العنوان:	Impact of Value Relevance of Financial Performance Information and Corporate Governance on Capital Structure : Evidence from Egyptian Manufacturing Firms
المصدر:	الفكر المحاسبي
الناشر:	جامعة عين شمس - كلية التجارة - قسم المحاسبة والمراجعة
المؤلف الرئيسي:	Abd Almegeid, Nevine Sobhy
المجلد/العدد:	مج19, ع1
محكمة:	نعم
التاريخ الميلادي:	2015
الشهر:	أبريل
الصفحات:	73 - 108
رقم MD:	662402
نوع المحتوى:	بحوث ومقالات
اللغة:	English
قواعد المعلومات:	EcoLink
مواضيع:	مصر، الشركات الصناعية، المعلومات المحاسبية، النظم المحاسبية، رأس المال، حوكمة الشركات، الصناعة، تقويم الأداء
رابط:	http://search.mandumah.com/Record/662402

Impact of Value Relevance of Financial Performance Information and Corporate Governance on Capital Structure: Evidence from Egyptian Manufacturing Firms

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Abstract

This research empirically investigates the impact of value relevance of financial accounting based performance information, stock valuation and corporate governance on capital structure choice in Egypt listed manufacturing firms. Multiple regression analysis is used to examine the association between leverage level and research independent variables for a sample of 52 Egyptian listed manufacturing firms from 2006-2010. The results show that capital structure choice has a weak-to-no relation to firm's performance and corporate governance. Findings show that the value relevance of organizational performance and corporate governance both have insignificant interactive influence on the capital structure. The results shows that profitability and operational performance has a negative insignificant relationship with capital structure, while liquidity and stock valuation has a positive relationship with firm financial leverage, price/earning has significant impact to the capital structure.

Keywords: Capital Structure, Value Relevance of Financial Accounting based Performance Information, Corporate Governance, Stock Valuation, and Egyptian Listed Manufacturing Firms.

1. Introduction

Capital structure decisions play a role in maximizing the performance of the firm and its valve. Capital structure refers to the percentage of capital at work in a business by type. It is a mix of a company's long-term debt, specific short-term debt, common equity and preferred equity and it describes how a firm finances its overall operations and growth by using different sources of funds. Each equity capital and debt capital has its own benefits and drawbacks and a substantial part of wise corporate management is attempting to find the ideal capital structure in terms of risk/reward payoff for shareholders. A firm's capital structure is then the composition or structure of its liabilities (Owolabi and Inyang 2012). Uremadu (2004) sees the capital of an organization as those pools of funds that the company commits to its fixed assets, to inventories, to account receivables, and to cash or marketable securities to lead to corporate growth.

The decision about the capital structure is one of the most important decisions in corporate governance. As it impact the company's performance and the value created to shareholders, in terms of maximizing their return on investment, and it affects the company's ability to conform to competitive and rapidly changing economic environment. Therefore, it is necessary to establish such a debt- equity ratio that would ensure a balance and stability of the company's performance (Norvaišiene and Stankevičiene 2012).

In the capital markets framework, the relevance of accounting information is the accounting explanatory power in terms of the most important market variables: returns and volatility. The value relevance literature has focused on the explanatory power of accounting numbers over prices and returns.

Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms. Audited balance sheets, income statements, and cash-flow statements, along with supporting disclosures, form the foundation of the firm-specific information set available to investors and regulators (Bushman and Smith 2003).

The purpose of accounting information is to provide information of a business about its: assets, liabilities, equity, revenues, income, expenses, profits and losses, cash flows. An accounting number is termed value relevant if it significantly related to the dependent variable (Beaver

2002). The researcher argues the ability of accounting and financial performance measures to explain capital structure decisions.

Accounting information expected to provide investors and other users of financial statements useful information to help them make informed economic decisions (Lopes 2002). Accounting information is important and powerful for participants in emerging markets than other sources of information in more developed markets (Lopes 2002). In Egypt, sources of credible and useful accounting information are limited, so the role of financial statements may be more important. Thus, their influence on the stock market may be more significant than in developed countries.

The main objective of financial reporting is to provide information to help users to understand the firm's current performance and to make assessments about future performance. In addition, accounting based performance measures are the most important measures that investors rely on to evaluate managers' ability and efforts and make investment decisions (Ebaid 2012).

This research structured as follows: Section 2 reviews the relevant literature on the subject, introduce the research objectives and hypotheses. Section 3 shows the relationship between value relevance of financial accounting based performance and capital structure. Section 4 identify the relationship between equity return and capital structure. Section 5 introduces the relationship between corporate governance and capital structure. Section 6 describes the data, research variables and the methodology employed in the empirical study. Section 7 presents and discusses the findings of the study. Finally, Section 8 concludes.

2. Literature Review

Hovakimian, et al. (2002) find that capital structure decisions of a firm are not dependent on any other factor but on the company's market or book ratio. They argued that the company's profitability has no direct relationship with the company's target leverage. They also argued that a less profitable company will issue more equity to offset their debt level and on the other side, a profitable firm will not issue equity to finance their operations, as it will be most interested in internally generated funds.

Deesomsak, et al. (2004) suggest that capital structure decisions are not only the product of a firm's own characteristics, but also the result

of the corporate governance, legal framework and institutional environment of the countries in which the firm operates.

Namazi and Shirzade (2005) examine the relationship between capital structure and profitability of firms that allowed in Tehran stock exchange. The results of their study showed that there is a weak relationship between capital structure and profitability and the relationship is different in various industries.

Otnet (2006) examine the relationship between corporate governance and capital structure using Jordanian companies' data while assuming ownership structure as a proxy of corporate governance. The results that the agency cost arises due to internal and external set of mechanism and ownership structure has positive and negative impact on the capital structure. Firstly, a negative relation between ownership structure and capital structure is due to short-term financing. Secondly, a positive relationship between ownership structure and capital structure is due to sustainability in financing and enforcement of block holders (shareholders) to avail the opportunity of high debt.

