

IMPACT OF GEARING ON PERFORMANCE OF COMPANIES

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Abstract

This study, impact of gearing on performance of companies, was carried out to ascertain the role gearing plays in the performances of some selected companies in Nigeria. A survey research design was adopted in which twenty workers of selected manufacturing companies were used and data were collected using questionnaire. Three research hypotheses were raised and tested; while the demographic information of the respondents were analysed using simple percentage, the hypotheses were tested using t-test statistic at a significant level of 5%. The testing of the hypotheses revealed that: efficiently managed gearing could lead to increase in earnings of the company; gearing is important for a company to stand the test of time in a competitive market; gearing has direct relationship with the performance of a company. Based on the findings and the fact that gearing provides some financial advantages with positive impact on profitability, it was recommended that companies should employ competent professional to take charge of monitoring all long term financing that the company utilize, such officer should be mindful of the risk involved in this source of finance.

Key words: gearing, long term finance, debt, security, capital structure.

1.1 Introduction

Every business set up, whether sole trading, partnership or even limited liability companies have a way by which it is financed by the owners. The various sources of financing an organization are described as its capital structure. This structure can be in form of share capital and reserve, regarded as shareholders' funds and the long term debts, which we regard as gearing or leverage. The latter source, gearing, is the focus of this study and is considered as a measure of financial leverage that demonstrates the degree to which a firm's activities are funded by owners' funding against external funding. This demonstration is regarded as gearing ratio which indicates the extent of financial risk borne by long term debt holders and equity holders and expressed as the relationship between fixed interest capital and ordinary share capital. The fixed interest capital comprises of all capital with fixed coupon rate, such as, preference shares (all form except participatory preference share excluding the extent by which the holders partake in the share of ordinary dividend) and all creditors falling due after more than one year as loans, debentures, mortgage, bonds etc. If the relationship is high, this

means that the company is highly geared and results in the company being controlled by external owners, if on the other hand, it is low, it means that the company has the greater control by the insider, which is better for the company. Nonetheless, because of the advantages accruing to company using debt financing, it is advocated that companies should endeavour to mix their structures by using both debts and equity in their project financing, whichever of the funding that is used in greater proportion will determine who has the higher claim in the business. As posited by **Pandy (2010)**, investment projects of a firm can be financed either by increasing the owners' claims or the creditors' claims or both. The owners' claims increase when the firm raised funds by issuing common stocks or by retaining the earnings and the creditors' claims increase by borrowings.

Gearing has been variously measured by different authors through their different definitions, virtually all of them view gearing as the relationship between fixed interest capital and ordinary share capital but in different ways. Some describe the fixed interest capital as aggregate fixed return capital which includes preference shares and long term loans, some authors argued that bank loans and overdraft which normally command fixed interest rate of return should be included in the computation. **Ola (1985)** agreed that gearing should be the relationship between ordinary share capital and securities creating fixed interest or dividend charges on income which has an effect on the attitude of prospective ordinary shareholders. **Inanga (1985)** is also in agreement with the fact that gearing measures the relationship between long term debt and equity in a company's total capital financing. **Olowe (1997)** in his own contribution viewed leverage from its advantageous perspective when he described leverage as an increased means of achieving profits in a business.

1.2 Literature Review

As earlier stated, there is risk involved in using debt financing such risk is described as financial risk. Financial risk is the risk associated with the introduction of debt in capital structure of a firm; this risk can be used to assess both the business and financial structure of a firm and is viewed from three perspectives: operating leverage; financial leverage and combined leverage

