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Role Of Capital Structure In Determining Firm Performance - Impact On Firm Performance

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Abstract:

This study examines the role of capital structure in determining firm performance and its impact on financial outcomes. The research focuses on how the mix of debt and equity influences profitability, risk, and overall firm value. Primary data were collected from 250 respondents using a structured questionnaire. The study adopts a descriptive and analytical research design and applies statistical tools such as percentage analysis, mean score analysis, and reliability tests. The findings reveal that factors such as financial risk, profitability, and optimal capital structure significantly influence firm performance. It is also observed that excessive debt increases financial risk, while a balanced capital structure enhances firm value and stability. The study highlights the importance of effective financial decision-making in achieving sustainable growth. Overall, the research provides valuable insights for managers, investors, and policymakers in optimizing capital structure for improved firm performance.

Keywords

Capital Structure, Firm Performance, Financial Risk, Profitability, Debt-Equity Ratio

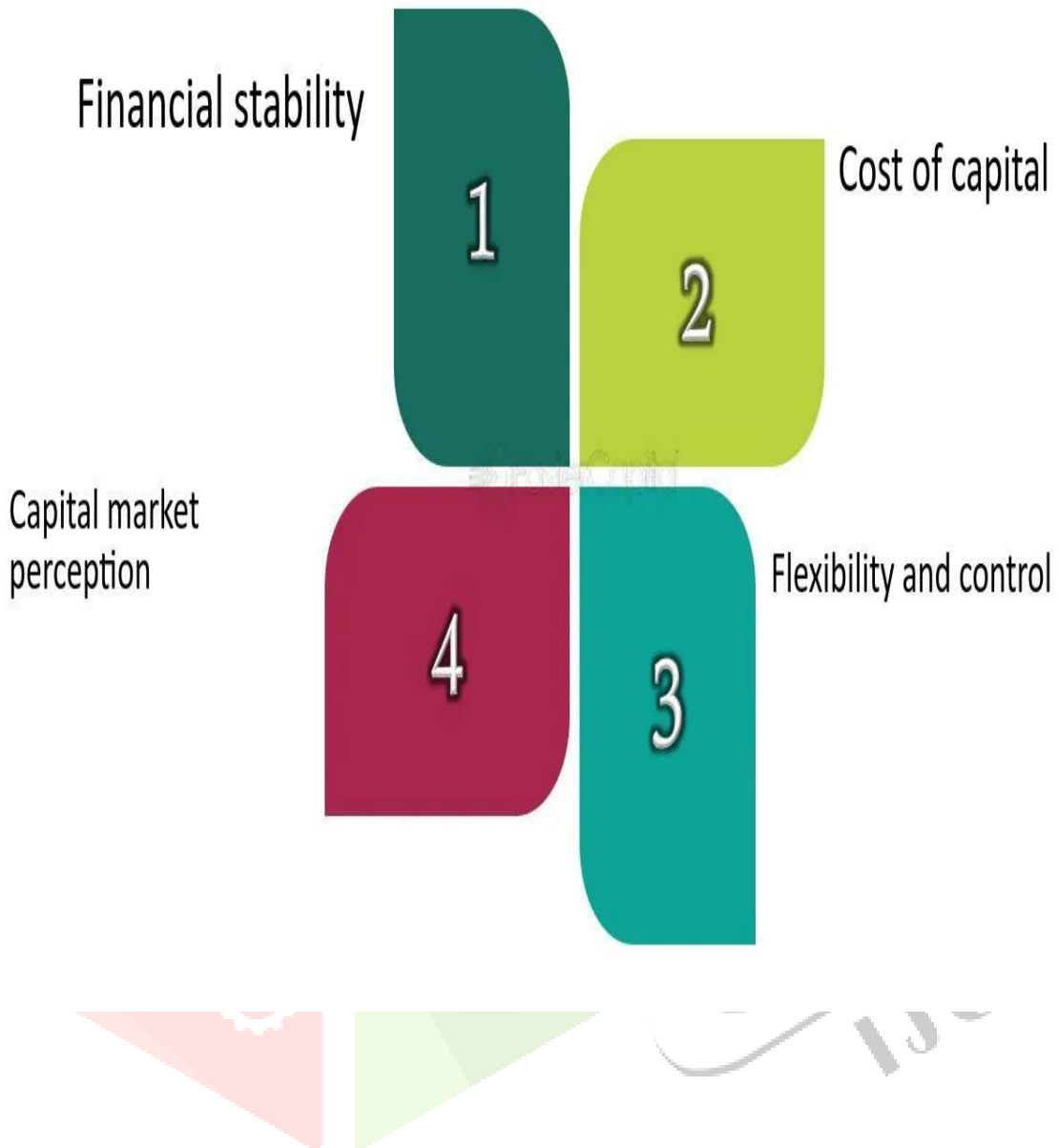
1.1 Introduction

In the modern financial environment, capital structure plays a crucial role in shaping the overall performance and sustainability of firms. Capital structure refers to the proportion of debt and equity used by a company to finance its operations and growth. The decision regarding the optimal mix of these sources of finance is one of the most important strategic choices faced by financial managers, as it directly influences the cost of capital, risk profile, and profitability of the firm. An efficient capital structure enables firms to minimize their cost of financing while maximizing returns to shareholders, thereby enhancing overall firm performance. Firm performance, on the other hand, is a comprehensive measure of how effectively a company utilizes its resources to generate profits and create value. It is commonly evaluated using financial indicators such as Return on Assets (ROA), Return on Equity (ROE), profitability margins, and market value. The relationship between capital structure and firm performance has been a subject of extensive research in financial management, as different combinations of debt and equity can significantly impact a firm's financial stability and operational efficiency.