Abor (2007) study how corporate governance affect the capital structure and found that is a significantly negative relationship between board size and capital structure and opposite finding on the association between CEO duality and leverage where it implies that larger boards adopt low debt policy and CEO as the Board Chairman tend to employ high proportion of debt.

Shijun (2007) examine the relationship between board composition and firm's performance. He used the return of assets (ROA) and that of shares as criteria for measuring performance and also the variables board size and proportion of outside directors for measuring board composition. The results showed that there is a positive relationship between board size and proportion of outside directors with the performance of firm.

Zertun and Tian (2007) show that a firm's capital structure had significantly negative impact on the firm's performance measures, in both the accounting and market's measures.

Jermias (2008) show that gearing and performance is significantly negative, and firm size negatively and significantly related to performance. The results indicate that competitive intensity and business strategy do affect the gearing performance relationship such that it is less negative for cost leaders than for product differentiations. The results are consistent with the view that debt financing and debt covenants not only

offer cost leaders the benefit of tax advantages, but also accord increased efficiency due to constraints imposed by debt holders.

Nimalathasan and Valeriu (2010) point out capital structure and its impact on profitability: a study of listed manufacturing companies in Sri Lanka. The analysis of listed manufacturing companies shows that Debt equity ratio is positively and strongly associated to all profitability ratios (gross profit, operating profit & net profit ratios). Saad (2010) investigate the compliance level among public listed companies with the implementation of corporate governance code of best practices and the association to firm capital structure in Malaysia. The study employs multiple regression analyses on board of director's facets such dual leadership, board size and board meeting. The results reveal that *most of the* company has complied well with the code and there is a significant association to the firm's capital structure.

Haque, et al. (2011) investigates the influence of firm-level corporate governance on the capital structure pattern of non-financial listed firms. The agency theory suggests that better corporate governance will reduce agency costs and improve investor confidence, which in turn will enhance the ability of a firm to gain access to equity finance, reducing dependence on debt finance. Conversely, the controlling shareholders of poorly governed firms are likely to prefer debt, in order to retain absolute ownership and control rights. The study results seem to support agency theory, with a statistically significant inverse relationship between corporate governance quality and the total as well as long-term debt ratios.

Ebaid (2012) examine and compare the relative and incremental value-relevance of a comprehensive set of accounting-based measures of firm's performance in the emerging capital market of Egypt. The results indicate that relative and incremental value relevance tend to increase when moving down in the income statement, with net income having the largest relative and incremental value relevance while total sales have the lowest relative and incremental value relevance. In addition, all of the accrual-based performance measures have relative and incremental value relevance statistically higher than that of operating cash flows.

Ganiyu and Abiodun (2012) examine the interaction between corporate governance mechanisms and capital structure decisions. The results show that corporate governance can greatly assist companies by infusing better management practices, effective control and accounting systems, stringent monitoring, effective regulatory mechanism and

efficient utilization of firms' resources resulting in improved performance. This will in turn assist them to gain easier access to credit at lower cost since such firms are able to repay their debt on time.

From reviewing the literature, empirical studies regarding the relationship between capital structure and value relevance of firm's financial performance information in developed countries provided mixed and contradictory evidence, on the other hand there is a few studies empirically examine this relationship in emerging developing economies. This research extends the literature by empirically examining the relationship between capital structure, firm's performance and corporate governance in Egyptian listed manufacturing firms.

2.3 Research Objectives

This research aims to fill this gap in literature by investigating whether accounting-based performance measures, stock valuation and corporate governance have the ability to capture or summarize information that affects capital structure decisions in Egypt as one of emerging markets that has not examined before.

Egypt is a unique case for two reasons. First, although Egypt has transformed its economic system into capitalism and open market, the managerial decision-making may still constrained by old school of government support to economic entities, which could explain the high level of financial gearing of Egyptian firms. Especially, those firms that belonged to public sector and gone to private (fully or partially) through the privatization policy adopted by Egyptian government by the mid-1990s. Second, capital market in Egypt is less efficient and incomplete and suffers from higher level of information asymmetry than capital markets in developed countries. In addition, the capital market in Egypt is still to now an equity market, the debt market structure is still very immature. This environment of the market may cause financing decisions to be incomplete and subject to a considerable degree of irregularity. It is important, therefore, to explore the validity of debt/equity financing firm's performance relationship under these unique economic settings.

The understanding of the capital structure decisions of Egyptian firms operating in an emerging market is extremely important. It can influence not only the return a firm earns for its shareholders, but whether or not a firm survives in a recession or depression with the existence of macro environment factors, such as high and soaring interest rates, volatility in economic and political situations.

Thus, this research aims to generate findings that provide references for capital structure decision-makers at Egyptian non-financial listed companies, through these two fold objectives:

1. To verify and understand whether value relevance of financial accounting organizational performance based information and firm stock valuation have an influence on the capital structure decisions.

2. To determine whether internal corporate governance have an influence on the capital structure.

2.4 Research Questions

This research addresses the following research questions:

1. Does capital structure adopted by Egyptian listed manufacturing firms affected by its profitability, liquidity and operational performance and stock valuation?

2. Have there been any observable significant effects of the corporate governance on capital structure adopted by Egyptian listed manufacturing firms?

2.5 Research Hypotheses

The objectives of this research achieved through testing the following research hypotheses:

H_1: The value relevance of financial accounting organizational performance based information has a negative and significant influence on the capital structure decisions at Egyptian listed manufacturing firms.

H_2: There is a significant positive relationship between gearing ratio of the Egyptian listed manufacturing firms and their stock valuation.

H_3: The internal corporate governance has a significant positive influence on the capital structure at Egyptian listed manufacturing firms.

3. Value Relevance of Financial Accounting Based Performance and Capital Structure

Relevance is one of the principal qualitative characteristics that financial statement information should possess to be useful for decision making by helping them evaluate past, present or future events relating to an entity and confirming or correcting their past evaluations (IASB 2001). The concept of the value relevance of accounting information defined as the ability of accounting numbers to summarize the information underlying the stock prices, thus a statistical association

between financial information and prices or returns indicates the value relevance.