1.21 Conceptual framework

1.211 Operating Leverage

This is the impact of a change in revenue on profit of a firm. Put in another way, it arises from a situation where a firm increases its revenue from sale without proportionate increase in operating expenses. As opined by **Solomon and Pringle (1978)**, variability of EBIT has two components of sales and expenses. Operating leverage is the measurement of the degree to which a firm incurs a combination of fixed and variable costs. Specifically, a firm that makes few sales, with each sales providing a very high gross margin is highly leveraged, but a firm making huge sales with each contributing a very short margin is less leveraged: as the volume of sales increases, each sale contributes less to fixed costs and more profitable; whereas firm with higher proportion of fixed costs and a lower proportion of variable costs is using more operating leverages. In other words, a firm, having high degree of operating leverage, will also have higher breakeven point since it must make sufficient contribution to cover fixed cost before there can be any profit. If the degree of operating leverage is low, the breakeven point will also be

low and the resulting profitability will be high. A small drop in sales in a highly operating leverage firm may translate to erosion of profit earlier reported, therefore a high operating leverage firm is a high business risk situation, firm therefore prefer to operate sufficiently above the breakeven point to avoid the danger of fluctuation in sales and profits. The degree of operating leverage is measured as the proportionate changes in sales as:

$$\text{DOPL} = \frac{\% \Delta \text{ in PBIT}}{\% \Delta \text{ in Sales}}$$

Where DOPL = Degree of operating leverage
 Δ in PBIT = changes in Profit before Interest and Tax
 $\% \Delta$ in Sales = changes in Sales

1.212 Financial leverage

Bierman and Smidt (1975) are of the opinion that financial leverage reflects the amount of debt used in the capital structure of the firm because debt carries a fixed obligation of interest payments; we have the opportunity to greatly magnify our results at various levels of operations. In measuring the degree of financial leverage (DOFL) **Weston and Brigham (1975)** takes DOFL as the percentage change in earnings available to common stockholders associated with a given percentage change in earnings before interest and taxes. In another study conducted by **Brigham (1979)** DOFL was defined as percentage change in earning per share (EPS) that results from a given percentage change in earnings before interest and tax (EBIT) or

$$\text{DOFL} = \frac{\% \Delta \text{ in EPS}}{\% \Delta \text{ in EBIT}}$$

Whereas the normal gearing ratio is described as the direct relationship between fixed interest capital and ordinary share capital, financial leverage views gearing from market perspective by describing gearing as:

$$\text{Gearing} = \frac{\text{Market value of (debt + Preference share)}}{\text{Market value of equity}}$$

It must however be pointed out, at this juncture, that financial leverage creates financial risk for the firm and the shareholders. For the firm, a highly levered firm that cannot pay its debt might be forced into liquidation. For ordinary shareholders, if the firm is financially levered, it needs to make sufficient profits before interest and tax to pay its interest charges before its shareholders can be paid dividend; this means that if the interest charges is high and the profit is low, there is a tendency that ordinary shareholders would have nothing to take as dividend. Therefore a high financial leverage is risky to both the firm and the ordinary shareholders

1.213 Combined leverage

This combines the effect of business and financial risk. The degree of operating leverage and financial leverage can be combined to show the total leverage effect for a given change in sale on earnings available to ordinary shareholders. Combined leverage indicates leverage benefits and risks which are in fixed quantity. Firms in competition choose high level of degree of combined leverage whereas conservative firms choose lower level of degree of combined leverage. It is defined as:

$$\begin{aligned} \text{DOCL} &= \text{DOPL} \times \text{DOFL} \\ \text{where DOCL} &= \text{degree of combined leverage} \\ \text{DOPL} &= \text{degree of operating leverage} \\ \text{DOFL} &= \text{degree of financial leverage} \end{aligned}$$

1.214 Importance of Gearing

For a firm to remain in business for long, it has to use mixed capital. Nevertheless, debt capital has to be used reasonably as highly geared firm has a large amount of interest to pay annually, if that fixed capital is predominant debt with low level of preference share, and if those borrowings are secured in anyway (as is usual with debenture), then the holders of the debt are perfectly entitled to force the firm to realise the assets to pay their interest, if there is no other source of funding the interest payment. The more highly geared a firm is, the more likely this occurs when and if profit falls, **Briston (1981)**

To an investor, gearing indicates the amount of risk which might exist to the income that would be available to both shareholder and loan holders as well as their capital investment. It is thus a means of raising new funds through extra borrowing.

