

Understanding Risk and Return: Shareholders' Perspectives on Capital Structure

Dr. Sanjay Kumar¹, Niti²

1 Assistant Professor, Faculty of Management & Commerce, Baba Mastnath University, Rohtak, Haryana

2 Research Scholar, Department of Commerce, Baba Mastnath University, Rohtak, Haryana

Abstract

This study, titled "Understanding Risk and Return: Shareholders' Perspectives on Capital Structure," employs a combined descriptive and exploratory research design. The descriptive aspect aims to comprehensively analyze existing capital structure decisions and influencing factors, while the exploratory component seeks to identify novel insights and patterns. Focused on manufacturing businesses in Haryana, the study utilizes a non-probability purposive sample design with 120 companies in Rohtak. Data collection involves face-to-face interviews and secondary sources, enhancing the study's depth and reliability. The objective is to identify and analyze key factors influencing capital structure decisions. Factor analysis reveals four distinct components: Financial Performance and Stability, Leverage Ratios and Credit Ratings, Market Conditions and Investor Sentiment, and Management's Risk Tolerance. The high communalities and rotated factor matrix underscore the robustness of selected variables, contributing to a nuanced understanding. Cross-loading indicates potential interconnectedness between factors, reflecting the complexity of capital structure decisions. Findings offer region-specific insights for practitioners, policymakers, and researchers, aiding businesses in making informed and strategic choices. This study lays a foundation for future research, encouraging exploration of nuanced interactions between financial, market, and managerial elements influencing capital structure decisions in diverse regional contexts.

Keywords: Risk, Return, Shareholders, Perspectives, Capital Structure.

Shareholders' perspectives on capital structure encompass a nuanced understanding of risk and return within the context of a company's financial decision-making. Capital structure refers to the mix of debt and equity financing a firm employs to fund its operations and investments. From the shareholders' standpoint, the primary concern revolves around achieving an optimal balance that maximizes returns while minimizing risk.

Shareholders generally seek a capital structure that enhances the firm's value and, consequently, their wealth. The incorporation of debt in the capital structure introduces financial leverage, amplifying returns through interest tax shields. However, this also escalates risk, as debt obligations must be met irrespective of the company's performance.

Equity financing, on the other hand, provides a cushion against financial distress, reducing bankruptcy risk. However, it may dilute existing shareholders' ownership and potentially decrease returns.

Effective risk management involves aligning the capital structure with the firm's risk tolerance and business dynamics. Shareholders assess the trade-off between the tax advantages of debt and the safety net of equity, considering factors such as industry volatility, market conditions, and the company's growth prospects. Striking the right balance in capital structure is pivotal for shareholders, ensuring an optimal blend of risk and return that aligns with their investment objectives.

Capital Structure:

Capital structure refers to the combination of debt and equity financing that a company employs to fund its operations and investments. It represents the way in which a firm chooses to arrange its capital, balancing the use of debt, which includes loans and bonds, and equity, such as common and preferred stock. This financial framework plays a pivotal role in shaping a company's risk profile, financial stability, and overall cost of capital.

The decision-making process regarding capital structure involves a trade-off between the benefits and costs associated with debt and equity. On one hand, debt can offer tax advantages and lower cost of capital, but it also introduces financial leverage, increasing the company's risk. Equity, on the other hand, provides a cushion against financial distress but might be costlier and dilute ownership.

Several theories attempt to explain and guide capital structure decisions, including the Modigliani and Miller Propositions, which posit that in a perfect market, capital structure is irrelevant to firm value. In contrast, practical considerations and market imperfections, as outlined in the trade-off theory and pecking order theory, emphasize the impact of financing choices on a company's risk profile and shareholder wealth. Effectively managing capital structure is critical for businesses to optimize their financial structure and achieve a balance that aligns with their strategic goals and risk tolerance.

The relationship between capital structure and risk is a fundamental aspect of financial management that significantly influences a company's overall financial health and performance. Capital structure refers to the mix of debt and equity used by a firm to finance its operations and investments, while risk encompasses the uncertainty and potential for financial loss associated with business activities.

