce the adverse signals that may be emitted. The Pecking Order Theory implies that firms don't have a target debt-equity ratio as they choose their leverage ratio based on their financing needs. This theory also implies that companies do not have target cash balances but that cash is used as a buffer between investment needs and retained earnings (Ferreira & Vilela, 2004). This can also mean that whenever a company increases its internal financing, its leverage automatically falls. As long as a firm continues to maintain a surplus of internal funds to reduce the adverse selection costs, it will accumulate excess cash which will be used to pay off its debt as and when due. A company that does not have a constrained investment policy simply uses cash flow to increase cash (Opler, Pinkowitz, Stulz & Williamson, 1999). Working capital is a readily available internal source of financing that can act as an alternate source of financing to external capital, especially for fixed-investment smoothing to maintain a stable fixed investment path. External finance can be very costly as a result of floatation costs and the problem of asymmetric information, especially for financially constrained organisations (Fazzari & Petersen, 1993). The Pecking Order Theory of Myers and Majluf (1984), was adopted for this study. The effect of financial structure on the financial performance of listed deposit money banks in Nigeria was also adopted. This study was underpinned by pecking order theory to explain the variable of the study.

Empirical Reviews

Ekwe and Inyiama (2014) studied the correlation between retained earnings and some key financial performance indicators in the listed Nigerian manufacturing industry. The sample used a sample of two firms from the years 2000 to 2013 and found that retained earnings played a very significant role in the improving firm's financial performance and can be used by managers to boost return on investments of shareholders without weakening the firm's control of the shareholders.

Inasmuch as the study was carried out in Nigeria, focusing on two firms alone in a sector that has over 70 firms may not be used to make a good inference. Also, the study case is from the manufacturing sector, which is distinct from the domain of the study.

Adera *et al.* (2015) assessed the effects of capital structure on corporate financial performance for manufacturing companies listed on the Nairobi Securities Exchange. The study used a sample of nine listed manufacturing companies. It was found that long-term debts, ordinary share capital, preference share capital, and reserves have a positive and significant relationship with corporate financial performance. The study concludes that long-term debts, ordinary share capital, preference share capital, and revenue and capital reserves are positively related to the corporate financial performance of manufacturing firms.

Adesina *et al.* (2015) examined the impact of the capital structure on the financial performance of banks listed on the Nigerian Stock Exchange. The study used a sample of ten (10) Nigerian banks listed on the Nigerian Stock Exchange (NSE) for the period of eight (8) years from 2005 to 2012. The ordinary least square regression analysis was employed and the result revealed that debt and equity have a significant positive influence on the financial performance of listed banks in Nigeria. The study concluded that debt and equity capital finance improve the earnings of banks.

Nguyen and Rugman (2015) evaluated the importance of internal financing in subsidiary performance using six emerging economies in Southeast Asia. They found out that internal financing yielded an increase in the subsidiary's performance. Although the study was survey in nature, employing questionnaires.

Joseph (2016) examined the effects of short-term debt, long-term debt, retained earnings, and other shareholder funds on financial performance. The study was carried out using 61 firms listed on Kenya's securities exchanges from the period of nine years from 2006 to 2014. Using the Feasible Generalized Least Squares method, the study confirmed on a standalone basis that long term debt, short term debt, retained earnings, and external equity had insignificant negative effects on return on assets (ROA). The study concludes that the financial structure of the firms does not influence their financial performance. Although the study captures the financial variables as used in this study, yet the domain is Kenya, which is different from the Nigerian environment, and it further lags four years behind.

Bassey, Godwin, and Aganyi (2016) conducted a study to assess the importance of retained profits as an alternative source of financing the activities of a corporation on the corporate performance of Niger Mills Company Limited, Calabar, Nigeria. The study used Karl Pearson product moment in the analysis of data and revealed that the future earnings ability of Niger Mills Limited Calabar is influenced by its retained profit. The study confirmed that accumulated profit retained by the firms has the ability to boost future earnings. They concluded that a corporate organisation should always

retain profits in their business rather than distribute all of them to shareholders. The study is a case study in nature as it focused on one firm alone.