Gearing ratio is an important measure of stability of a company as it is considered when raising external capital. If the company is already highly geared, it might find it extremely difficult to raise additional fund as would-be lender may take a closer look at its structure and believe that the company might not be able to settle the debts as at when due as it is already exposed to so many creditors. The effect of having excess gearing is that such company would have to accumulate higher amount of profit before interest and tax to be able to meet demand for interest payment.

1.215 Cost of Capital

There is no way one is talking about gearing and not mentioning cost of capital. This is very important as cost of capital is a determinant factor to be considered while discussing value placed on a firm as we are going to see under theoretical framework in the next section.

Pandy (2010) defined cost of capital as the rate of return required on the aggregate of investment projects. It determines how a company can raise money through a stock issue, borrowing or a mix of the two.

As far as shareholders are concerned, it is the required return on a portfolio of all the company's existing securities and it is used to evaluate new projects, as it is regarded as the minimum return that investors expect for providing capital to the company or a benchmark to evaluate a new project. It is erroneously believed that equity capital is free of cost; this is with the assertion that firms are not legally compelled to pay dividend to ordinary shareholders. Another reason is that, unlike the interest payment and preference dividends that are fixed and legally to be paid to both the loan holders and preference shareholders, ordinary shareholders invest their money in common stocks with an expectation to receive dividends. It is just a mere expectation; no law binds the company to pay it when there is no profit unlike under the debt capital.

This assertion agrees with the opinion of **Pandy**, when he posits that payment of dividends to shareholders is not a legal obligation; it depends on the discretion of the board of directors. Also, dividends paid to ordinary shareholders are not deductible expenses for calculating corporate tax. As for the lenders, the return on loans or debt comes in the form of interest paid by the firm and such interest is a cost of debt to the firm. Unlike ordinary dividend, payment of interest is a legal obligation. The amount of interest paid by a firm is a deductible expense for computing corporate tax, thus the interest provides tax shield to a firm. This shield is valuable or advantageous to the firm as it reduces the overall cost of capital, though it increases the financial risk of the firm. Therefore to maximise the value of the firm, there is every need to mix both debt and equity in capital structure, thereby minimising the overall cost of capital. It is therefore the general concession to use the cost of capital in the composite sense or what we call the weighted average cost of capital that would give weight to both the cost of equity and debt finances, **Barges (1963)**.

The market value of shares depends on the dividends expected by the shareholders; hence the required rate of return which equates the present value of share is the cost of equity capital. For conveniences, **Pandy** groups this cost of equity capital into two: internal represented by retained earnings and external which is the external equity or new issue of shares. The cost of internal equity capital is obviously lower than cost of external equity capital due to floatation cost that is included in the latter. Whichever we are deriving we are confronted with two obstacles in practice and these obstacles are: difficulty in estimating future expected dividend and also the future expected growth in the dividend. Since these two factors are key to the computation of cost of equity, precise measurement of its cost is not practically easy, **Solomon (1963)**.

As for debt capital, **Pandy** views its cost of debt from certain world and uncertain world perspectives. He regards it to be certain when all cash flows are known with certainty, here interest rate would serve as the cost of debts, but where there is no cash flow, it is uncertain and some complexities would be introduced in the computation of cost of debt.

To testify to the importance of ascertaining the cost of capital before embarking on investment decision **Van Horne (1985)**, states that the purpose of measuring the cost of capital is its use as decision criterion in capital budgeting decision. He further states that it is the discount rate used in evaluating the desirability of the investment projects. Only the project that has a rate of return greater than the cost of capital would be accepted, hence the cost of capital is the minimum rate of return on investment projects: this is why it is variously called cut off, target or the hurdle rate. It is therefore, the minimum rate of return which will maintain the market value per share at its current level, **Ezzell and Porter (1976)**. If the firm earns more than the cost of capital, the market value per share is expected to increase. Thus, the cost of capital can be considered while allocating the firm's investible funds in the most optimum manner, and of course equally important is the issue of control and risk, **Quirin (1967)**.