The use of debt financing offers advantages such as tax benefits and leverage, which can improve returns to shareholders when managed effectively. However, excessive reliance on debt increases financial risk and the burden of interest payments, which may adversely affect firm performance during periods of economic instability. Conversely, equity financing reduces financial risk but may dilute ownership and earnings per share. Therefore, achieving an optimal capital structure is essential for balancing risk and return, ensuring long-term growth, and maintaining financial stability. Furthermore, the impact of firm performance extends beyond profitability, influencing investor confidence, market reputation, and the firm's ability to attract future investments. Strong firm performance reflects efficient management practices and sound financial decisions, including capital structure choices. In contrast, poor performance may indicate inefficiencies and suboptimal financing decisions, leading to reduced competitiveness in the market.

In this context, the present study titled "The Role of Capital Structure in Determining Firm Performance and Its Impact on Firm Performance" aims to examine the relationship between capital structure and firm performance. The study seeks to analyze how different financing decisions influence profitability, growth, and financial stability of firms. By providing empirical insights, the research will contribute to a better understanding of financial decision-making and assist managers, investors, and policymakers in formulating effective strategies for improving firm performance.

Understanding the Importance of Capital Structure Decisions



1.2 Review of Literature:

S.No	Author & Year	Title of the Study	Objective	Methodology	Key Findings	Research Gap
1	Modigliani & Miller (1958)	Capital Structure Theory	To analyze the effect of capital structure on firm value	Theoretical Model	Capital structure is irrelevant in a perfect market	Does not consider real-world factors like taxes and risk
2	Jensen & Meckling (1976)	Theory of the Firm: Agency Costs	To examine agency conflicts between managers and owners	Conceptual Study	Debt helps reduce agency costs and improves performance	Lacks empirical validation across industries
3	Myers (1984)	Capital Structure Puzzle	To explain financing preferences of firms	Analytical Study	Firms prefer internal funds, then debt, then equity	Does not fully explain behavior in all firms
4	Rajan & Zingales (1995)	What Do We Know About Capital Structure?	To identify determinants of capital structure	Empirical Analysis	Profitability, size, and growth influence capital structure	Limited focus on developing countries
5	Abor (2005)	Capital Structure and Firm Performance	To study relationship between debt and profitability	Regression Analysis	Short-term debt positively impacts performance	Focused on specific region; lacks generalization

Source: Compiled by researcher from various articles.