Financial accounting information supplies a key quantitative representation of individual corporations that supports a wide range of contractual relationships. Financial accounting information also enhances the information environment more generally by disciplining, the un-audited disclosures of managers and supplying input into the information processing activities of outsiders (Bushman and Smith 2003). A fundamental prerequisite for the value relevance of accounting information is the quality of the accounting regulations prescribed. High-quality accounting standards are necessary to ensure that capital markets and the economy, as a whole, function well. Such standards are important for investors, firms and those who set accounting standards (Hellstrom 2006). Higher quality accounting figure such as the earnings more accurately reflects a firm's economic performance and provides relevant information for investors' valuation of firm value (Teoh and Wong 1993).

Investors are not in a position to directly access the performance of the company in which they intended to invest. They usually depend on the financial statements prepared by the management of the company.

A firm's financial statement is value relevant if it leads to a change in investors assessments of the probability distribution of future returns and if it significantly relates to equity market value and contributes to their equity investment decisions (Francis and Schipper 1999).

Financial accounting information of firms and their competitors aid managers and investors in identifying and evaluating investment opportunities. Quality financial accounting data enhances efficiency by enabling managers and investors to identify value creation opportunities with less error. This directly leads to accurate allocation of capital to highest valued uses. Lower estimation risk can also reduce the cost of capital, further contributing to economic performance (Bushman and Smith 2003).

Accounting and disclosure standards provide a means for investors to monitor their investment by accessing information about a firm's activities. The board of directors is the mechanism through which owners influence the firm's insiders to do their bidding. The key issues in evaluating a corporate governance system are therefore: legal protection of investor rights, trustworthy accounting and disclosure standards,

effective boards, and preferably an active market for corporate control (Nganga et al. 2003).

4. Stock Valuation and Capital Structure Theories

In financial markets, stock valuation is the method of calculating theoretical values of companies and their stocks.

Capital structure refers to the combination of funds, in the form of debt and equity, a firm uses to finance its asset investments. The capital structure choice that provides the greatest appeal *to* investors and shareholders results in the lowest cost of capital and maximized firm value in presence of efficient investment strategies and is called Optimal Capital Structure (Muzir 2011).

The main problem in determining the capital structure is that considering the differences between equity and debt, for optimum performance in the capital structure, how much debt and how much equity there should be to the company is not subject to the bankruptcy risk and less cost to pay (Nikbakht and Paikani 2009).

The main objective of the business units is to improve the shareholders' wealth. The existence of the debt in the capital structure of companies due to tax advantages leads to the increase in benefit and earnings per share will increase accordingly. On the other hand, due to interest costs and the possibility of non-fulfillment of obligations at maturity, the possibility of financial risk increases, stock market prices reduce and consequently range of shares diminishes (Izadi Nia and Rahimi Dastjerdi 2009).

Debt is a capital source that increases the risk associated with future earnings while it allows a firm to generate a higher expected rate of return because of the tax benefit arising from interest charges. There is a trade-off related with changing levels of the use of debt, thus, firms should use the amount of debt that enables stock value maximization. The other source of capital is equity that represents the right of shareholders on the firm's assets. Its contribution to the cost of capital is higher with respect to debt financing choice since creditors have privileged rights over the firm's investments as compared to the shareholders in case of liquidation. Besides that, the increase use of debt in raising capital expected to make the shareholders perceive much risk about the firm's future due to increasing level of financial risk stemming from borrowing more (Muzir 2011).

The price/earnings ratio (P/E) is the best known of the investment valuation indicators. A stock with a high P/E ratio suggests that investors are expecting higher earnings growth in the future compared to the overall market, as investors are paying more for today's earnings in anticipation of future earnings growth. Hence, as a generalization, stocks with this characteristic considered growth stocks. Conversely, a stock with a low P/E ratio suggests that investors have modest expectations for its future growth compared to the market as a whole.

Capital Structure Theories

- Modigliani-Miller Theorem (Traditional Theory) (1963): Is the starting point for any research in capital structure, it suggested that firms should use as much debt capital as possible in order to maximize their value by maximizing the interest tax shield (Sayilgan et al. 2006).

- Trade off Theory (Static Exchange Theory): It holds that the decision of a firm about the use of debt finance or equity finance based on the costs and benefits associated with each source of funds (Khan 2012). This theory usually regards a firm's optimal debt ratio as determined by a trade-off of the costs and benefits of borrowing, holding the firm's assets and investment plans constant. The firm portrayed as balancing the value of interest tax shields against various costs of bankruptcy or financial embarrassment. The firm is supposed to substitute debt for equity, or equity for debt, until the value of the firm maximized. According to the trade off model, larger firms expected to have higher debt capacity and more highly geared (Sayilgan et al. 2006).

- Capital Signaling Theory (Asymmetric Information Theory): According to this theory, the managers have more information than the investors do about the future of company and this phenomenon called asymmetric information. Therefore, because the managers have more information about the future of company, they do not involve others in the future profit of company. Hence, they provide the financial needs of company through the debt; and when they do not have the favorable predictions about the future of company, they will meet the financial needs of company through the share distribution (Abdoli et al. 2012). Signalling theory suggests that the choice of the firm's capital acts as a signal to outsider investors of the information held by shareholders, the well-informed managers try to send positive information to the market or ill-informed investors to increase the firm value. Managers have incentives to use various tools to send signals to the market about the difference that exist between them and weaker firms. One of the key tools to send these

signals is the use of debt. Employment of debt in capital structure shows that managers have better expectations about the future performance whereas equity sends a bad news about the firm performance in the future (Khan, 2012). Information asymmetry demands an extra premium for firms to raise external funds, irrespective of the true quality of their investment project. In the case of issuing debt, the extra premium reflected in the higher (Gill et al. 2009).