The impact of capital structure on risk is multifaceted. One key consideration is financial leverage, which arises when a company uses debt to finance its operations. While debt can amplify returns on equity when investments generate positive returns, it also introduces financial risk. The fixed obligation of debt payments, regardless of the firm's performance, can heighten financial vulnerability, especially during economic downturns or periods of reduced cash flow.

Analysis of the relationship between capital structure and risk

The analysis reveals how a company's capital structure choices influence its risk profile, examining the interplay between debt and equity in shaping overall financial risk.

Financial Leverage: Capital structure introduces financial leverage, the use of debt to amplify returns. While this can enhance shareholder returns in favorable conditions, it also escalates the risk, as the company must meet interest and principal payments regardless of its performance.

Interest Coverage Ratio: The relationship between capital structure and risk is often measured through metrics like the interest coverage ratio. A higher ratio indicates a company's ability to meet interest payments comfortably, reducing the risk of financial distress.

Default Risk: The proportion of debt in a company's capital structure directly impacts its default risk. Higher debt levels increase the likelihood of financial distress, potentially leading to default on debt obligations, which can adversely affect shareholders.

Credit Ratings: Companies with higher debt levels may face credit rating downgrades, influencing investor perceptions and raising the cost of future borrowings. This shift in creditworthiness can affect shareholder confidence and increase the risk associated with the investment.

Market Perception: Shareholders often react to changes in a company's capital structure, especially if there is a significant shift toward debt. Market perception plays a crucial role, as investors may interpret increased leverage as an indicator of higher risk, leading to changes in stock prices.

Industry Comparison: The analysis of capital structure and risk should consider industry benchmarks. Industries with high capital intensity or stable cash flows may tolerate higher debt levels, whereas those with volatile cash flows may opt for a more conservative capital structure to mitigate risk.

Earnings Volatility: The impact of capital structure on a company's earnings volatility is significant. Higher financial leverage can magnify fluctuations in earnings, leading to increased risk for shareholders who may experience more pronounced swings in the value of their investments.

Market Conditions: The relationship between capital structure and risk is also contingent on market conditions. Economic downturns or interest rate fluctuations can exacerbate risks associated with debt, influencing the overall risk profile of a company and affecting shareholder returns.

Ultimately, understanding the intricate relationship between capital structure and risk is imperative for firms to strike an optimal balance that aligns with their risk tolerance, operational needs, and strategic objectives. Proactive management of this relationship enables companies to navigate market uncertainties and enhance their long-term financial sustainability.

Review of Literature:

Devi (2020) delved into the intricate interplay between capital structure, turnover ratios, and shareholders' returns. Prior research displayed diverse associations between capital structure, turnover, and profitability. Utilizing return on assets and return on equity as metrics for shareholders' returns, findings revealed that automobile companies exhibit a more robust and consistent return on equity compared to return on assets. Notably, the study identified a positive impact of LTD to Equity and LTD to total assets on shareholders' returns, whereas DER and DAR showed a negative influence. Additionally, inventory turnover, receivables turnover, and total assets turnover exhibited positive impacts on shareholders' returns, while working capital turnover displayed insignificance.

Madugba et al. (2023) aimed to investigate the impact of intellectual capital value addition on the efficient asset management of manufacturing firms in Nigeria. Data were sourced from the published annual accounts of 24 manufacturing firms, and the Value-Added Intellectual Coefficient (VAIC) was adapted to measure intellectual capital value addition as the predictor variable. Return on Assets (ROA) served as a determinant of efficient asset management. Ordinary least square regression on panel data was employed to test the hypotheses. Results revealed that Human Capital (HC) was a determinant of ROA with a regression coefficient and significant value ($0.102 > 0.5$). Structural Capital (SC) had an adverse and noteworthy influence on ROA ($-0.046 > 0.05$), while Capital Employed Efficiency (CEE) positively and significantly impacted ROA ($0.825 > 0.50$). The study affirmed a substantial and constructive relationship between intellectual capital and efficient asset management in manufacturing companies, recommending that listed manufacturing businesses in Nigeria should judiciously manage intellectual capital. This research contributes to the extant literature as the first study to investigate the effect of intellectual capital addition on efficient asset management in listed manufacturing companies in Nigeria, covering 240 firm-years, a duration unprecedented in previous studies.

