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**ABSTRACT**

*The study sought to establish to establish the effects of financial structure on firm value of non-financial firms listed in Nairobi Securities Exchange. The research concentrated on long term debt, current liabilities, share capital and retained earnings as independent variables and firm value as the dependent variable. Tobin's Q was used to indicate firm value while Pearson correlation and regression analysis were adopted to analyze the panel data collected from 36 firms sampled out of all the 50 listed non-financial firms in Kenya. Secondary panel data was collected from audited and published financial reports for the period from 2012-2016. STATA was used for regression analysis. Panel data diagnostic test was carried out to determine the nature of the panel data and best model for analysis. The findings indicated that current liabilities and retained earnings have significant positive effect on firm value while long term debt and share capital were found to have an insignificant positive and negative effect on firm value respectively. This study recommended that the listed non-financial firms should seek to employ more debt given its tax benefits but more so work towards attaining an optimal financial structure that features an optimal cost of financial and hence better returns and improved firm value. Secondly, the firms should consider a dividend policy that enhances retained earnings as this was found to have a positive and significant effect on firm value. Retaining sizeable earnings enables the firm to easily pursue growth without having to raise funds from external forms of financing which comes with costs.*

**Key Words:** Long Term Debt, Current Liabilities, Share Capital, Retained Earnings, Firm Value

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## INTRODUCTION

Finance is playing an increasingly important role in global economies. According to Salem (2013), financial structure of a firm can be defined as the various financing options that a firm uses to acquire its assets. The firm can finance its activities with different sources of finance like Equity (Common and Preferred Equity) and debt (Short-term and Long-term). The left-hand side which shows the liabilities plus equity of the statement of financial position represents all the long-term and short term sources of finance. Debt and Equity are the basic components of the firm's financial structure.

Firm value can be defined as an economic measure reflecting the market value of the business (Kurshev and Strebulaev, 2005). According to Ehrhard and Bringham (2003), firm value is a sum of claims of all claimants that is, creditors (secured and unsecured) and equity holders (preferred and common). Firm value is one of the fundamental measures used in business valuation, financial modeling, accounting and portfolio analysis.

A great dilemma to all stakeholders is whether there exists an optimal financial structure that maximizes the stakeholders' wealth, as the core object of firms except public utility providers. In the local front, there is a significant drop in the share performance of firms trading in the NSE where the equity turnover in 2016 stood at KES25.39 Billion compared to an equity turnover of KES 46.10 Billion registered in 2015 indicating a 44.92% decrease in equity turnover confirming low investor participation at the NSE in 2016.

In service industry, uchumi made a loss of Ksh.3.4 Billion in 2015 and a loss of Ksh. 2.8 Billion in 2016. Even though the loss reduced by 17%, it impacted the closure of non-performing branches in parts of East Africa region. The sugar industry in Kenya is also facing economic hardship due to constant losses being made by the giant Mumias Sugar Company

from year 2013 to 2015 where the loss stood at Ksh 4.6 Billion. At the closure of financial year 2016, Mumias Sugar Company recorded a loss of Ksh. 4.7 Billion. On the other hand some firms like CMC holdings were suspended from trading in the NSE market and Access Kenya delisted following a takeover in 2013 and others undertook financial restructuring (CMA annual bulletin, 2014). The poor performance being witnessed in the NSE can be largely linked to the financial structure that they have in place unlike financial firms whose capital holding is strictly regulated by the CBK, capital holding regulations do not apply among non-financial firms in spite of all listed firms falling under the preview of CMA.

Three relevant theories were used; the pecking order theory was advanced by Myers & Majluf in 1984 and reviewed by Lucas and McDonald (1990). The theory is based on the idea of asymmetric information between managers and investors whereby the managers of a firm have more information about the true value of the firm and the risk uncertainties of a firm than the outside investors. The theory explains why firms tend to depend on internal sources of funds and why firms prefer debt to equity in case an external source of finance is required. Hence, a firm's debt is not driven by trade-off theory but it's driven by the cumulative results of the firm's attempts to mitigate information asymmetry.