- Pecking Order Theory (Hierarchy Theory of Financing Options): The theory argues that firms would prefer debt financing rather than issuing equity because of lower information costs associated with debt financing. This leads to an increase in the debt-to-equity ratio. If there is a requirement of further external financing, firms work down from safe to riskier debt. Pecking Order Theory of capital structure states that companies use internally generated funds as first priority to finance project. According to pecking order theory, firms adapt their target dividend payout ratios to their investment opportunities, but the ratios are adjusted slowly and if firms have cash requirements for investments, they will run down cash balances or sell marketable securities first (Sayilgan et al. 2006). Then as second priority, debt is used and finally option of equity exercised to finance company projects. Pecking order theory suggests that a firm's growth negatively related to its capital structure (Gill et al. 2009).

- Agency theory: Explains the relationship of principal (shareholders of the firm) with agent (managers or management of the firm) in the decision making process about the firm optimal capital structure combination (Khan 2012). It argued that managers have incentives to make investment decisions that reduce their employment risk or increase their compensation. Agency costs are the costs that arise from the principal-stakeholder relationship, such as between shareholders or managers of the firm and debt-holders. Moreover, the given incentives to the firm will benefit shareholders at the expense of debt-holders. Thus, debt- holders need to restrict and monitor the firm's behavior, thus, costly monitoring devices of contractual covenants incorporated into debt agreements to protect the debt-holders. Hence, it should increase the cost of capital offered to the firm. Therefore, firms with relatively higher agency costs due to inherent conflicts between the firm and the debt-holders should have lower levels of outside debt financing and gearing levels (Ahmad et al. 2012). The agency problem suggests a negative relationship between capital structure and a firm's growth.

- Market Timing Theory: States that firms issue equity finance to generate funds when the market prices or values of the company stocks high compared to its book value or past market values and buys back these stocks when market values are down for the company (Khan 2012).

- Transaction Cost Theory: Explains that transaction cost economies is concerned with the governance of contractual relations in transactions between two parties. Each governance structure is associated with different levels of transaction costs. These include costs arise from the setup and running costs of the governance structures, as well as other costs, such as those due to renegotiation, that arise from a shift in the alignment. Transactions costs for equity issuance are usually higher than transaction costs for debt issuance. Furthermore, it known that large firms tend to have more transactions in the stock market compared with small firms. Therefore, this theory predicts that transaction costs of large firms are more likely to be lower than transaction costs for small firms. Hence, large (small) firms expected to use more (less) equity financing than debt financing.

- Balance Theory: According to the theory of balance, the optimal capital structure is estimated based on the balance between the interests and cost of debt.

- Net Income Theory: According to this theory, the optimal capital structure achieved when there is the minimum capital cost, and this can be achieved through using debt in financing.

- Theory of Net Operating Income: Based on this belief that the profit unit cannot affect the total cost by using the financial gearing and this is due to the increase of shareholders' sensitivity to higher debt in the capital structure (Abdoli et al. 2012).

5. Corporate Governance and Capital Structure

Egypt started to give due importance to the subject of corporate governance in 2001 with an initiative taken by the Ministry of Economy and Foreign Trade (now the Ministry of Foreign Trade). The Ministry was of the opinion that the economic reform program initiated in the early 90s could only completed by installing an organizational and supervisory framework that governs the private sector performance in the context of liberalized markets.

Corporate Governance refers to the set of laws and procedures, which guide and direct the behavior of corporations, shareholders and managers, in accordance with the state policies and practices. Cheng

(2008) defined corporate governance as the rights and obligations of all participants in a company, including the managers, shareholders, board of directors, or any other party with interests involving the company, along with a set of rules/procedures laid down for a company's management-related matters.

Corporate governance entails processes and structure, which facilitate the creation of shareholder value through management of the corporate affairs in such a way that ensures the protection of the individual and collective interest of all the stakeholders. Sound corporate governance principles are the foundation upon which the trust of investors and lenders is built. Good corporate governance practices may have significant influence on the strategic decisions of a company, e.g. external financing, that are taken at board level. Therefore corporate governance variables like size of board, composition of board, skill set at board and CEO/Chair duality may have direct impact on capital structure decisions (Hasan and Butt 2009). It is important to split the activities of the Board Chairman and the CEO between different directors to obtain good corporate governance practice by avoiding a single person in the board to control the others in decision-making process so to promote fair judgment and reasonable concern (Alkdai and Hanefah 2012).

Corporate governance provides the basis for a stable and productive business environment, which protects the interests of internal and external stakeholders (Ur Rehman et al. 2010). Corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny 1997).

A prime element of corporate governance is the alignment of shareholders' interests with the interests of managers hired to run the firm. Moreover, shareholders gain from any other party's control effort (e.g., creditors) without having to contribute to incur costs. Corporate debt policy viewed as an internal control mechanism, which can reduce agency conflicts between management and shareholders, particularly the agency costs of free cash flow (Stiglbauer 2011).

Corporate governance and capital structure has succeeded in attracting a good deal of public interest because it is a tool for socio-economic development. In addition, when there is good corporate governance and capital structure, there will be proper and efficient practice in the administration of business entities. This will ultimately lead to reduction in the incidence of corporate failures, poor internal

control system, poor corporate structure and indiscipline on the part of both management and workers. Poorly governed corporations do not only pose a risk to themselves, they do to others and could indeed pull down capital market (Ganiyu and Abiodun 2012).

Corporate governance considered as having significant implications for the growth prospects of an economy, because proper corporate governance practices reduce risk for investors, attract investment capital and improve performance of companies (Spanos 2005). Effective corporate governance is the rules and practices that govern the relationship within the managers and shareholders of corporations, as well as stakeholders such as employees and creditors, which contribute to growth and financial stability by underpinning market confidence, financial market integrity and economic efficiency (OECD 2004).