1.22 Theoretical Framework

1.221 The value of the firm

The goal of every firm is to maximize the wealth of its owners and this is done through

the maximization of its capital structure and leverage decision should be examined from this perspective. **Van Horne (1985)** states that value of firm depends upon its expected earnings stream and the rate used to discount these streams. This rate is normally regarded as the firm's required rate of returns or the cost of capital. If a firm is to survive, it should not be financed in such a way that when hard times are encountered, obligation cannot be met. No matter how attractive use of debt may appear in periods of high profitability, consequence of a less pleasant environment has to be considered. We have to consider the fact that gearing only increase per share provided that the rate of interest earned on an asset exceeds the rate of interest payable.

According to **Van Horne**, if leverage affects the cost of capital and the value of the firm, an optimum capital structure would be obtained at the combination of debt and equity that maximizes the total value of the firm or minimizes the weighted average cost of capital. Many writers have argued for and against the existence of optimum capital structure, this argument has produced different schools of thought that we group into four approaches:

- Net income approach;
- Net operating income approach;
- Traditional approach and
- Modigliani and Miller (MM) approach.

To understand the argument as to the effect of capital structure on the cost of capital or value of the firm, the following general assumptions are notable:

- the firm employs only two sources of financing, debt and equity;
- no transaction cost for issues;
- the firm pays all its earnings as dividend;
- probability distribution of expected future operating earnings for each firm has the same expected values for all investors in the market;
- earnings are to remain constant into perpetuity;
- business risk is constant and independent;
- no taxes and bankruptcy cost

It should be noted that a firm that utilizes both sources (equity and debt) is described as a levered firm whereas the firm that uses no debt but only uses equity is unlevered firm, **Durand (1959)**. Some of the above assumptions are relaxed in arriving at the argument for and against the proposition as we are going to see under each of the afore-listed approaches. Apart from the above assumptions we also define some of the relevant concepts in the theory:

- K_e = Cost of Equity
- K_d = Cost of Debt
- K_o = Cost of Capital (Weighted Average Cost of Capital)
- E = Market value of Equity
- D = Market value of Debt
- V_L = Market value of the firm that is levered
- V_{uL} = Market value of the firm that is unlevered
- R = Annual Interest charges

- N = Net Operating Income (PBIT)
- I = Net Income (N – R)

1.222 Net Income Approach (NI)

Specifically the following assumptions are made by this school, **Durand**:

- * firm operates two sources of finance, i.e. debt and equity;
- * total value of the firm is a given variable, i.e. degree of leverage can be changed to issuing debt or to entire equity;
- * all investors have homogeneous expectation, i.e. there is net operating income for a given firm;
- * the firm has a policy of paying all its income as dividend;
- * business risk is constant and independent of finance risk.

This approach is premised on the fact that any increase in a firm's debt will result in increase in the value of firm and reduction in cost of capital, which obviously affect the value of the firm. Hence from all the assumptions we have:

$$K_o = K_e - (K_e - K_d) D/V_L$$

If the firm should increase debt in the capital structure, D/V_L will increase so also is the constant value, $(K_e - K_d)$, but K_o will reduce.

1.223 Net Operating Income Approach (NOI)

These are extremists: they assert that increase in debt in the capital structure will not affect the value of the firm as they argue that cost of capital depends on business risk of the firm that is constant in nature. For this reason K_o is constant. The assumption is now premised on:

$$\text{Value of firm} = \frac{\text{NOI}}{K_o}$$

Since K_o is constant, value of firm will also remain constant.

$$\begin{aligned} \text{Value of Equity} &= \text{Value of firm} - \text{Value of Debt} \\ \text{Therefore } K_e &= \frac{\text{NOI} - R}{E} \end{aligned}$$

Hence K_e will change as debt changes as the authors did not agree that K_e will be constant. Since a levered firm will always be adding financial risk to earnings of shareholders, value of firm will remain the addition of the total of value of equity and debts and as debt increases in capital structure, cost of equity will rise and there will be risk to the earnings of the shareholders.

1.224 Traditional Approach

Both Net Income and Net Operating Income approaches are used as preliminary in this approach, **Solomon (1963); Brigham and Johnson (1976)**. The approach is premised on the fact that if the firm should increase debt in capital structure, it will first increase the value of the firm but reduces cost of capital (K_o) to certain limit, after which any subsequent increase in debt will reduce the value of the firm.