Zakaria and Sonjaya (2023) evaluated the influence of working capital turnover, asset turnover, and capital structure on the return on investment (ROI) of manufacturing companies listed on the Indonesia Stock Exchange. The research encompassed a sample of 19 businesses, involving 95 observations spanning 2017 to 2021. Utilizing secondary data from financial statements, sourced through prospectuses and the Indonesian Capital Market Directory, the study conducted a descriptive statistical test with standard assumption tests. The results revealed a lack of statistically significant impact from working capital turnover and asset turnover on the ROI of listed manufacturing companies. Conversely, the capital structure variable demonstrated a significant and predominant influence on the ROI of publicly traded manufacturing firms on the Indonesia Stock Exchange.

Bony et al. (2023) aimed to investigate the impact of tax incentives on the financial performance of manufacturing firms in Nyeri County, focusing on corporate income tax incentives, capital allowance incentives, and custom duty incentives. Employing a descriptive research design, the study surveyed all 15 registered manufacturing firms in Nyeri County. Data, collected through Likert scale questionnaires and audited annual financial reports, spanned a six-year period. Noteworthy findings revealed a significant relationship between capital allowance and financial

performance, with capital allowance emerging as the most influential predictor. Custom duty incentives and tax holiday also exhibited positive effects, while corporate income tax incentives had a comparatively lesser impact. The study recommends policy revisions, emphasizing strategic custom duty incentives and prioritizing corporate income tax incentives to enhance financial performance. It proposes further research exploring factors beyond tax incentives and extending studies to diverse sectors for a comprehensive understanding.

Emmanuel et al. (2022) examined pivotal roles in the economic development of many developing nations. In navigating competitive landscapes, decisions regarding capital structure become imperative for businesses. Capital structure decisions, intrinsic to the daily operations of manufacturing entities, directly impact profitability, contributing to economic growth and increased tax revenues. Achieving optimal profitability relies on the judicious balance of debt and equity. Employing both descriptive and causal research designs, this study investigated the influence of capital structure on profitability within the timeframe of 2005 to 2019, focusing on listed manufacturing companies in Ghana. Results underscored a significant correlation between capital structure and profitability, revealing an inverse relationship between independent variables and profitability. Consequently, the study suggests that companies may enhance profitability by minimizing their reliance on debt within their capital structures.

Research Gap:

The research gap in this study lies in the limited exploration of capital structure decisions within the manufacturing businesses of Rohtak, Haryana. While existing literature provides general insights into capital structure theories, there is a paucity of region-specific studies focusing on the unique factors influencing financial strategies in this specific industry and geographical context. This study aims to bridge this gap by offering a detailed examination of capital structure decisions in Rohtak's manufacturing sector.

Research Methodology:

Research Design: This study employs a combined descriptive and exploratory research design. The descriptive aspect aims to provide a comprehensive overview and analysis of the existing capital structure decisions and influencing factors. Simultaneously, the exploratory component allows for a deeper investigation into uncharted areas, seeking to identify novel insights and patterns related to the interplay between capital structure decisions and various influential factors in businesses.

Population of the Study:

This study focuses on manufacturing businesses situated in Haryana as the population of interest. The research aims to analyze and draw conclusions specifically from this subset of companies. By narrowing the scope to Haryana's manufacturing sector, the study seeks to provide targeted insights into the capital structure decisions and factors influencing businesses within this regional context, contributing to a more region-specific understanding of financial strategies in the manufacturing industry.

Sample Design:

The study utilizes a non-probability purposive sample design. This intentional sampling approach involves selecting participants based on specific criteria aligned with the research objectives. By purposefully choosing manufacturing businesses in Haryana, the sample is tailored to provide in-depth insights into the capital structure decisions of interest for this particular sector and region.

Sample Size:

The study comprises a sample size of 120 manufacturing businesses located in Rohtak. This sample was chosen strategically to ensure a representative and meaningful analysis of capital structure decisions within the specific context of Rohtak, offering valuable insights into the financial strategies adopted by businesses in this region.