The prevalent corporate governance practices in Egypt are (Nganga et al. 2003):

- Boards: Companies have a single tier Board with an odd number of directors and must have more than three members who must also be shareholders (except of up to two directors appointed as 'experts' in specific fields). Most directors tend to be insiders or family members. There are no specific rules about the split between execs and non-execs, board committees, or about the role of the Chairman/CEO (which is often the same person). Directors may only serve on a maximum of two boards (one for the managing director).
- Remuneration: The board determines compensation for the CEO. Board remuneration must disclose at the Annual General Meeting (AGM) but there is no requirement to disclose executive remuneration.
- Shareholder Rights: Companies may have multiple classes of shares and shareholders can obtain information on the rights attached to the different classes from the commercial registry or from the Companies Organization. Voting at AGMs is subject to the restriction that no 'natural' person may vote more than 10% of total shares (or 20% of shares represented at a meeting). Some capital structures allow a shareholder to exercise a degree of control over the corporation disproportionate to the shareholders' equity ownership in the company. Pyramid structures, cross shareholdings and shares with limited or multiple voting rights can

used to diminish the capability of non-controlling shareholders to influence corporate policy (OECD, 2004).

- Accounting, Audit and Disclosure: All listed companies are required to submit quarterly and annual financial statements together with a Board of Directors Report. The financial statements must be prepared under Egyptian Generally Accepted Accounting Principles (EGAAP), which closely resemble International Accounting Standards with a few exceptions. While listed companies comply with these disclosure requirements, very few voluntarily provide additional information. Independent auditors must audit annual financial statements and most large listed firms have their audit done by local affiliates of the Big Four Accounting Firms.

- Signaling: Companies with traded Global Depository Receipts (GDRs) on developed markets believed to have exemplary corporate governance standards, good disclosure, independent directors etc. These companies also typically have a large number of foreign and institutional shareholders.

6. Research Methodology

6.1 Sample and Data Collection

The data used in this research comes from the annual reports of the Egyptian stock Exchange (ESE) and a representative sample of 52 traded manufacturing firms for the period 2006-2010.

The researcher selects the manufacturing sector as, manufacturing has become the main means for developing countries to benefit from globalization and bridge the income gap with the industrialized world (Owolabi and Inyang 2012). The manufacturing sector in Egypt is one of the most powerful engines for economic growth. It acts as a catalyst to transform the economic structure of the country. The potential benefits from the sector are even greater today especially with rapid technological change, sweeping liberalization and the increased de-fragmentation and internationalization of production. Listed manufacturing firms enjoy tax exemption equivalent to the value of the paid-in capital multiplied by the interest rate, which decided by the Central Bank of Egypt every three months.

6.2 Research Variables

This research employs multivariate regression analysis in a panel data framework to measure the dependence of capital structure on value

relevance of financial performance based information, stock valuation and corporate governance variables. The panel data analysis helps to explore cross-sectional and time series data simultaneously. In addition, the panel data allows the unobservable heterogeneity for each observation in the sample to eliminate and multicollinearity among variables to alleviate. Figure (1) presents the research conceptual model used in this research.

Figure (1) Research Conceptual Model
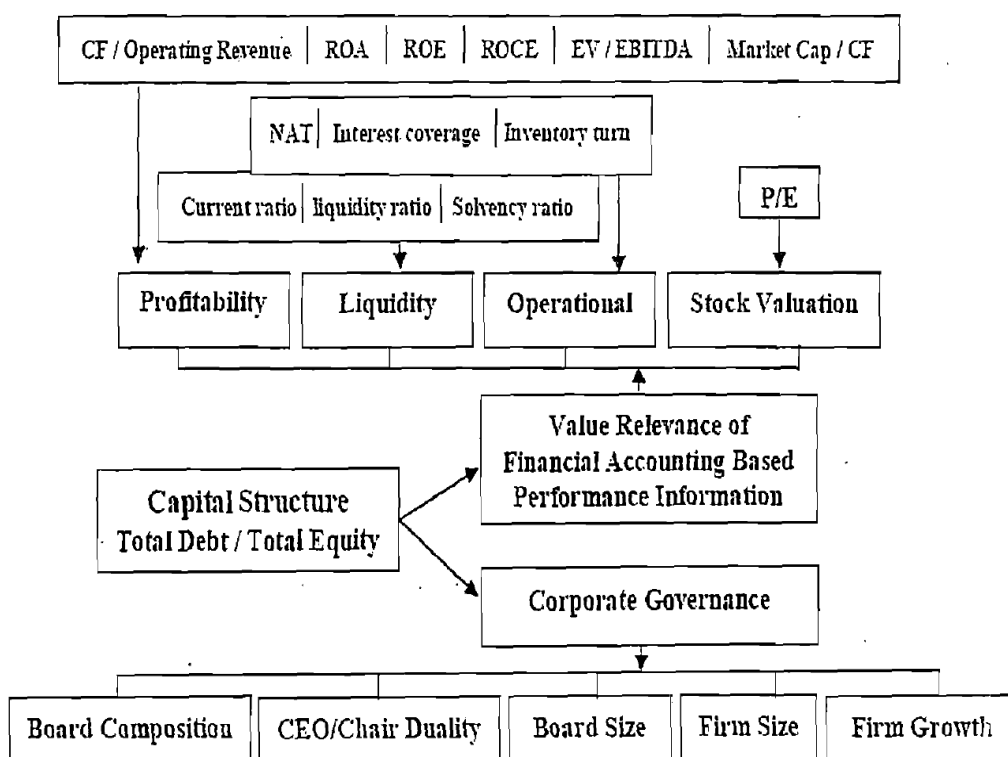
To test the first two hypotheses, the significance of value relevance of financial performance information and value of equity stock on capital structure, the multiple regression models takes the following form:

H_1: The value relevance of financial accounting organizational performance based information has a negative and significant influence on the capital structure decisions at Egyptian listed manufacturing firms.

H_2: There is a significant positive relationship between gearing ratio of the manufacturing firms and their stock valuation.

$$CS_{it} = \alpha + \beta_1 \, PRO_{it} + \beta_2 \, LIQ_{it} + \beta_3 \, OPE_{it} + \beta_4 \, SV_{it} + \varepsilon_{it}$$

Where,

CS = Capital Structure represent the dependent variable of the model.

X_1, X_2, X_3, X_4 = Profitability (PRO), Liquidity (LIQ), and Operational (OPE) ratios are used as proxies of value relevance of financial accounting performance based information, Stock Valuation (SV).

Value relevance indicates the ability of financial statement information to capture or summaries information that affects capital structure decisions.

it = i denoting the cross-sectional dimension and t representing the time series dimension.