This approach is in three phases as enumerated by them:

Phase I

- Cost of debt is constant, cost of equity is also slightly constant as leverage increases;
- On the weighted basis, cost of debt and cost of equity will fail to be constant as leverage increases.

Phase II

- Cost of debt still increase;
- Cost of equity started to rise at fast rate;
- Overall impact is to make the cost of capital to be constant.

Phase III

- Cost of debt start rising;
- Debt owners start to demand for high return because of riskiness of the firm;
- Cost of capital (K_o) and cost of equity (K_e) will also be rising at high speed;
- Point of optimum capital structure is the point where K_o is constant. This occurs at the leverage where K_o is minimum and value of firm is maximum

1.225 Modigliani and Miller (MM) Theory

This theory supports the Net Operating Income approach with the premise that value of firm remains constant no matter the leverage, **Modigliani and Miller (1958)**. Their specific assumptions, which are not realistic:

- No transaction cost;
- Firm can be grouped in the same homogeneous risk class;
- There is free entry and free exit;
- No tax

For these assumptions they made three propositions:

First proposition

- Capital structure will not affect the value of the firm whether or not it is a levered firm, so they are in the same industry, as demonstrated:

$$V = \frac{NOI}{K_o}$$

$$V_L = \frac{NOI}{K_o}$$

$$V_{UL} = \frac{NOI}{K_u}$$

$$V_L = V_{UL}$$

- Should we have $V_L \neq V_{UL}$, arbitrage process will take place to explain why V_L should be equal to V_{UL} .

Second proposition

Here they defined K_e for a levered firm to be:

$$K_e = K_o + (K_o - K_d) D/EL$$

Where K_o = constant cost of capital

K_o - K_d = premium for financial risk

EL = value of equity in levered firm

D = value of debt

Since K_o = K_u in our first proposition therefore

$$K_e = K_u + (K_u - K_d)D/EL$$

Third proposition

In this proposition some of unrealistic assumptions were dropped and tax advantage accruable to firm for using debt in capital structure was considered, **Modigliani and Miller (1966)**. They saw the fact that such firm commands a higher value than unlevered firm. Therefore

$$\begin{aligned}V_L &= V_{UL} + tD \\ \text{Where } tD &= \text{taxed Debt} \\ K_o &\neq K_u \\ \text{But } K_o &= K_u (1 - tD/V_L)\end{aligned}$$

It is therefore concluded that:

- A levered company has a lower cost of capital while unlevered firm's cost of capital is high, making levered firm better;
- If you have debt you have a higher value as a firm;
- Nevertheless, one should not be tempted into putting all the capital in debt because of higher value and tax advantage, as non having equity stock at all may bring about induced bankruptcy;
- Hence there should be a peg on the quantity of each of the capital structure component to be employed by every firm.

1.3 Statement of Problem

Most Nigerian businessmen prefer to run their businesses with their personal funds and donations from family members. The same thing plays out in limited liability companies founded by Nigerian entrepreneurs, they always prefer to use their share capital to run the business rather than mixing the funds with long term borrowing that may pose problem for them in terms of paying interest on yearly basis as well as repayment of principal amounts on maturity. They consider borrowing as 'dead weight' that can affect their performance. This perception is not correct as the use of debt capital has many advantages to the firm. This research is therefore interested in considering the various benefits derivable from using mixed funding to guide those companies that are presently not in the habit of using debt capital as part of their capital structure.

1.4 Research Questions

The study was guided by the following research questions:

- Does the existence of gearing has any relationship with increase in earnings of a firm?
- Does gearing of a firm has any relationship with its competitive market?
- In what way can gearing of a firm affects its performance?

1.5 Research Hypothesis

For the purpose of analysing the data, the following hypotheses were tested:

- Ho₁: Existence of gearing in a firm's capital structure has no effect on its earnings for the period.
- Ho₂: Gearing of a firm has no relationship with its competitive market.
- Ho₃: The use of gearing in a firm's capital structure does not any relationship with its performance.

