



The Mediating Effect of CEO Power on Creditor Rights and Capital Structure among Firms Listed in Nairobi Securities Exchange

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Abstract

Capital is an important component of all types of business activities, which are determined by the size and nature of the company. Various sources of capital can be used to raise funds. The company is expected to earn high profits and be able to pay out more dividends to its shareholders if it maintains a sufficient and adequate level of capital. Firms confront difficulties in determining the appropriate combination of equity and debt that optimizes the advantages of debt while limiting the costs of debt that could put them in financial crisis. Despite extensive study, the expected impact of CEO domination on the relationship between creditor rights and capital structure has received little consideration. To solve this problem, the study sought to establish the effect of creditor rights on capital structure mediated by CEO power. The study aimed at determining the effect of creditor rights on capital structure, establish the effect of CEO power on capital structure and find out the mediating effect of CEO power on the relationship between creditor power and capital structure. A panel data and explanatory research design were used to conduct a survey of all the firms listed at Nairobi securities exchange. The total number of registered firms at NSE were 67 which made up the study population. The study focused on 40 firms that met the inclusion exclusion criterion over the period 2008-2020. This gave a total of 520 firm year observations. The study analyzed data obtained from secondary sources using a data analysis schedule. The study found that an increase in creditor rights, CEO power leads to firms borrowing more to finance their investments and assets. Also, there was partial mediation relationship between the creditor rights relationship and capital structure. The study concluded that creditor rights and CEO power had a positive and significant effect on capital structure and that, increase in these variables significantly increased debt ratio. The mediating effect showed a partial mediation and reduction in the relationship between creditor rights and capital structure.

Keywords: Creditor Rights, CEO Power and Capital Structure.

INTRODUCTION

Deciding the optimal capital structure is the important decision of the financial management because it is closely related to the value of the firm. According to (Babalola, 2012), marginal bankruptcy costs connected with a firm's debt are equivalent with marginal tax advantages at the optimal capital structure. Firms seek the best capital structure possible based on tax

benefits and financial crisis risks. Firms are regarded to strive for their goal and might change their structure to signify their future prospects. Increasing debt levels boosts a company's worth by giving the market the impression of greater tax benefits or reduced bankruptcy expenses. However, the best capital structure for a 100% debt financing is clearly incompatible with current capital structures.

Corporate capital formation is linked to access to financial capital and cost of capital drivers, according to (Robb and Morelix, 2016), which can have a detrimental influence on profitability. (Sosnovska and Zhytar, 2018), ensuring firms' financial security is a precondition for assuring their long-term operation and the construction of competitive development criteria in both the internal and external market environments. Building a high-quality financial architecture as the main structural element of the company's financial system is critical to the process's effectiveness. The company determines the proportion of equity and debt to total capital based on its financial position and ability to raise such capital. Instead of financing growth, equity issues in emerging markets may be used to recapitalize existing assets through debt restructuring or control transfers (Kim et al., 2019). Equity ratio, debt ratio, and solvability are the most important capital structure indicators. These ratios define the amount of stock and debt used to finance a company's assets, as well as the company's ability to repay its debt. Larger organizations and those with more fixed asset investments use more debt financing, whereas profitable companies and those with more tangible assets use less (Arsov and Naumoski, 2016).

The capital structure and impacts of financial leverage in so-called transition economies are still a hot topic. This problem manifests itself differently in each country, depending on a variety of factors. The completion of the privatization process, the progress made in capital market growth, the availability of diverse financing sources, the level of investor protection, legal stability, and managerial quality are the most crucial. Depending on the country, each of these characteristics may have varying degrees of impact on specific businesses. (Sekar et al., 2014) determined that a low debt-to-equity ratio indicates a low level of debt in the capital structure, which leads to a reduction in owner funds and confidence since the risk to equity holders increases as the number of loans increases. Also, a company's ROE, ROI, and EPS are negatively correlated with its ROE, debt, and equity, and the value of the company is favorably correlated with its ROE, debt, and equity. Finally, the study found that a company's value rises as a result of a well-balanced capital structure, as evidenced by its EBIT and low cost of capital.