Agency theory was formulated by Jensen and Meckling in 1976. Jensen & Meckling argue that an optimal financial structure is attainable by reducing the costs resulting from the conflicts between the owners, managers and debt holders. Trade off theory was advanced by DeAngelo and Masulis in 1980. The theory argues that firms will seek to maintain an optimal financial structure by maintaining balance between the benefits and the costs of debt the firms are using. The benefits can be the tax shield and the costs include expected financial distress costs. The implication of these trade-off models is that firms

have target debt and they adjust their long term debt toward the target over time. The theory predicts that firms maintain an optimum financial structure where the marginal benefit of debt equals the marginal cost.

## METHODOLOGY

A descriptive research design was used to establish the relationship between two variables. Secondary panel data was extracted from audited and published financial reports of listed non-financial firm then the data was cleaned, sorted and then coded before being captured into STATA for analysis. It was analyzed using descriptive statistics such as mean

scores, standard deviations, percentages, and frequency distribution computed to describe the characteristics of the variables of the study. Inferential statistics such as correlation and regression analysis was used to establish the nature and magnitude of the relationship between the variables and to test the hypothesized relationships. A regression model was developed and correlation analysis conducted at 95% confidence level as panel data diagnostic test was conducted and the random effect model was found to be the best mode.

## FINDINGS

**Table 1: Descriptive statistics of the study variables**

Variable		Mean	Std. Dev.	Min	Max	Obs.
Long-term Debt	Overall	0.23	0.23	0.00	1.42	N = 180
	Between		0.20	0.00	0.86	n = 36
	Within		0.12	-0.45	0.79	T = 5
Current Liabilities	Overall	0.42	0.35	0.01	1.85	N = 180
	Between		0.30	0.05	1.03	n = 36
	Within		0.17	-0.43	1.24	T = 5
Share Capital	Overall	0.11	0.15	0.00	0.66	N = 180
	Between		0.15	0.00	0.53	n = 36
	Within		0.04	-0.14	0.32	T = 5
Retained Earnings	Overall	0.39	0.32	-0.78	0.95	N = 180
	Between		0.27	-0.09	0.89	n = 36
	Within		0.17	-0.47	0.83	T = 5
Firm Value	Overall	1.18	1.46	0.55	1.46	N = 179
	Between		1.37	0.12	5.92	n = 36
	Within		0.55	-0.99	3.91	T = 5

## Correlation Analysis

**Table 2: Correlation Matrix**

	Firm Value.	Long-term Debt	Current Liab.	Share Cap.	Retained Ear.
Firm Value	1				
Long-term Debt	-0.1175	1			
Current Liabilities	0.0306	0.0464	1		
Share Capital	-0.1198	-0.0545	0.4316	1	
Retained Earnings	0.1128	-0.3199	-0.2037	-0.2701	1

With a correlation coefficient of -0.1175, the findings indicated a negative but weak correlation between long term debt to total assets and entity's value. This means that a rise in long term debt leads to an insignificant decline in firm value. The findings agreed with those of Babatunde et al., (2014) who indicated an insignificant correlation between highly geared firms and net returns and eventually firm value. However, the findings differed with those of Maina and Kondongo (2013) who indicated no correlation between debt and firm value

