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ABSTRACT

Capital structure is the proportion or each type of capital debt and equity used by a business organisation. Many organizations employ debt in their capital structure because of its benefits. One of the benefits is that interest on debt is tax deductible and reduces tax liability of the organizations concerned. Furthermore, failure to pay interest commitment can result to financial backwardness. The financial managers consider so many factors in their capital structure decisions because of the implications in the use of debt. The factors are cost of capital, debt capacity cash flow. Etc.

The primary aim of business organisation is to make maximum profit if possible. The researcher made a study of selected quoted manufacturing and oil servicing companies to see how capital structure related to profitability of business organizations.

Five companies were selected and their financial statements for four years extracted and analyzed. The analysis showed that there is a strong relationship between capital structure and profitability between debt equity ration and shareholders' return. It means that the cost of debt in the companies put together is less than their return on investment. A company having return on investment greater than cost of debt will have an increasing shareholders' return.

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CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND OF STUDY

The most important decision all corporate managers should take into consideration is the way in which the long-term capital requirements of their companies should be financial. Capital structure is the permanent financing of a firm represented primarily by equity and long-term liability without including all short-term credits. Many factors have to surface in order to determine the capital structure of a business organisation. These factors are what the financial managers consider first in order to determine appropriate capital structure suitable to his firm. Some of the factors are: cost of capital, floation costs, size of the company, government policies and market condition. The combination of debt and equity has some implication. The first is that debt-equity ratio, which is regarded as an indicators of risk. According to Samuel etal (1992:44) high fixed interest commitment which must be paid by the business organisation irrespective of whether profits are made or not. Debt capacity which is the ability of a firm to service its debt payment of interest and principal is usually measured. On eof the ways of measuring debt capacity is by raising the ratio of net cash inflow to interest charges.

Pandey (1998-656) has it that the ratio indicates the number of times the interest obligation are covered by the next cash inflows generated by the company. The greater the coverage the lower the risk arising from the debt in the capital structure. Conversely, the lower the coverage the higher is the risk arising from the debt in capital structure. And failure of a company to pay its interests obligation can lead to bankruptcy. Furthermore, left for the business owners, they will employ more of debt in their capital structure as to increase profit. All things being equal will accrue to them and they only have to pay interest to provide of debt capital. Thus less amount of tax is paid by the company with debt capital.

In determining whether to employ more of debt and less of equity or more of equally and less of debt in its capital structure, the financial managers of the firms concerned should take into account, the profit objectives of that business. They should consider how the capital structure will affect the profitability of their business organisation. The profitability of any business organisation will determine whether it will remain in business or not especially in the long run. Profitability is normally measured using return on capital employed return on equity, earning per share, return on assets, net profit margin and gross profit margin.

1.2 STATEMENT OF PROBLEM

The owners of a company will not like to loose the control they have in their company by issuing more shares to the public in order to finance their capital projects. Instead, they to borrowing, this means using debt instrument like debenture stock. These owners of the business should not fail to know that whether there is profit or not that the debentures should be settle their interest. Nobody can perfectly predict the future, there can be business boom and there can equally be stump in business.

The problem then is how can business combine debt and equity financing in order to ensure profitability?

1.3 OBJECTIVE OF THE STUDY

1. To critically evaluate the variations in capital structure used by different companies under study.
2. To see how the capital structure affects the profitability of the business organizations concerned.
3. To identify some of capital structure problems encountered by these companies.
4. To recommend solutions to these problems.

1.4 SIGNIFICANCE OF THE STUDY

Business financing is a very important business decision. Corporate financial managers have to decide whether to employ more of debt or more of equity whichever measure is adopted has effects. Everybody should bear in mind that the main objective of every business is to make profit of which this research work will through its findings achieve the followings:

1. To convince corporate managers of the relationship between capital structure and profitability of business organisation and will enable them make appropriate decision to that effect.
2. It will help intending investors to plan their capital structure very well from the statement in order to maximize profit.
3. This will be of good advantage to future researchers in their research work.

1.5 SCOPE AND LIMITATION OF THE STUDY

Not minding that capital structure has many implications on a company such as profitability, market value of shares and financial distress, this study took at the relationship between capital structure and profitability of business organisation. Business organisation studied was manufacturing companies and oil servicing companies quoted in Nigerian Stock Exchange.

In course of the research work, the researcher encountered some problems that bring up their ugly heads. Business organizations should some elements of indifference in relating to their financial statement. Also, there was problems of dund and some gate men who refused that the researcher could not meet the

financial managers e.g. Nigerian Bottling Company 9th Mile Corner Enugu.
However, the researcher was not discouraged by the problems. Through the mercy of God enough information were collected form general securities, a member of Nigerian Stock Exchange, Apes a member of Nigerian stock exchange all in Enugu, and University of Nigeria Enugu Campus Library.

1.6 RESEARCH HYPOTHESIS

The following hypothesis have been formulated to guide the study.
(a) Ho: There is a relationship but not strong between capital structure and profitability of business organizations as measured be return on equity.
Hi: There is a strong relationship between capital structure and profitability of business organizations as measured by return on equity.
(b) Ho: There is a relationship but no strong between capital structure and profitability of business organizations as measure by return on investment.
Hi: There is a strong relationship between capital structure and profitability of business organisation as measured by return on investment.

1.7 DEFINITION OF TERMS

1. FINANCIAL LEVERAGE: This is the use of fixed charges source of fund such as debt and preference capital along with the owner’s equity in the capital structure.
2. DEBENTURE STOCK: These are loans that companies raise by the issue of stocks to members of the public. A fixed rate of interest is offered and the rights of the investors in the event of non-payment of either interest or principal. Mortgage debenture shows that the deeds of title to property have been deposited with the trustee in which case the property can be sold to repay the debenture hoders in the event of the company or defaulting.
3. PREFENCE STOCK: These are stocks which give the holders the right to stated rate of dividend, such sums being due for payment out of the company’s profits before any dividend is paid to the holders of ordinary stock. Preference stock holders are members of the company but do not usually have voting rights. It is a hybrid security because it has qualities of debt and equity instrument.
4. DEBT: Debt is loan borrowed from outsider to finance a business. It is repayable and receives a return in form of interest charged on the amount of debt outstanding. The holders of debt instruments are legally creditors of the borrowing company. Debenture is an example of debt.
5. EQUITY: It is a permanent investment in a company. Equity investment makes a person a part owner of the company. This is also a method of long-term financing. It includes share capital, share premium and reserves.
6. DIVIDENDS: These are cash payments to shareholders when credited accounts are published the company may declare dividend and this is under the approval of the shareholders at the annual general meeting. In a bad year, a company may wish to pay a larger dividend that total earning allowed. The difference must be paid from reserves which are accrued profits from previous years.
7. CAPITAL COMPONENTS: These are items on the left hand side of the balance sheet on the old method of computation of balance sheet statement. The item viz: various types of debts, preferred stock, and common equity. According to J. F. Weston at al (19977:695) any net increase in assets must be financed by an increase in one or more capital components.
8. EARNINGS BEFORE INTEREST AND TAX (EBIT): Earning before interest and tax is the earnings of a

business organisation before deduction of interest and tax. In this research work, it is denoted by EBIT

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