When long-term debt is substituted by short-term debt during a financial crisis, corporate leverage rises. In times of financial crisis, a maturity debt profile heavily dependent on short-term issuances indicates greater financial difficulties at the business level, as the firm is more exposed to rollover risk (Alves and Francisco, 2015). Leverage ratios rise with firm size and fall with profitability, however there is no correlation between tangibility, growth potential, business risk, and leverage ratios. As a result, business size and profitability are important factors in capital structure (Thippayana, 2014).

Stronger creditor rights might have negative consequences for highly leveraged enterprises, according to (El Ghoul et al. 2018) paper on Creditor Rights and the Costs of High Leverage. High debt combined with strong creditor rights inhibits sales growth because the possibility of creditors liquidating the company prematurely raises the prevalence of both protective and predatory customer actions. Furthermore, excessive leverage combined with strong creditor rights may make it more difficult for businesses to attract and retain staff.

CEOs may use sub-optimal levels of leverage to enrich themselves at the expense of shareholders. Leverage is viewed unfavorably by powerful CEOs, who avoid taking on excessive debt. CEOs, on the other hand, seem to use sub-optimal leverage only when their

power is sufficiently concentrated. CEOs that are relatively weak do not appear to avoid using leverage. As a result, the impact of CEO power on capital structure decisions is not uniform. Only when managers have enough power in the organization do agency issues lead to self-serving behavior (Chintrakarn et al., 2014).

(Munir et al., 2017) have published their empirical findings on powerful CEOs, loan financing, and leasing in Chinese SMEs: The CEO power debt relationship and the CEO power-operating lease relationship have threshold effects, according to evidence from the threshold model. When CEO power index falls below a particular threshold, firms utilize more debt financing (and operating leasing); when it rises beyond that barrier, CEOs manipulate the capital structure to pursue their own interests, utilizing less debt financing and operating leasing. Their findings also reveal a positive association between debt and operational leases when CEO power is below a particular threshold, but a negative relationship when the power index surpasses that level.

Objectives of the Study

1. To determine the effect of creditor rights on capital structure
2. To establish the effect of CEO power on capital structure
3. To find out the mediating effect of CEO power on the relationship between creditor rights and capital structure

Study Hypotheses

H₀₁: creditor rights have no significant effect on capital structure

H₀₂: CEO power has no significant effect on capital structure

H₀₃: CEO power does not mediate the relationship between creditor rights and capital structure

Scope of the Study

The study sought to look at the effect of creditor rights on capital structure mediated by CEO power. The study focused on Kenyan listed firms at Nairobi securities exchange that have been in operation from 2008-2020 periods. The target population for the study was 67 listed firms in Nairobi securities exchange and 40 firms were surveyed, that were in operation for the period. The study gathered secondary data from these companies audited financial accounts over the time period. Panel and explanatory approach were used as the research design.

THEORETICAL REVIEW

The following theories will be employed to support the research. Some theories that have been proposed include agency theory, stakeholder theory, and pecking order theory.

The Pecking Order Theory

The Pecking Order Model was developed by Myers et al. (1984). The pecking order hypothesis states that there is no desirable capital structure. According to their approach, retained earnings are preferable to debt, while debt is preferable to equity. If a company needs external capital, it prefers debt to equity, and equity is only used as a last resort. Managers (insiders) and investors, according to Myers and Majluf (1984), have asymmetric information (outsiders). The capital structure variable in the study was influenced by this idea.

The Stakeholder Theory

The Stakeholder Theory of organizational management and business ethics, which tackles morals and values in managing a company, was first described by Edward Freeman in 1984. According to the principle, a company should generate value for all parties involved, not just shareholders. The theory defines and models the groups that make up a corporation's

stakeholders and describes and suggests ways that management might take into account those groups' interests. The creditor rights in the study were informed by this theory.

Agency Theory

Agency theory was developed by Jensen and Meckling (1976). Agency theory is concerned with the conflicting interests of principals and agents. Agency theory holds a central role in the corporate governance literature. When self-interested managers and owners control a business but bear the majority of the wealth impacts, a fundamental tension between them arises. Each of these groups has different interests and objectives. This theory informed the CEO dominance variable in the study.