In Kenya, Njabi, Maina, and Kariuki (2017) assessed the influence of equity financing on financial performance using small and medium-scale businesses. Equity financing was examined from the perspectives of ploughback profit, retained earnings, and angel investors. They concluded that equity finance causes an increase in financial performance. However, the study used primary data sources to evaluate this relationship.

Achieng *et al.* (2018) in their paper evaluated the role of equity financing options on the financial performance of firms in Kenya. They focused on non-financial firms, using a sample of 40 firms from the period 2000 to 2015. They confirmed that common stock has a negative influence on financial performance, while retained earnings improve the financial performance of the firms. Omai, Memba, and Njeru (2018) sought to evaluate the effect that share capital finance had on the profitability of petroleum marketing companies in Kenya. The study used thirty-five (35) listed firms between 2007 and 2016, with primary data obtained through the administration of questionnaires along with secondary data. By employing descriptive statistics, t-test and Pearson correlation, the study revealed that share capital has a negative but insignificant effect on profitability at a 5% level. The study found that a firm's use of share capital finance does not affect its profitability. Retained earnings and profitability are able to be captured using secondary data, whereas using a primary source may introduce biasness due to subjectivity involved in respondents' opinion.

Emenuga (2019) examined the role of equity finance on the performance of Nigerian banks, using the first banks as a case study from 2008 to 2016. The study confirmed that total equity funds positively influence the performance of the banks using return on equity as a proxy for performance. However, the study examined only first banks plc.

III. METHODOLOGY

The population of this study is comprised of the fifteen listed deposit money banks in Nigeria as at 31st December 2018. The study covers the period of ten (10) years from 2009 to 2018. The population was adjusted using a single filter criterion. Firms that were not listed as at December 31st 2009 till December 2018 would be excluded from the study. The study excluded Jaiz Bank Plc for the study. Thus, the adjusted population is 14 deposit money banks listed as at December 31st, 2018. The techniques adopted in the data analysis include the use of descriptive statistics and regression analysis. Other tests were carried out to validate the classical linear regression model (CLMR) assumptions. The data collected has been summarised using descriptive statistics and was analysed using Karl Pearson correlation and multiple regression analysis using statistical software for social sciences.

Model Specification

The study adapted the model of Joseph, 2016 with some modification, hence the empirical regression model is specified as follows:

$$ROA_{i,t} = \beta_0 + \beta_1 SC_{i,t} + \beta_2 REORS_{i,t} + \beta_3 FSIZE_{i,t} + \beta_4 FAGE_{i,t} + \epsilon_t$$

Whereas:

- ROA = return on assets
- β_0 = the intercept
- β_1, β_4 = the parameters to be estimated in the equation
- REOR = retained earnings and other reserves
- SC = share capital
- FSIZE = firm size
- FAGE = Firm age
- t = Time subscript (in this case 10 years)
- e = Stochastic error term

The variables are measured as:

$$ROA = \frac{\text{Profit before Tax}}{\text{Total Assets}} \times \frac{100}{1}$$

Retained Earnings and Other Reserves

$$= \frac{\text{The Retained Earnings and Other Reserves}}{\text{Total Assets}}$$

$$\text{Share capital} = \frac{\text{Preference, Ordinary Capital}}{\text{Total Assets}}$$

Firm size = log of total asset,

Firm age = date of incorporation

IV. RESULT AND DISCUSSIONS

Table 1. Descriptive Statistic

Variable	No of obs	Mean	Std deviation	Min	Max
ROA	140	.019	0.3	-.091	.11
SC	140	.013	.011	.003	.055
REORS	140	.106	.188	-1.58	.279
FSIZE	140	1.49e+12	1.17e+12	1.57e+11	5.57e+12
FAGE	140	41.64	32.17	3	124

Source: Descriptive Statistics Result using STATA 13: Researcher (2019).