1.3 Objective of the Study:

The Main objective of the study is to analyse the Market Performance in the FMCG Sector in Chennai City

1.4 Research Methodology:

Sampling Design

- **Population:** Manufacturing Companies.
- **Sample Size:** 250 respondents
- **Sampling Technique:** Convenience sampling method

- **Tools used for the Analysis:** Mean Score Analysis and Kolmogrov Test.

1.5 Data Analysis and Interpretation:

Table 1.1 Demographic Profile of the Respondents'

S.No	Variable	Category	No. of Respondents	Percentage (%)
1	Type of Industry	Manufacturing	80	32
		Service	95	38
		Trading	50	20
		Others	25	10
		Total	250	100
2	Nature of Ownership	Private	110	44
		Public	60	24
		Partnership	55	22
		Others	25	10
		Total	250	100
3	Size of the Firm	Small	85	34
		Medium	95	38
		Large	70	28
		Total	250	100
4	Years of Operation	Below 5 years	60	24
		5–10 years	80	32
		10–20 years	65	26
		Above 20 years	45	18
		Total	250	100
5	Position of Respondent	Manager	95	38
		Finance Officer	70	28
		Accountant	55	22
		Others	30	12
		Total	250	100

Source: Primary Data

Type of Industry:

From the above table, it is inferred that among 250 respondents considered for the study; 80 respondents (32.0%) belong to manufacturing, 95 respondents (38.0%) belong to service sector, 50 respondents (20.0%) belong to trading, and 25 respondents (10.0%) belong to others category. Thus, the majority of the respondents belong to the service sector. Therefore, service-based firms play a significant role in the study.

Nature of Ownership:

From the above table, it is inferred that among 250 respondents considered for the study; 110 respondents (44.0%) are from private firms, 60 respondents (24.0%) are from public firms, 55 respondents (22.0%) belong to partnership firms, and 25 respondents (10.0%) belong to others category. Thus, the majority of the respondents are from private firms. Therefore, private sector organizations dominate the sample.

Size of the Firm:

From the above table, it is inferred that among 250 respondents considered for the study; 85 respondents (34.0%) are from small firms, 95 respondents (38.0%) are from medium firms, and 70 respondents (28.0%) are from large firms. Thus, the majority of the respondents are from medium-sized firms. Therefore, medium enterprises play a major role in the analysis.

Years of Operation:

From the above table, it is inferred that among 250 respondents considered for the study; 60 respondents (24.0%) have below 5 years of operation, 80 respondents (32.0%) have 5–10 years, 65 respondents (26.0%) have 10–20 years, and 45 respondents (18.0%) have above 20 years. Thus, the majority of the respondents fall under 5–10 years of operation. Therefore, moderately experienced firms are highly represented in the study.

Position of Respondent:

From the above table, it is inferred that among 250 respondents considered for the study; 95 respondents (38.0%) are managers, 70 respondents (28.0%) are finance officers, 55 respondents (22.0%) are accountants, and 30 respondents (12.0%) belong to others category.

Thus, the majority of the respondents are managers. Therefore, managerial-level employees contribute significantly to the responses.

Table 1.2 Reliability Test (Cronbach's Alpha)

Variable	No. of Items	Cronbach's Alpha
Capital Structure Factors	6	0.842

Source: Primary Data

The above table shows that the Cronbach's Alpha value for the six items measuring capital structure factors is **0.842**, which is greater than the acceptable limit of 0.70. This indicates that the scale used in the study is **highly reliable** and the items have strong internal consistency. Therefore, the data collected is suitable for further statistical analysis.