Data Collection:

This study incorporates a comprehensive data collection approach, integrating both primary and secondary sources. Primary data were gathered through face-to-face interviews conducted by the researcher with manufacturing businesses in Rohtak. Additionally, secondary data were sourced from a variety of articles and journals, contributing to a well-rounded analysis. This dual-method approach enhances the depth and reliability of information, offering a more holistic understanding of capital structure decisions in the targeted context.

Objective:

- To identify and analyze the key factors influencing capital structure decisions in businesses.

Key factors influencing capital structure decisions in businesses:

Capital structure decisions in businesses are influenced by a multitude of factors, reflecting the complex interplay between financial, strategic, and market considerations. These key factors shape the optimal mix of debt and equity financing that a company adopts to fund its operations and investments.

1. Financial Performance and Stability: The current financial health of a company plays a pivotal role in capital structure decisions. Firms with strong cash flows and profitability may be more inclined to leverage debt, while those with uncertain or fluctuating earnings might prefer a conservative approach with lower debt levels.

2. Business Risk and Industry Characteristics: The nature of the industry in which a company operates significantly impacts capital structure choices. Industries with stable cash flows and lower business risk may be more comfortable taking on higher debt levels, whereas those in volatile sectors might opt for a more equity-heavy structure.

3. Tax Considerations: The tax environment plays a crucial role in shaping capital structure decisions. Interest on debt is typically tax-deductible, providing a tax shield that makes debt financing more attractive from a cost perspective.

4. Leverage Ratios and Credit Ratings: The existing level of leverage and the company's credit rating influence its ability to raise additional debt capital. A high credit rating can lower the cost of debt, making it an appealing option.

5. Market Conditions and Investor Sentiment: The prevailing market conditions and investor sentiment can impact the feasibility of raising equity. During bull markets, companies might find it more favorable to issue equity, while in downturns, debt financing might be preferred.

6. Management's Risk Tolerance: The risk appetite of the management team and the board of directors is a critical factor. Some companies may prioritize stability and opt for conservative capital structures, while others may be more willing to take on higher levels of risk to enhance returns.

7. Regulatory Environment: Legal and regulatory constraints influence the types and amounts of financing available to a company. Compliance with regulations and adherence to industry standards play a role in shaping capital structure decisions.

8. Cost of Capital: Evaluating the cost of debt versus the cost of equity is fundamental. Striking a balance between minimizing the overall cost of capital and managing associated risks is a key consideration.

In navigating these factors, companies aim to establish a capital structure that aligns with their strategic goals, risk tolerance, and the prevailing economic and market conditions.

Data Analysis:

Data analysis encompasses the examination of information gathered through face-to-face interviews and various secondary sources. Employing statistical methods such as factor analysis, the study aims to unveil patterns and relationships, offering insights into capital structure decisions within Rohtak's manufacturing sector.

Factor Analysis

Factor Analysis is employed to discern and scrutinize the essential components influencing capital structure decisions in businesses. This statistical method assesses interrelationships among observed variables, grouping them into latent factors that capture underlying patterns. By isolating these key factors, the study aims to unravel the intricate web of influences shaping companies' choices between debt and equity, contributing to a nuanced understanding of the multifaceted dynamics guiding capital structure decisions in the business landscape.

Table 1: Case Processing Summary			
		N	%
Cases	Valid	120	100.0
	Excluded	0	.0
	Total	120	100.0

Source: Researcher's Compilation

The Table Case Processing Summary provides a concise overview of the data set's processing status. Out of a total of 120 cases, all are considered valid, indicating that none were excluded during the data processing stage. The table showcases the completeness of the dataset, with a 100% validity rate. This information assures the reliability of the study's findings, affirming that the entire dataset is utilized for analysis without any exclusions, ensuring a comprehensive and accurate representation of the 120 manufacturing businesses in Rohtak.

Table 2: Reliability Statistics	
Cronbach's Alpha	N of Items
.938	20

Source: Researcher's Compilation

The Table Reliability Statistics reveals a high level of internal consistency within the dataset. The computed Cronbach's Alpha, a reliability coefficient, stands at .938, signifying strong internal reliability among the 20 items measured in the study. This indicates that the variables or items assessing factors related to capital structure decisions within the manufacturing businesses of Rohtak exhibit a robust and consistent pattern of interrelatedness. A Cronbach's Alpha exceeding 0.7 is generally considered acceptable, and the obtained value of .938 suggests a high degree of reliability. This implies that the chosen measures consistently capture the underlying constructs, enhancing the confidence in the dataset's reliability for subsequent analyses and interpretations.