α = Denotes the fixed effect on capital structure.

β = Coefficients of the independent variables,

ε = Random error-term.

Table (1) summarizes the list of explanatory variables examined by the first and second hypotheses in this study, the proxies used to represent them, and their expected effect on the dependant variable.

Table (1): Variables and Proxies Tested in the First and Second Hypotheses

Variable	Proxies / Ratios	Definition
Dependent Variables: Capital Structure (CS)	Gearing Ratio (Financial Leverage) (TD/TE)	Gearing ratio measured by the total debt to equity ratio (TD/TE) of the firm. The TD/TE ratio indicates whether the company is more reliant on borrowings (debt) or shareholder capital (equity) to fund assets and activities. A high TD/TE suggests that the firm uses debt financing aggressively. The fund can used to support long-term growth for the firm so it can earn profit.
Independent Variables: X_1 = Profitability (PRO)	Cash Flow / Operating Revenue	The operating cash flow-to-sales ratio indicates management's ability to turn revenue into profits and net cash flow. A high ratio usually means the company is able to turn a higher percentage of its revenue into profits and net cash flow.
	Return on Assets (ROA)	ROA is a measure of how effectively the firm's assets being used to generate profits. ROA calculated by dividing a company's net income by its total assets.
	Return on Equity	ROE is the bottom line measure for the

Variable	Proxies / Ratios	Definition
	(ROE)	shareholders, measuring the profits earned for each dollar invested in the firm's stock. ROE defined by dividing net income by shareholder equity.
	Return on Capital Employed (ROCE)	ROCE measures the profitability of a company by expressing its operating profit as a percentage of its capital employed. Capital employed is the sum of stockholders' equity and long-term finance. Alternatively, capital employed calculated as the difference between total assets and current liabilities. ROCE measured by dividing Net Operating Profit by Capital Employed. Higher value of ROCE is favorable indicating that the company generates more earnings per dollar of capital employed. A lower value of ROCE indicates lower profitability.
	Enterprise Value / Earnings Before Interest, Taxes, Depreciation and Amortization (EV/EBITDA)	EV/EBITDA is a valuation multiple used in finance and investment to measure the value of a company. It is the most widely used valuation multiple based on enterprise value and It is one of the best measures of a company's cash flow and is used for valuing both public and private companies. To compute EBITDA, use a company's income statement, take the net income and then add back interest, taxes, depreciation, amortization and any other non-cash or one-time charges. An advantage of this multiple is that it is capital structure- neutral, and, therefore, this multiple can be used to directly compare companies with different levels of debt
	Market Capitalization /	The price-to-cash-flow (P/CF) ratio equals a company's market

Variable	Proxies / Ratios	Definition
	Cash Flow from Operations (P/CF)	capitalization divided by its operating cash flow or equivalently divides the per-share stock price by the per-share operating cash flow and shows how much the market is willing to pay for each dollar of a company's operating cash flow. Market capitalization is the market value of a company's common stock. Operating cash flow is the actual cash flow a company generates from its operations, excluding depreciation and other non-cash accounting measures. Many investors and analysts favor the price-to-cash-flow ratio over other ratios because operating cash flow is less subject to accounting measures that can distort a company's true performance.
X₂ = Liquidity (LIQ)	Current Ratio (CR)	The current ratio compares a firm's current assets to its current liabilities. It is an indication of a firm's market liquidity and ability to meet creditor's demands. If current liabilities exceed current assets (the current ratio is below 1), then the company may have problems meeting its short-term obligations. If the current ratio is too high, then the company may not be efficiently using its current assets or its short-term financing facilities. This may also indicate problems in working capital management. Low values indicate that a firm may have difficulty meeting current obligations. However, it does not indicate a critical problem. If an organization has good long-term prospects, it may be able to borrow against those prospects to meet current obligations.

Variable	Proxies / Ratios	Definition
	Liquidity Ratio (LR)	Acid Test (Liquidity Ratio), a ratio used to determine the liquidity of a business entity. It expresses a company's ability to repay short-term creditors out of its total cash. The liquidity ratio is the result of dividing the liquid assets by short-term liability. It shows the number of times short-term liabilities covered by cash. If the value is greater than 1.00, it means fully covered. The higher this ratio means the greater the company's liquidity and the better able to meet current obligations using liquid assets.
	Solvency Ratio (SR)	Solvency ratios measure the ability of a company to pay its long-term debt and the interest on that debt to creditors and shareholders. These groups are interested in the long-term health and survival of business firms.
$X_3 =$ Operational (OPE)	Net Assets Turnover (NAT)	The net asset turnover ratio measures the ability of management to use the net assets of the business to generate sales revenue. It is calculated by Sales Revenue divided by Capital Employed, which gives a figure of x times. A company with significant assets but middling sales totals might be failing somewhere in an area that needs to be addressed. An extremely high turnover ratio could mean that a company is doing a poor job of investing its assets, which could lead to stagnation in the face of more aggressive competition.
	Interest Coverage (IC)	Interest Coverage (times interest earned) ratio indicates how well the firm's earnings can cover the interest payments on its debt. It calculated by dividing earnings before interest and

Variable	Proxies / Ratios	Definition
		taxes by interest charges.
	Inventory Turnover (INVT)	This ratio looks at how efficiently a company converts inventory to sales. Inventory turnover ratio calculated by dividing cost of goods sold by average inventory or net sales / average inventory. High stock turnover means increased efficiency. However, it depends on the type of business. Low inventory turnover could mean poor customer satisfaction as people might not be buying the stock.
X4 = Stock Valuation (SV)	Price Earning (P/E)	P/E calculated as the market stock price divided by the annual earning per share (EPS). The result indicates how many years it takes for dividends to return the investment (without selling). High P/E is associated with growth companies and stable financially strong companies, winning higher market prices because of the (apparent) greater security. Low P/E is associated with stable companies.

The following multiple regression model is used to test the third hypothesis, the association between the dependent variable of capital structure and the independent variables of corporate governance.