Table 1.3 KMO and Bartlett's Test (Sampling Adequacy)

Test	Value
KMO Measure of Sampling Adequacy	0.811
Bartlett's Test Chi-square	612.45
Significance (p-value)	0.000

Source: Primary Data

The KMO value of **0.811** indicates that the sample is adequate for factor analysis. The Bartlett's Test is significant ($p < 0.001$), which shows that the variables are correlated and suitable for structure detection.

Table 1.4 Kolmogorov–Smirnov Test (Normality Test)

Variable	Statistic	Sig. Value
Capital Structure Factors	0.089	0.000

The Kolmogorov–Smirnov test shows a significance value of **0.000**, which is less than 0.05. This indicates that the data **does not follow a normal distribution**. Therefore, non-parametric tests may be more appropriate for further analysis.

Table 1.5 Mean Score and Rank Analysis of Factors Influencing Capital Structure

S.No	Statements	Mean Score	Rank
1	Cost of capital influences financing decisions	4.38	2
2	Tax advantages encourage use of debt	4.12	4
3	Risk level affects capital structure decisions	4.45	1
4	Market conditions influence financing choices	4.05	5

5	Firm size determines capital structure	3.88	6
6	Profitability influences financing decisions	4.26	3

Source: Primary Data

From the above table, it is inferred that among the various factors influencing capital structure decisions, risk level has secured the highest mean score of 4.45 and is ranked first, indicating that it is the most important factor considered by firms. Cost of capital (4.38) is ranked second, followed by profitability (4.26), showing that financial considerations play a crucial role in financing decisions. Tax advantages (4.12) and market conditions (4.05) are ranked fourth and fifth respectively, indicating moderate influence. Finally, firm size has the lowest mean score of 3.88 and is ranked sixth, suggesting it has comparatively less impact on capital structure decisions. Overall, the analysis reveals that risk and cost-related factors dominate capital structure decisions, while firm-specific characteristics like size have relatively lower influence.