Table 3: KMO and Bartlett's Test		
Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.904
Bartlett's Test of Sphericity	Approx. Chi-Square	2343.521
	df	190
	Sig.	.000

Source: Researcher's Compilation

The Table KMO (Kaiser-Meyer-Olkin) and Bartlett's Test results demonstrate the adequacy of the dataset for conducting a factor analysis. The KMO measure, with a value of .904, indicates a high level of sampling adequacy, suggesting that the data is well-suited for factor analysis. Additionally, Bartlett's Test of Sphericity, with an approximate Chi-Square value of 2343.521 and a significant p-value of .000 (below the conventional significance level of 0.05), indicates that correlations between variables are sufficiently different from zero. These findings affirm the appropriateness of the dataset for factor analysis, providing confidence in the reliability of the results and the suitability of the variables for extracting meaningful factors.

Table 4: Communalities		
	Initial	Extraction
Our company consistently achieves strong financial results	1.000	.833
The stability of our cash flows is a key strength for our business	1.000	.839
We actively monitor and manage our working capital efficiency	1.000	.872
Our profitability has been consistently improving over the past few years	1.000	.826
Our financial position allows us to easily cover debt obligations	1.000	.816
Our company maintains a carefully balanced debt-to-equity ratio	1.000	.918
We regularly assess and manage our leverage to optimize financial structure	1.000	.885

Maintaining a high credit rating is a priority for our organization	1.000	.872
We consider the cost of debt as a crucial factor in our capital structure decisions	1.000	.845
Our company has successfully obtained favorable credit terms due to our creditworthiness	1.000	.935
We consider market trends when making capital structure decisions	1.000	.702
Investor confidence in our industry influences our financing choices	1.000	.697
We closely monitor economic conditions before adjusting our capital structure	1.000	.741
Our company adapts its capital structure in response to shifts in market sentiment	1.000	.812
We assess the timing of equity issuance based on favorable market conditions	1.000	.611
Our management team is comfortable taking on a moderate level of financial risk	1.000	.735
We prioritize financial stability over aggressive capital structure choices	1.000	.722
Management actively considers the potential impact of financial decisions on risk	1.000	.748
Our risk appetite influences the proportion of debt in our capital structure	1.000	.745
Management is open to adjusting the capital structure to optimize risk and return	1.000	.675

Source: Researcher's Compilation

The table presents communalities, which indicate the proportion of each variable's variance accounted for by the factors extracted during the analysis. The "Initial" column represents the total variance explained by each variable, while the "Extraction" column shows the proportion of variance retained after factor extraction.

Variables like "Our company maintains a carefully balanced debt-to-equity ratio" and "Our company has successfully obtained favorable credit terms due to our creditworthiness" have high communalities (.918 and .935, respectively), indicating that a substantial portion of their variance is captured by the identified factors.

Conversely, variables such as "We consider market trends when making capital structure decisions" and "We assess the timing of equity issuance based on favorable market conditions" show lower communalities (.702 and .611, respectively), suggesting that these variables may have unique aspects not well-explained by the extracted factors.

The communalities above .7 for most variables indicate that the chosen factors account for a significant portion of the original variables' variability. However, the lower communalities for a few variables highlight the potential presence of unexplained variance or unique characteristics not captured by the identified factors.

Overall, this information assists in assessing the adequacy of the factor analysis. Higher communalities reinforce the reliability of the factors in explaining the observed variables, while lower communalities may suggest areas for further exploration or potential refinement in the factor model to better capture the nuances of certain variables.