H3: The internal corporate governance has a positive and significant influence on the capital structure at Egyptian listed manufacturing firms.

$$CS_{it} = \alpha + \beta_1 \, CG_{it} + \varepsilon_{it}$$

Where,

CS = Capital Structure represent the dependent variable of the model.

CG = Corporate Governance mechanisms are used as an independent variable.

it = i denoting the cross-sectional dimension and t representing the time series dimension, the set of explanatory variables X_{it} includes Board Composition (BC), CEO/Chairman Duality, Board Size (BS), Firm Size

(FS), Firm Growth (FG) are used as proxy variables of corporate governance.

α = Denotes the fixed effect on capital structure.

β = Coefficients of the independent variables.

ε = Random error-term.

Table (2) Summarizes the list of explanatory variables examined by the third hypothesis in this study, the proxies used to represent them, and their expected effect on the dependant variable.

Table (2): Variables and Proxies Tested in the Third Hypothesis

Variable	Proxies / Ratios	Definition
Dependent Variables: Capital Structure (CS)	Gearing Ratio (Financial Leverage)	Gearing ratios measure the extent to which a company utilizes debt to finance growth. It can provide an indication of a company's long-term solvency. Whilst most financial experts acknowledge that debt is a cheaper form of financing than equity, debt carries risks and investors need to be aware of the extent of this risk.

The capital structure of a firm or more specifically the firm's debt to equity ratio provides insight into how risky a company is. Usually a company more heavily financed by debt poses greater risk, as this firm relatively highly levered. |

Variable	Proxies / Ratios	Definition
Independent Variables: Corporate Governance (CG)	Board Composition (BC)	Variable Board, composition represents the proportion of non-executive board directors. It calculated as the number of non-executive directors divided by total number of directors. Presence of non-executive directors on a. company's board gives signal to the market that company monitored efficiently so lenders consider company more credit worthy. In turn, this makes it easier for the company to raise long- term funds through debt financing. It hypothesized that higher representation of non- executive directors on board leads to higher gearing levels.
	CEO / Chair Duality	It indicates the corporate management where the chief executive officer also serves as Chairman of the board. This situation has direct impact on the financing decision of the company.
		Higher level of control by CEO may lead to managerial opportunistic behavior and can lead to lower gearing levels. It hypothesized that CEO/Chair duality negatively related to leverage levels. The variable CEO/Chair duality is included as a binary variable (=1, if CEO is Chairman of the board, otherwise, 0). If the Chairman and president's positions not separated, it is an indication of relatively poorer corporate governance and thus impact on the performance of a firm. The result shows a negative and highly significant relationship the Chairman and president being the same person and gearing. Thus, this indicates that under these circumstances, listed firms are more likely to lean towards equity financing.

Variable	Proxies / Ratios	Definition
	Board Size (BS)	The board of directors is highest body of a company that is responsible for managing the firm and its operation. It plays vital role in strategic decisions regarding financial mix. It therefore considered an important variable to study the impact of corporate governance on capital structure. The size referred to as the total number of the directors in the board. The variable board size measured as logarithm of number of board members (Log base 10). It hypothesized that larger boards have negative relationship with gearing.
	Firm Size (FS)	Firm size is one of the most common variables used in explaining a company's level of debt. It measured as Natural Logarithm of total assets (Log base 10). Firms with high levels of tangible assets provide greater protection for debt holders. Firms with greater levels of operating income or profitability are better able to service debt, and are more likely to have higher gearing ratios. Large firms generally have close links with their lenders and find it easy to arrange debt on favorable terms. Therefore, it hypothesized that there exists a positive relationship between the Size of Firm and gearing level of the firm.
	Firm Growth (FG)	Growth opportunities may consider assets that add value to a firm, but cannot collateralize and are not subject to taxable income. Growth refers to the value of a company's sales of goods and services to its customers. Even though a company's

Variable	Proxies / Ratios	Definition
		"bottom line" (its net income) gets most of the attention from investors, the "top line" is where the revenue or income process begins. In addition, in the end, a profit margin on a company's existing products tends to be eventually reaching a maximum that is difficult on which to improve. Thus, companies typically can grow no faster than their revenues. High-growth opportunities firms may find it too costly to rely on debt to finance growth and gearing expect to be negatively related to growth opportunities.

7. Results

This research uses the regression and panel data analysis to test the research hypotheses and to examine the impact of research independent variables on the capital structure using a sample of 52 Egyptian manufacturing listed firms.

The researcher runs Hausman test to differentiate between fixed effects model and random effects model in Panel data. In this case, Random effects model is preferred under the null hypothesis due to higher efficiency. Using Hausman test, the researcher selects the random effects model where the p value for the calculated chi^2 is $p > 0.05$.

The researcher runs these regression models, to test the first and the second hypotheses:

First, to examine the relationship between the profitability and capital structure, these regression models are used:

$CS_{it} = \alpha + \beta_1 PRO_{it} + \varepsilon_{it}$.. (1)

$CS_{it} = \alpha + \beta_1 CF / Oper Revenue_{it} + \beta_2 ROA_{it} + \beta_3 ROEE_{it} + \beta_4 EV / EBITDA_{it} + \beta_5 Market Cap / CF_{it} + \varepsilon_{it}$
(2)

Regarding the effects of profitability on the financial leverage ratio of the firms, the results of the panel data analysis presented in table (3), indicates that there are negative relationship between CF / Oper Revenue,

ROA, ROCE, Market Cap / CF and capital structure, and a positive relationship between ROE, EV / EBITDA and capital structure.

The F- test = 0.0021 shows that there is a significant relation between profitability levels and gearing levels. However, all variables are statistically insignificant in influencing financial gearing except CF / Oper Revenue and EV / EBITDA.