Table 4.1 shows the detailed account of the descriptive statistics for the explained and explanatory variables. The return on assets, which is the dependent variable of the study, has a minimum value of -9.1% and a maximum value of 10.52%. The average value of the ROA is 1.9% with a standard deviation of 2.58%, signifying that there is a wide dispersion across the sample firms' return on assets from the mean.

Also, table 1 shows that share capital (SC) has a mean value of .013 and a standard deviation of .011. The standard deviation shows there is low variation of the individual firms' share capital from the mean, signifying that the sample banks

have a similar pattern of share capital. The least value of SC is .0030 and the highest value is .055.

In addition, the result also shows that retained earnings and other reserves (REORS) have a minimum loss of -1.58 and a maximum value of .279, respectively. The average value of retained earnings is .106 with a standard deviation of .188. The standard deviation shows that it is not a common practice as there is a wide dispersion of the variable from the mean.

Furthermore, the control variable firm size reveals a mean value of 1.49 trillion and a standard deviation of 1.17 trillion, revealing that the banks are similar in size. The final variable firm age reveals an average value of 42 years of incorporation with a standard deviation of 32 years.

4.1 Diagnostic Test

For better validity of all statistical inferences to be drawn from the study, this part presents the result of the diagnostic test conducted. The diagnostic tests included a test for normality of the residual, a multicollinearity test, and a heteroscedasticity test.

Table 2. Diagnostic Check

Variables	VIF	Tolerance value
SC	2.28	0.43
REORS	1.12	0.89
FSIZE	2.42	0.41
FAGE	1.08	0.92
Other Tests	Chi square	P-value
Normality of residual	27.97	0.0000
Heteroscedasticity	3.76	0.052
Auto serial correlation	9.25	0.010

The classical assumption of the OLS regression model assumes the explanatory variables are not perfectly correlated (absence of multicollinearity). According to Gujarati (2004), tolerance less than 0.1 and the VIF value of 10 and above imply the presence of multicollinearity in the estimates. However, the results from Table 2 above proved that there is no excessive correlation among the independent variables because the smallest tolerance value (TV) is 0.41, while the highest variance inflation factor (VIF) is 2.42.

One of the assumptions of classical ordinary least square regression is the assumption of normality of data and residuals. The normality of individual data was tested using Jacque Bera tests at a 5% level of significance. The results in table 2 above show that the chi square is significant with a p-value of 0.000, which suggests that the residual is not normally distributed.

Based on the assumption of OLS assumption, a heteroscedasticity test was carried out to check the homoscedasticity assumption of a regression model. To test for

the existence of heteroskedasticity, this study uses the Breusch-Pagan or Cook-Weisberg to test for normality of the data. The result reveals that χ^2 is 3.76 and the $\text{prob} > \chi^2$ is 0.052, which is insignificant at the 5% level of significance. This indicates the residual is homoskedastic and there is no presence of the effects of heteroskedasticity. Also, there is constant variance in the residuals.

Also, no serial/auto correlation test was conducted in line with OLS assumption. The study used the Wooldridge test for autocorrelation in panel data. The null hypothesis is that there is no first order autocorrelation at a 5% level of significance. The test reveals a chi square of 9.25 and a p-value of 0.010, which is significant at a 5% level of significance. Hence, the study concluded that there was the presence of autocorrelation in the study.

Table 3. Panel Analysis Test

Tests	Chi square	P-value
Hausman specification test	2.73	0.151
Langragian multiplier test	1.20	0.136

Due to the panel nature of the data, panel analysis was conducted in which a hausman specification test was carried out to make a decision in relation to choosing a fixed model or a random effect model. The result shows that at the 5% level of significance, the χ^2 is 2.73 and the $\text{prob} > \chi^2$ is 0.151, which is insignificant. This insignificant p-value shows that the Hausman test favours the random effect model.

Furthermore, the study carried out a Breusch and Pagan Lagrangian multiplier test for random effects to check if there is a panel effect, that is, to choose between the random effect result and pooled OLS regression. The result revealed a chi square of 1.20 and a $\text{Prob} > \text{chibar}^2$ of 0.136, which is insignificant and indicates that there is no panel effect. Hence, the study interpreted the OLS.