EMPIRICAL REVIEW

The existence of growth opportunities places greater demand of funds. If the internal funds are not sufficient, firms resort to external finance including debt. A majority of empirical evidence argues that firms in developed countries prefer long term debt, which could be due to developed capital market. The result also depicts that to a certain extent, capital structure theory is portable across countries. This is because there are those factors like profitability and size that have been found to be significantly across developed countries. (Goh et al., 2017) the use of equity (versus debt) increases with the level of conservatism when firms raise a significant amount of external financing. The reduction in the cost of equity associated with conservatism is greater for large equity issuers than for large debt issuers, but do not find an analogous difference when we examine the cost of debt. In addition, the association between conservatism and the issuance of equity (versus debt) is stronger when there is greater information asymmetry between firms and shareholders.

Lau et al. (2016) under cash-flow existence leverage is deemed counterproductive. The cash-flow implications are supported by conventional capital structure theories. The tradeoff theory implies that volatility of cash flow tends to affect the financial distress cost, which would make firms reluctant to borrow. Firms with higher cash flow volatility have higher debt levels and this positive link is only for firms with the weakest financial performance as measured by operating cash flow (Harris and Roark, 2019). Signaling theory implies that firms with higher cash flow signal their performance with a higher leverage. The pecking order theory proposes a negative relationship in which firms with higher internally generated cash flow require less borrowing. Free cash flow, however, frequently implies low growth opportunities and hence higher over-investment problems. The theory of the agency, implies that debt can be used for firms with excess free cash flow but with low growth opportunities to monitor the agency relationship between managers and shareholders. Cash flows is particularly relevant because cash flow is a resource that involves low transaction costs (Dufour et al., 2018).

Lewis and Tan (2016) while managers depend on their information advantages to time the market, future stock return also reflect the realization of news that managers cannot forecast ex ante. Thus, tests based solely on future stock return may not have sufficient power to detect managerial attempts to time the market. In addition, certain firm characteristics may affect both debt-equity choices and future stock return. We find managers issue more equity relative to debt when analysts are relatively optimistic about their firms' long-term growth prospects. At subsequent earnings announcements, equity issuers earn lower returns than debt issuers as the debt-equity timing hypothesis predicts. (Antwi et al., 2012) the result of the study reveals that in an emerging economy, equity capital as a component of capital structure is relevant to the value of a firm, and Long-term-debt was also found to be the major determinant of a firm's value. Following from the findings of this study, corporate financial decision makers are advised to employ more of long-term-debt than equity capital in financing their operations since it impacts more on a firm's value.

Sundareshan et al. (2015) showed that financing and anticipated endogenous default decisions have significant implications of firms' growth-option exercising decisions and leverage policies. The firm's ability to use risky debt to borrow against its assets in place and growth options substantially influences its investment strategies and its value. Quantitatively, they found that the firm consistently chooses conservative leverage in line with empirical evidence in order to mitigate the debt-overhang effect on the exercising decisions for future growth options. Finally, they found that debt seniority and debt priority structures have both conceptually important and quantitatively significant implications on growth-option exercising and leverage decisions as different debt structures have very different debt-overhang implications.

Cronqvist et al. (2012) found that firms behave consistently with how their CEOs behave personally in the context of leverage choices. Analyzing data on CEOs' leverage, we find a positive, economically relevant, robust relation between corporate and personal leverage in the cross-section and when examining CEO turnovers. The results were consistent with an endogenous matching of CEOs to firms based on preferences, as well as with CEOs imprinting their personal preferences on the firms they manage, particularly when governance is weaker. CEOs' personal behavior can, in part, explain corporate financial behavior of the firms they manage.

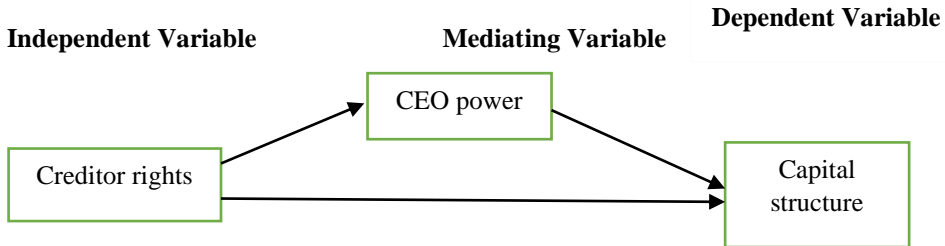
Ozdagli (2012) showed that tax deductibility of interest payments increases effective investment irreversibility and that investment irreversibility weakens the relation between book-to-market values and returns. This provides a clear and novel mechanism showing how financial leverage affects stock returns beyond the standard Modigliani-Miller paradigm. The article argues that market leverage, rather than operating leverage or investment irreversibility, explains a major portion of the value premium. (Cho et al., 2014) using firm-level data from 51 countries, they documented evidence that creditor protection is an important country-level determinant of corporate capital structure. Also found that under strong creditor protection, firms tend to substitute safe capital (i.e., shareholders' equity) for long-term debt.