Table (3) Regression Model - Impact of Profitability on Capital Structure

Model	Un-standardized Coefficients		Sig.
	B	**Std. Error**	
Constant	62.680	24.799	0.013
CF / Oper Revenue	-0.237	0.101	0.022
ROA	-2.507	3.649	0.494
ROE	0.271	1.325	0.838
ROCE	-0.200	2.067	0.923
EV/EBITDA	2.055	0.902	0.025
Market Cap / CF	-0.354	0.873	0.675
R-square 0.0464 F-statistics 0.0021 Significant at $p < 0.05$			

Second, to examine the relationship between the liquidity and capital structure, these regression models are used:

$CS_{it} = \alpha + \beta_1 LIQ_{it} + \varepsilon_{it}$ ………..(1)

$CS_{it} = \alpha + \beta_1 CR_{it} + \beta_2 LR_{it} + \beta_3 SR_{it} + \varepsilon_{it}$…….(2)

The findings of the panel data analysis presented in table (4), shows that there is a negative relationship between the current and solvency ratios and financial gearing, and a positive relationship between liquidity levels

and financial gearing measured by TD / TE. However, all variables are statistically insignificant in influencing financial gearing.

Table (4) Regression Model - Impact of Liquidity on Capital Structure

Model	Un-standardized Coefficients		Sig.
	B	**Std. Error**	
Constant	111.722	22.603	0.000
CR	-41.390	29.530	0.161
LR	22.364	35.511	0.529
SR	-0.223	0.182	0.222

R-square 0.0612

F-statistics 0.0029

Significant at $p < 0.05$

Third, to examine the relationship between the operational performance and capital structure, these regression models are used:

$CS_{it} = \alpha + \beta_1 \, OPER_{it} + \varepsilon_{it}$ ………….. (1)

$CS_{it} = \alpha + \beta_1 \, NAT_{it} + \beta_2 \, \text{Interest Cover}_{it} + \beta_3 \, \text{Inventory Turn}_{it} + \varepsilon_{it}$ ……(2)

The results of the panel data analysis presented in table (5), indicates that there are negative non-significant relationship between the operational performance and gearing levels measured by TD / TE.

Table (5) Regression Model - Impact of Operational Performance on Capital Structure

Model	Un-standardized Coefficients		Sig.
	B	**Std. Error**	
Constant	83.953	19.018	0.000
NAT	-13.010	8.004	0.104
IC	-0.048	0.118	0.681
INVT	-1.370	1.602	0.392

R-square 0.0250

F-statistics 0.0025

Significant at p < 0.05

Fourth, to examine the relationship between the stock valuation and capital structure, this regression model is used:

$$CS_{it} = \alpha + \beta_1 \, P/E_{it} + \varepsilon_{it}$$

The results of the panel data analysis presented in table (6), indicates that there are positive significant relationship between the price/earnings and gearing levels measured by TD / TE.

Table (6) Regression Model - Impact of Stock Valuation on Capital Structure

Model	Un-standardized Coefficients		Sig.
	B	**Std. Error**	
Constant	46.745	12.464	0.000
P/E	0.316	0.155	0.042

R-square 0.0375

F-statistics 0.0038

Significant at p < 0.05

The researcher runs these regression models, to test the third hypothesis:

$CS_{it} = \alpha + \beta_1 BC_{it} + + \beta_2 CEO/Chairman\ Duality_{it} + \beta_3 BS_{it} + \beta_4 FS_{it} + \beta_5 GRO_{it} + \varepsilon_{it}$

This research analyzed the effect of Board composition, CEO / Chairman Duality, Board size, Firm size and Firm growth on firm financial gearing measures by TD / TE, the R-Square results shown in table (7) indicates a very weak relationship between corporate governance and capital structure (0.0017). The results of test indicated that there is a no relationship between board composition and CEO duality to debt to equity ratio and thus it should drop from the model. However, it indicated that there is no significant positive relationship between board sizes to firm financial gearing.

The model shows a positive significant relationship between firm size and capital structure, a negative significant relationship between firm growth and capital structure ($\alpha = 5\%$), and a negative non-significant relationship between board size and capital structure. Aggregate ANOVA F statistic of 0.0001 is significant with a P-value > 0.05.

Table (7) Regression Model - Impact of Corporate Governance on Capital Structure

Model	Un-standardized Coefficients		Sig.
	B	**Std. Error**	
Constant	1768.341	2935.284	0.548
BC	Dropped		
CEO/chairman Duality	Dropped	3311.98	0.538
BS	2044.706	70.649	0.000
FS	318.357	75.904	0.000
FG	-311.125		
R-square 0.0017			
F-statistics 0.0001			
Significant at p < 0.05			

Generally, the results shows that all research models used in this study have significant aggregate F statistic with F-Stats probability at significance level of 95%. The statistical analysis shows that tested independent variables CF / Oper Revenue, EV / EBITDA (measuring profitability), P/E, Firm size and Firm growth have significant effect on dependent variable (capital structure).

The value of R^2 calculated for all regression models used in this study shows that the level of capital structure not affected by independent variables tested in this research. In other words, the financial performance indicated by liquidity and operational performance and also corporate governance do not impact the firm financial leverage as it is influenced more by other factors,

However, control variables firm size and firm growth found to have a significant effect on capital structure. Therefore, results suggest that corporate governance variables do not play important role in determination of financial mix of the firms.

Findings of our study suggest that capital structure of firms insignificantly affected by their financial performance and their relationship is negative in nature. Moreover, capital structure of a firm measured by debt to equity ratio significantly positively related to its P/E.

8. Conclusion

Firm financing considered as an important issue manager's face. This research investigates the effect of financial performance and corporate governance on capital structure of the Egyptian manufacturing firms listed in Egyptian stock market. The researcher used multiple regression model and the panel data analysis as a technique to examine what is the effect of independent variables on the firm financial gearing by applying on 52 manufacturing firms for the period (2006-2010). The results concluded that firm performance associated negatively and statistically with capital structure on the study sample generally. Findings show that, at Egyptian listed manufacturing companies, the value relevance of organizational performance and corporate governance both have insignificant interactive influence on the capital structure. The results shows that profitability and operational performance has a negative insignificant relationship with capital structure, while liquidity and stock valuation has a positive relationship with firm financial leverage, price/earning has significant impact to the capital structure. Generally, this research found out that there was weak to no significant

difference to the impact of the firm performance and corporate governance on financial gearing.

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