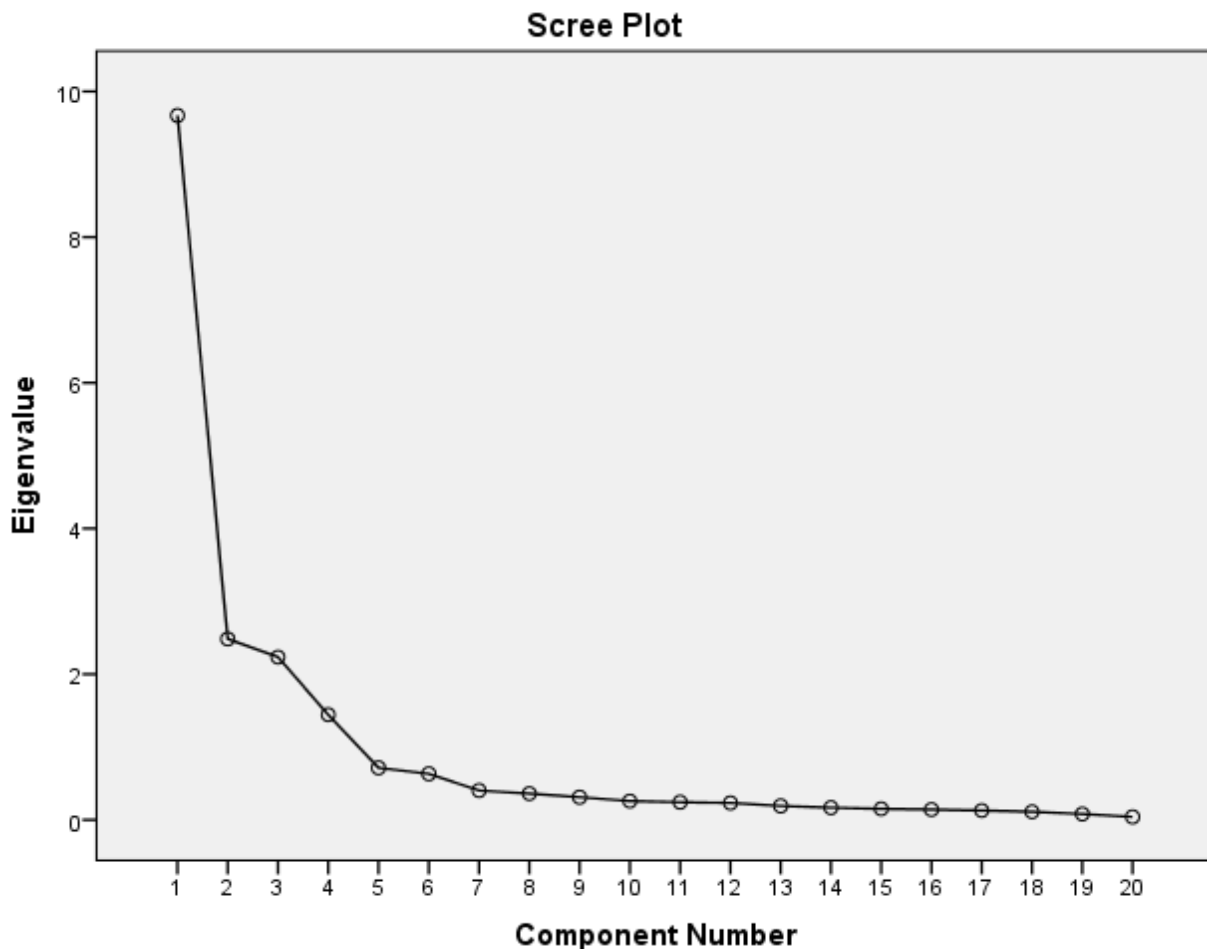


Figure 1: Scree Plot

Table 5: Rotated Component Matrix				
	Component			
	1	2	3	4
Financial Performance and Stability				
Our company consistently achieves strong financial results	.923			
The stability of our cash flows is a key strength for our business	.912			
We actively monitor and manage our working capital efficiency	.883			
Our profitability has been consistently improving over the past few years	.882			
Our financial position allows us to easily cover debt obligations	.864			
Leverage Ratios and Credit Ratings				
Our company maintains a carefully balanced debt-to-equity ratio		.832		
We regularly assess and manage our leverage to optimize financial structure		.832		
Maintaining a high credit rating is a priority for our organization		.815		
We consider the cost of debt as a crucial factor in our capital structure decisions		.802		
Our company has successfully obtained favorable credit terms due to our creditworthiness		.799		
Market Conditions and Investor Sentiment				
Our company maintains a carefully balanced debt-to-equity ratio			.807	
We regularly assess and manage our leverage to optimize financial structure			.801	