Manufacturing companies that avoid borrowing money and keep a high amount of equity in their capital mix are more profitable. The real-estate sector relies heavily on equity finance to raise funds (Effendi, 2018). Total debt and short-term debt have negative associations with ROA and ROE, whereas shareholders' equity has a favorable impact on performance measures. Companies with a high proportion of fixed assets earn less money. According to the survey, manufacturing organizations either do not efficiently use their assets or do not have adequate internal funding to make lucrative investments. Taxes have a favorable impact on performance measures, according to this study. Companies in the manufacturing sector were more profitable when faced with a tax burden, owing to better resource allocation. Inflation, too, had a positive impact on ROA (Vätavu, 2015). Companies sell their assets when inflation is high. High inflation causes businesses to sell off part of their fixed assets, resulting in lower expenses and higher profits. Companies with higher equity ratios and less fixed assets are more lucrative when taxes are high. Finally, the study concludes that businesses only employ debt when they are in financial trouble, face substantial business risks, or are unable to settle owing to a cash shortage. A dynamic revision of the debt ratio in response to a tax cut is predicted by standard capital structure trade-off theory. Neither Corporate Tax nor Inflation Rate have a substantial impact on the Financial Capital Structure, according to (Nasution et al., 2017).

Financial leverage is higher in companies that engage in higher earnings management operations. High debt would increase the likelihood of poor earnings management (Alzoubi, 2018). As the firm's earnings management reflects the agency conflicts between insider

managers and outside investors, debt lowers the agency cost of free flow. In countries with better institutional environments, the link between earnings management and financial leverage is also much less prominent. When it comes to resolving agency conflicts, investors in nations with robust institutional environments rely more on free macro-level institutional arrangements than on debt (An et al., 2016).

CONCEPTUAL FRAMEWORK



Source: Researcher 2022

METHODOLOGY

This study was based on positivism research philosophy since, the study sought to investigate the effect of creditor rights on capital structure mediated by CEO power among Kenyan listed companies which relates to the philosophical stance of the natural scientist and entails working with an observable social reality to produce law-like generalizations. This study adopted panel and explanatory research designs. The study measurements were taken on each variable over 13 year's periods (2008-2020). The target population comprised of 67 firms that are listed in Nairobi securities exchange over the period between 2008 and 2020. The study's inclusion exclusion criteria focused on firms which were in operation within the 2008-2020 period. 27 firms were eliminated because they failed to meet the criteria. As a result, the final sample surveyed consisted of a balanced panel of 40 firms over a period of 13 years. Therefore, there was 520 firm-year observations for the firms listed in NSE. Secondary data was used in the study. Capital structure was measured using debt ratio (Daher, 2017), (Salim and Yadav, 2012) and (Vätavu, 2015). Debt ratio is defined as book debt scaled by total assets, where book debt is calculated as the sum of short-term debt and long-term debt. This study measured creditor rights using net debt issuance defined as the difference between book debt at year t and book debt at year t-1 scaled by total assets (Daher, 2017) and (Lu and Abeysekera, 2014). This study adopted (Brown and Sarma, 2007) measure of CEO power using CEO compensation package, calculated as the natural logarithm of the ratio of CEO total annual remuneration to the firm's total assets. CEO remuneration is calculated as the base salary + directors' fees + performance bonuses + allowances and non-cash benefits. Total assets are a measure of the size of the firm.

RESULTS

The main study objective was to determine the effect of creditor rights on capital structure mediated by CEO power among firms listed at the Nairobi securities exchange. The study research hypotheses were: creditor rights and CEO power have no significant effect on capital structure and that CEO dominance does not mediate on the relationship between creditor rights and capital structure. The study used the fixed effects model to run regression analysis.