4.2 The Regression Result

This table presents the regression results of the dependent variable (ROA) and the independent variables of the study (SC and REORS).

Table 4. Robust OLS Regression Analysis

Variables	Coefficient	Std error	T-value	P-value
SC	.422	.231	1.83	0.070
REORS	.052	.015	3.44	0.001**
FSIZE	.023	.010	2.29	0.024
FAGE	-.0002	.00005	-4.77	0.000**
Constant	-.260	.125	-2.08	0.039*
R2	0.271			
F-statistic	11.76			0.0000***

*, **significant at 5%, 1%.

Source: R.OLS regression result using STATA 13

Interpretation

Table 4 presents random effect regression results selected for the research work based on the Hausman test. The regression result reveals that the independent variables, equity financing proxies by share capital, retained earnings with other reserves, and the control variables are able to explain up to 27.1% of the changes in the financial performance of the sampled listed deposit money banks. The F-statistics chi square is 11.76 with a p-value of 0.0000, which reveals that the model is fitted at a 1% significant level and that the variables jointly have an effect on the financial performance of listed deposit money banks in Nigeria.

Share capital and financial performance

Also, the table 4 shows that share capital (SC) has a positive coefficient of .422 and a p-value of 0.076, which is not significant at the 5% level of significance. It shows that share capital, a component of an equity fund, does not influence the return on assets of the listed deposit money banks in Nigeria. This means that any increase in share capital will not have any impact on the financial performance of the listed deposit money banks in Nigeria. This finding is a pointer that share capital from preference shares and ordinary shares does not improve the financial performance of listed deposit money banks in Nigeria. This finding could result from the static nature of the sampled banks' share capital and the reluctance of them to issue shares due to the cost involved. The finding is in line with the pecking order theory that suggests that external equity financing is the last option in sourcing for funds for financing activities. It is also a revelation that the pecking order theory is prevailing in Nigeria's banking sector. Furthermore, the findings corroborate with prior studies by Joseph (2016) and Omai *et al.* (2018) who found that increases in share capital and other reserves have a negative and insignificant influence on financial performance. It is also inconsistent with the findings of Adera *et al.* (2015), who discovered that increasing share capital and reserves improves firm financial performance.

Retained earnings and other Reserves and Financial Performance

The results in table 4 show that retained earnings and other reserves were found to have a significant positive effect on the return on assets. The table reveals that retained earnings and other reserves have a coefficient of 0.052 and a p-value of 0.001, which is significant at a 1% level of significance. It implies that any percentage increase in retained earnings and other reserves will increase the return on assets by 5.2%, vice versa. This suggests that using retained earnings and other reserves as a source of internal funds enhances the financial performance of the listed deposit money banks in Nigeria. This finding shows the importance of retained earnings for the banks. This finding is in line with the pecking order theory that retained earnings are the first rank source of finance due to no cost involved, and it is further in line with the study of Ekwe and Inyama (2014), Adera *et al.* (2015), Bassey *et al.* (2016), and contrary to Joseph (2016) and Omai *et al.* (2018), who

found retained earnings and other reserves to have an insignificant influence on financial performance.

V. CONCLUSIONS AND RECOMMENDATIONS

This study examined the effect of equity financing on the financial performance of listed deposit money banks in Nigeria from 2009 to 2018. The study found that share capital has a positive and insignificant effect on the financial performance of the listed deposit money banks in Nigeria, while retained earnings and other reserves have a positive and significant effect on return on assets. The study concluded that share capital does not influence the financial performance of listed deposit money banks in Nigeria. Further, the study concluded that retained earnings and other reserves positively influence the return on assets of listed deposit money banks in Nigeria. Thus, long-term debt improves the financial performance of listed deposit money banks in Nigeria. The study recommends that the board of directors should critically and closely monitor the financial structure decisions of the banks by closely ensuring that retained earnings and other reserves are ploughed back into profitable investment.

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