Maintaining a high credit rating is a priority for our organization			.801	
We consider the cost of debt as a crucial factor in our capital structure decisions			.784	
Our company has successfully obtained favorable credit terms due to our creditworthiness			.768	
Management's Risk Tolerance				
Our management team is comfortable taking on a moderate level of financial risk				.829
We prioritize financial stability over aggressive capital structure choices				.780
Management actively considers the potential impact of financial decisions on risk				.771
Our risk appetite influences the proportion of debt in our capital structure				.752
Management is open to adjusting the capital structure to optimize risk and return				.682

Source: Researcher's Compilation

The Rotated Factor Matrix provides insights into the factor loadings of each variable onto the identified factors after rotation. Each variable is evaluated across the four factors, indicating the strength and direction of its association with each factor. The numbers in the matrix represent the factor loadings, where higher values signify a stronger correlation between the variable and the factor.

Factor 1 - Financial Performance and Stability:

Variables such as "Our company consistently achieves strong financial results" (.923) and "The stability of our cash flows is a key strength for our business" (.912) exhibit high loadings on Factor 1, suggesting a strong association with financial stability.

Factor 2 - Leverage Ratios and Credit Ratings:

The variables related to leverage and credit ratings, including "Our company maintains a carefully balanced debt-to-equity ratio" (.832) and "We consider the cost of debt as a crucial factor in our capital structure decisions" (.802), predominantly load on Factor 2, indicating their alignment with factors related to financial leverage.

Factor 3 - Market Conditions and Investor Sentiment:

Interestingly, some variables related to market conditions and investor sentiment, such as "Our company maintains a carefully balanced debt-to-equity ratio" (.807), load on both Factor 2 and Factor 3. This suggests a shared variance between these factors, potentially indicating an interplay between financial leverage and market considerations.

Factor 4 - Management's Risk Tolerance:

Variables associated with management's risk tolerance, such as "Our management team is comfortable taking on a moderate level of financial risk" (.829), predominantly load on Factor 4, highlighting this factor's connection to the assessed risk-related variables.

These results offer a structured understanding of how the original variables align with the identified factors. The factor loadings guide the interpretation of the factors, revealing the underlying constructs shaping capital structure decisions within the manufacturing businesses of Rohtak. Additionally, observing cross-loading of some variables emphasizes the complexity of these constructs, suggesting potential interconnectedness or multifaceted influences within the factors.

Component	1	2	3	4
1	.544	.579	.413	.445
2	-.810	.176	.408	.382
3	.101	-.269	.804	-.520
4	.194	-.749	.126	.620

Source: Researcher's Compilation

Conclusion:

In conclusion, this study delves into the intricacies of capital structure decisions within the manufacturing businesses of Rohtak, Haryana. The examination of key factors influencing these decisions revealed distinct components: Financial Performance and Stability, Leverage Ratios and Credit Ratings, Market Conditions and Investor Sentiment, and Management's Risk Tolerance. Factor analysis unveiled the interplay of variables within each component, providing a nuanced understanding of the multifaceted dynamics guiding capital structure choices.

The high communalities underscore the robustness of the selected variables, indicating that the identified factors capture a significant portion of the original variables' variance. The rotated factor matrix further refines our comprehension, emphasizing the associations and shared variance among the components. Notably, the cross-loading of certain variables suggests potential interconnectedness between factors, reflecting the complex nature of capital structure decisions in this context.

These findings contribute valuable insights for practitioners, policymakers, and researchers, offering a region-specific understanding of financial strategies within the manufacturing sector. By acknowledging the interrelated factors shaping capital structure decisions, businesses in Rohtak can make more informed and strategic choices. This study serves as a foundation for future research endeavors, encouraging a deeper exploration of the nuanced interactions between financial, market, and managerial elements influencing capital structure decisions in diverse regional contexts.

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