Table 1: Summary of Fixed Effects Regression Results

Variable	Estimate	Std. Error	t-value	p-value
Creditor rights	0.34255	0.018087	18.9393	0.000***
CEO power	0.000033343	0.000010306	3.2352	0.001**
Average causal mediation effect	0.006547			0.022*
Average direct effect	0.348135			0.000***
Total effect	0.354682			0.000***
Prop. mediated	0.017737			0.022*

Table 1 showed that creditor power had a positive and significant effect on capital structure ($\beta=0.34255$, $p=0.000$) showing that a unit change in creditor power increases debt by 0.34255 and the p-value was less than 0.05 indicating that creditor power significantly affects debt ratio. This agreed with the findings of (El Ghoul, Guedhami et al. 2021) which found that Strong creditor protection helps less leveraged businesses, but it hurts highly leveraged businesses by raising negative responses from consumers, competitors, and staff. Creditor rights have a greater negative impact on high-leverage costs in nations with developed debt markets and banking systems, but are largely inconsequential in countries with developed stock markets and low information asymmetry but inconsistent with the findings of (Singh et al., 2021) which found that strengthening creditors' rights had a negative impact on debt ratio and debt heterogeneity, but a good impact on long-term debt maturity structure.

CEO dominance had a positive and significant effect on capital structure ($\beta=0.000033343$, $p=0.001$) indicating that a unit change in CEO dominance leads to debt increase by 0.000033343, and the p-value was less than 0.05 showing that CEO dominance significantly affects debt ratio. The results agreed with the findings of (Bhagat et al., 2011) which indicated that managerial discretion and manager-specific qualities are major predictors of financial policies in businesses and (John and Litov, 2010) that firms with entrenched managers use more debt finance and have greater leverage ratios.

Table 1 also presents the mediation results on the effect of creditor rights on capital structure mediated by CEO power. The table showed that the average causal mediation effect (ACME) was positive and significant ($\beta= 0.007$, 95% CI= 0.000678, 0.01, $P=0.022$) indicating that a unit change in the entire indirect effect of creditor rights increases debt ratio by 0.007. The 95% confidence interval showed that 0.007 was within 0.000678 and 0.01 indicating that there was a partial mediation, with 95% certainty. The p-value was less than 0.05 reporting that the entire indirect effect of creditor rights affects capital structure. This was contrary to the findings of (Boubakri and Ghouma, 2010) that when there is poor creditor rights, debt covenants have a negative influence on loan costs.

The average direct effects (ADE) showed a positive and significant effect on capital structure ($\beta=0.35$, $p=0.000$) indicating that a unit change in average direct effects of creditor rights increases debt ratio by 0.35. The p-value was less than 0.05 reporting that the average direct effects of creditor rights affect capital structure.

The total effect showed a positive and significant effect on capital structure. This showed that the summation of direct and indirect effects of creditor rights have a positive and significant effect on capital structure ($\beta=0.35$, $p=0.000$) indicating that a unit change in the total effects of creditor power increases debt ratio by 0.35. The p-value was less than 0.05 meaning that the total effects of creditor rights affect capital structure.

The proportion of the effect of the creditor rights on capital structure that goes through CEO dominance was positive and significant ($\beta=0.02$, $p=0.022$) indicating that a unit change in the proportion increases debt by 0.02. The p-value was less than 0.05 meaning that the proposal affects capital structure.

CONCLUSION

According to the study, the capital structure was directly impacted by creditor rights. When the creditor right is disproportionately great, the debt ratio rises, which means that Nairobi Securities Exchange-listed companies utilize more debt than equity to finance actual investment. When there are inadequate finances within the company, firms registered on the Nairobi Securities Exchange use debt more frequently than equity to fund its assets each year. This supports the pecking order theory, according to which corporations use retained earnings to finance investments and turn to debt as a last resort before turning to equity in the event of a deficit. Also, when creditor rights are considerably high and goes via CEO dominance, it significantly increases its effects, resulting in a significantly increased debt ratio. This means that firms issue less equity than borrowing when creditor rights go through CEO power. The study recommends that the same research could be carried out among other firms not listed at the Nairobi securities exchange. The study can be carried out among unlisted firms and also among firms listed on other securities exchanges. The study found contradictory results compared to findings of other studies on the areas of CEO power. The study recommends that the same study be carried out, especially focusing on the CEO but with different statistical powers or measurements.

Conflict of Interest

The authors declare no conflict of interest.

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