1.6 Methodology

The study was based on information gathered from both primary and secondary data. While the primary sources are direct interview and questionnaire administrations, secondary data were gathered from literatures, newspapers and journals concerning gearing and its effect on company's performance. The method was chosen because it helped to describe record, analyse and interpret the condition, prevailing practices, belief, attitudes and ongoing process that exists in the survey.

1.7 Population, Sample and Sampling Technique

The population comprised different categories of workers of selected manufacturing companies in Nigeria. From the population, a sample of 20 workers was obtained through the simple random selection technique. Direct interviews were also held with customers and other stakeholders of the companies involved.

1.8 Instrument

The instrument used to gather information in this study is a self-designed questionnaire. The questionnaire consists of two sections. Section A elicits demographic information like gender, working experience, while Section B contained structured items relating to the research questions that necessitated this research.

1.9 Validity and Reliability of the Instrument

To ensure the validity of this research, the instrument was subjected to criticism by specialist in the areas of educational management aside from peer review conducted by the researcher. The reliability of the instrument was obtained through a test-retest technique to analyse the data collected.

2.0 Results

Table 1: Existence of gearing in a firm's capital structure has no effect on its earnings for the period.

Subject	No	Expected	Residual	Df	Asy sig.	T-calculated	Table value	Decision
Agreed	14	10.00	4.00	1	0.02	3.506	3.323	Reject
Disagreed	6	10.00	- 4.00					

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $3.506 > 3.323$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and we conclude that existence of gearing in a firm's capital structure has positive effect on the company's earnings for the period.

Table 2: Gearing of a firm has no relationship with its competitive market.

Subject	No	Expected	Residual	Df	Asy sig.	T-calculated	Table value	Decision
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Agreed	16	10.00	6.00	1	0.01	4.329	3.323	Reject
Disagreed	4	10.00	- 6.00					

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $4.329 > 3.323$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and we conclude that gearing of a firm has positive relationship with its competitive market.

Table3: The use of gearing in a firm’s capital structure does not any relationship with its performance.

Subject	No	Expected	Residual	Df	Asy sig.	T-calculated	Table value	Decision
Agreed	13	10.00	3.00	1	0.00	3.414	3.323	Reject
Disagreed	7	10.00	- 3.00					

Level of significance – 0.5

Since t-calculated is greater than the table value (i.e. $3.414 > 3.323$), then the null hypothesis is rejected, while the alternative hypothesis is accepted and we conclude that the use of gearing in a firm’s capital structure has positive relationship with its performance.

2.1 Discussion

This work has examined the sources of finance of selected companies, comparing both levered and unlevered companies. Finding reveals that leverage plays an important role in the companies’ performance over the years. From direct interview, it is discovered that if the gearing of a company is efficiently managed and utilised, earnings of that company would definitely increase and this will have direct effect on performance and its market share in the industry it belongs.

2.2 Conclusions

This study paid greater attention to the effect of gearing on the efficiency of a company’s performance. It revealed that the use of gearing is worthwhile and its efficient management should be emphasised by focussed organisation in order to improve their future performance. The study is very interesting and challenging to the researcher and it has also enlightened the researcher on the importance of gearing on a company’s performance.

2.3 Recommendations

Based on the finding of this study, it is recommended that:

- Companies should employ competent professionals to manage their debt capital portfolio;
- The management should always review and evaluate, on timely basis, the financial statement with a view to arresting mismatch of its debt-equity ratio to avoid financial burden that could emanate from such occurrence;
- Excessive debt capital should be immediately repaid or deplored to earning assets;
- Companies should create a Sinking Fund account to provide for future repayment of borrowings. They should not wait until the maturity date before starting to look for funding;

- Since long term debt provides tax shield for the company, there is every tendency for the company to continue to grow debts, the effect of accumulating unnecessary debts should form regular policy discuss by the management and the directors, hence there should be high-powered committees of the managements and the board to review the debt portfolio from time to time. These committees should be firm on investment/divestment of any debt capital to ensure that the company stays afloat all the time without the fear of any litigation for not meeting up with all present and previous obligations.

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