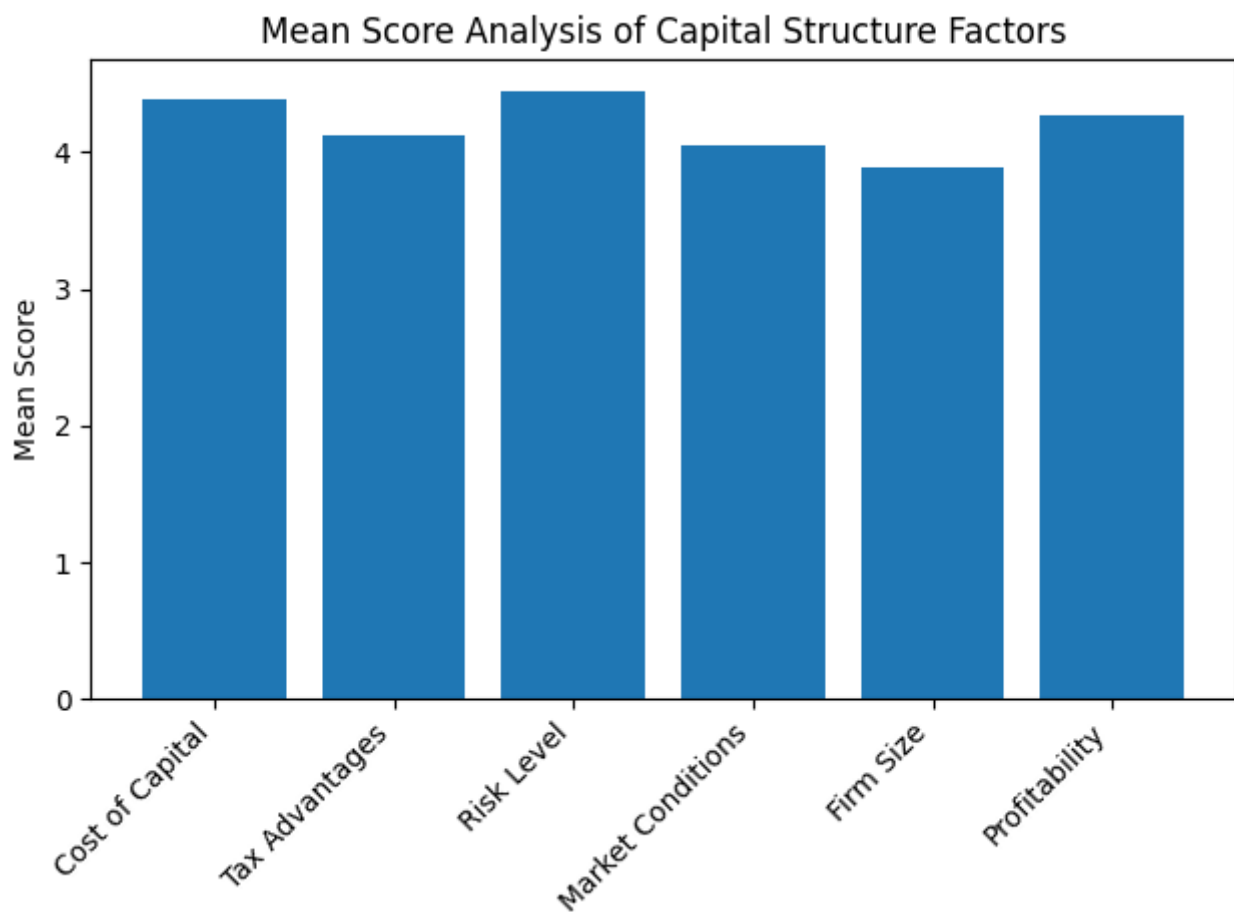


Table 1.6 Mean Score and Rank Analysis – Impact of Capital Structure on Firm Performance

S.No	Statements	Mean Score	Rank
1	Capital structure affects profitability	4.32	2
2	Debt financing improves return on equity	4.18	4
3	High debt increases financial risk	4.45	1
4	Optimal capital structure enhances firm value	4.36	3
5	Capital structure influences business growth	4.10	5

Source: Primary Data

From the above table, it is inferred that among the factors relating to the impact of capital structure on firm performance, high debt increases financial risk has secured the highest mean score of 4.45 and is ranked first, indicating that respondents strongly agree that excessive debt leads to higher financial risk. Capital structure affects profitability (4.32) is ranked second, followed by optimal capital structure enhances firm value (4.36) ranked third, showing that financial structure significantly contributes to firm performance and value creation. Debt financing improves return on equity (4.18) is ranked fourth, indicating moderate agreement among respondents. Finally, capital structure influences business growth has the lowest mean score of 4.10 and is ranked fifth, suggesting comparatively lesser influence.

1.6 Conclusion:

Capital structure plays a critical role in shaping a firm's financial performance, stability, and long-term sustainability. The mix of debt and equity financing influences not only profitability but also risk exposure, cost of capital, and overall market value of the firm. The findings generally indicate that an optimal capital structure enhances firm performance by minimizing the cost of capital and maximizing shareholder wealth. Moderate use of debt can improve profitability through the tax shield advantage and increased return on equity. However, excessive reliance on debt leads to higher financial risk, increased interest obligations, and potential financial distress, which may negatively affect firm performance. The relationship between capital structure and firm performance is therefore not linear but depends on several factors such as industry characteristics, firm size, asset structure, and economic conditions. Firms with stable cash flows may benefit more from higher leverage, whereas firms operating in uncertain environments should adopt a conservative financing approach. Furthermore, effective financial management and strategic decision-making are essential in maintaining an appropriate balance between debt and equity. Companies must continuously evaluate their capital structure to align with changing market dynamics and organizational goals. In conclusion, capital structure significantly impacts firm performance, and achieving an optimal balance between debt and equity is crucial for enhancing profitability, reducing risk, and ensuring long-term growth and competitiveness.

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