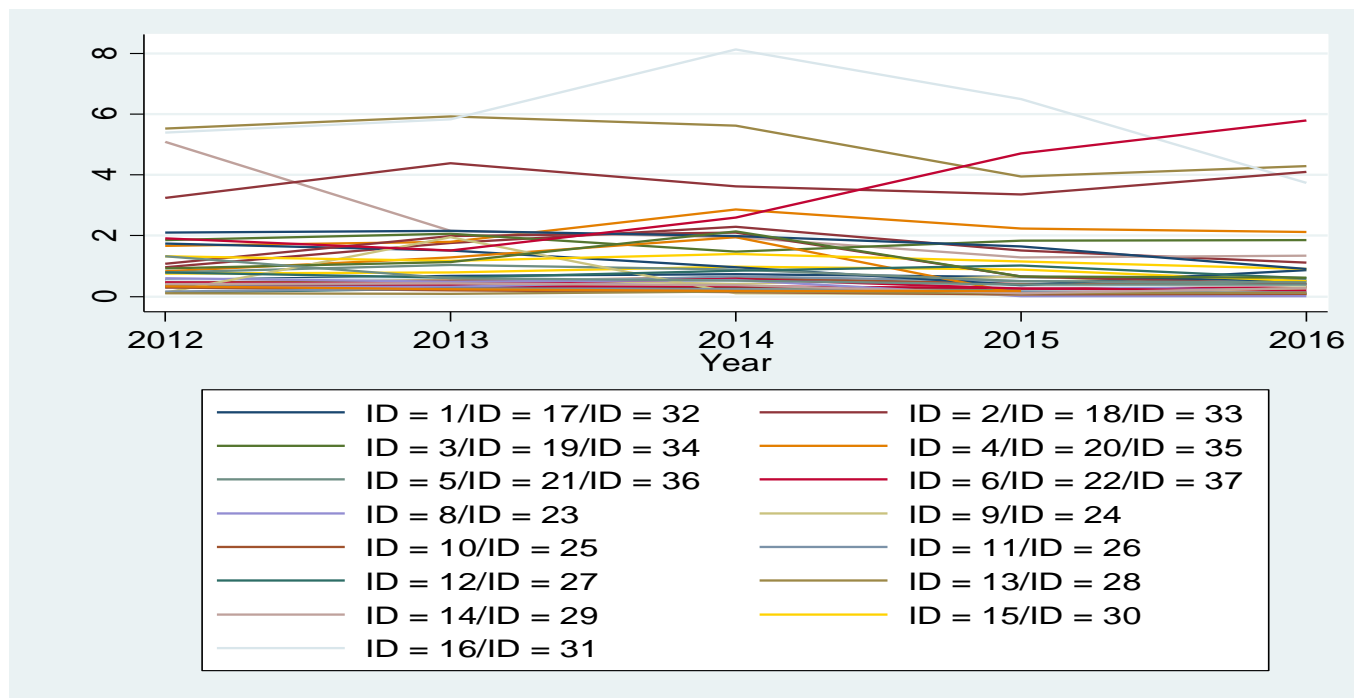
The study found out that the ratio of short term obligations to total assets has an inconsiderable positive correlation amid the two variables. This basically means that a rise in current liabilities leads to an insignificant increment in firm value. The findings agreed with those of Muhammad Umar et al (2012) who indicated a weak correlation between current liabilities on corporate returns and hence firm value.

With a correlation co-efficient of -0.1198, the correlation between share capital financing and firm value is weak one and negative. This means that a rise in share capital financing leads an insignificant decline in firm value.

The findings also indicated a positive but weak correlation with correlation coefficient of 0.1128 between retained earnings and firm value. This means that a rise in retained earnings financing leads an insignificant rise in firm value.

### Overlay graph

The pictorial presentation in Figure below features the overlay of all the quoted non-financial enterprises from 2012 to 2016. From the results, it can be seen that all the quoted non-financial companies had distinct intercept terms for each firm and were steady over time. These preliminary findings impress on that the variation across entities is postulated to be random and uncorrelated with the independent variable included in the model, a clear demonstration that the suitable model is random effects model.



This study concluded that short term obligations and retained earnings have a significant positive influence

on corporate value while it was found out that long term obligations and share capital have a non-

significant positive and negative influence on enterprise value correspondingly. The positive influence on company's value by long term obligations is due to the tax benefits that come with debt financing. However the results point out that the effect is not significant. The tax benefits have a positive impact on net corporate returns and such firms post better stock performance in the market and hence a rise in firm value. However, as explicated under trade off theory firms should strike a balance between debt and equity financing. This is given the liquidity-return trade off involved in debt financing. While debt financing comes with tax benefits and hence come with better returns, excessive leverage.

Retained earnings have a significant positive implication on firm value just comes about the firm having adequate earnings ploughed back to orchestrate firm growth and hence value. Use of current liabilities is a form of short term financing. Despite its significant positive effect on corporate value, delay to pay short term obligations has adverse effect that could cost the firm. For instance delays to pay suppliers for goods supplied on credit could lead

to delays in replenishment of stock and this could impede production and eventually lower corporate returns and value.

Share capital was found to have an insignificant negative effect on firm value. Like indicated earlier the focus is to attain an optimal mix of debt and equity. As excessive long term debt pose risk of insolvency, excessive use of share capital comes with a high required rate of return and hence a high cost of finance.

#### **Suggestion for Further Research**

This study adequately met its aim and objectives. However, there are areas that future studies should focus on. Firstly future studies should relate the influence of financial structure on enterprise value for both financial and non-financial corporations. Secondly this study collected data for the period from 2012-2016. Future studies should focus on a lengthier period such as 10 years to effectively comprehend the link between the variables and as well enhance the reliability of the study's findings.

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