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Co-Alignment among Corporate Strategy, Financial Structure and Firm Performance in Non-Financial Sector of Pakistan

Ammara Mubashar[1], Abdul Raheman[2], Bushra Zulfiqar[2]

[1]Student of MS-Finance, University Institute of Management Sciences, PMAS-Arid Agriculture University, Rawalpindi, Pakistan.
[2]Assistant Professor, University Institute of Management Sciences, PMAS-Arid Agriculture University,Rawalpindi, Pakistan.

ABSTRACT

The purpose of this paper is to analyze the co-alignment amongcorporate strategies, financial structure and firm performance. Data is taken for 158 non-financial firms listed at Karachi Stock Exchange for the period 1998 to 2009. Estimation is made by panel data methodology using common coefficient model. Sales growth, growth potential and corporate liquidity proved to have significant positive impact on firm performance measured through return on asset. Free cash flow per share used as proxy for finance measure of firm performancerevealed a significant positive relationship with growth potential and corporate liquidity measures of corporate strategy. On the other hand, debt ratio, a measure of financial structure proved to havesignificant negative impact on firm performance measured by return on total assets and free cash flow per share. It has proven the implication of Pecking order theory by Pakistani non-financial listed firms. This study also provides a base to practitioners as well as decision makers while making financial and strategic decisions.

Keywords: Corporate strategies, financial structure, firm performance, panel data analysis, common coefficient setting, pecking order theory.

1. INTRODUCTION

Finance and strategy are jointly emerging and a good integration between dimensions of finance and strategy can be proved as a competitive edge for the firm. Strategy formulation is the most decisive decision of firm therefore, it is crucial for the firm to implement an appropriative corporate strategy that will fulfill the expectations of all stakeholders. This paper analyzes corporate level strategies and particularly those strategies that directly add value to the firm such as growth strategies and liquidity strategy (Chathoth and Olsen, 2007; Su and Vo, 2010; Kim et al., 1998).Growth strategies have been considered as a key element of success by the researchers and industry analysts. Growth strategy should be rightly implemented so it will produce stability, security and profitability for the firm (Baskin, 1987).

Delmar et al., (2003) analyzed different indicators of growth and it was suggested that the most preferred indicator to analyze growth of the firm is sales growth. Reason behind that it captures short term as well as long term change and therefore, it is favored by entrepreneurs themselves. Moreover, this measure has been favored on the basis of growth process that will take place when demand for the products and services will increases. However, technologically growing firms, which are not sales oriented still enjoying high growth in terms of asset or have more potential to grow. Therefore, sales growth should not only be used as a measure of growth.

Another strategy is growth potential strategy which refers to the firm ability to grow in future by pursuing the opportunities of new investments that are prevailing in the market. Pursuing growth opportunity leads the firm to incur high capital expenditure in order to attain desired results (Chathot and Olsen, 2007).

Corporate liquidity is another strategy that significantly impacts the profitability of the firm. Liquidity management belongs to the payment of current obligations of the business that include financial as well as operational expenses. Liquidity of the firm is measured by firms in order to know whether they can meet the payment obligations by cash and near cash assets or not. If not, then it is an alarming situation for the firm that it might cause some drastic consequences which a firm can face (Saleem and Rehman, 2011).

Decisions related to corporate strategy cannot be made in isolation. There are some other decisions which should be in synchronization with strategic choice of the firm. These decisions are the financing decisions, if not taken accordingly can lead the firm towards financial distress and ultimately to

Corresponding Author: Ammara Mubashir, Student of MS-Finance, University Institute of Management Sciences, PMAS

bankruptcy. Financing decisions refer to the combination of debt and equity and the ratio of this combination can vary from firm to firm due to firm specific characteristics.

The mixture of best strategy and structure is followed, in order to enhance the value of the firm. Firm performance refers to the outcomes of the activities and actions taken by a firm over a span of time. Profitability is the vital element that measures performance of the firm in financial terms (Chathot and Olsen, 2007).

Financial performance has always been the fundamental issue for the firm and its stakeholders. Moreover, finding out superior profits is the basic objective of the management because superior profits provide high cash flows in order to invest future growth. Utilization of profits to fund future growth also depends on the financial strategies of the firm (Majumdar and Bhattacharjee, 2010).

Prior literatures of finance have addressed two relationships frequently, one is relationship between corporate strategy and firm performance and the other is financial structure and firm performance. These two issues have been addressed separately but combined effect of both has been ignored.

The objective of this paper is to test theco-alignment among corporate strategy, financial structure, and firm performance in non-financial firms of Pakistan and also to analyze that whether these constructs affect each other in isolation and altogether as well. Another objective is to suggest the managers and decision makers while devising companywide strategies and financial decisions.

The presentpaper is organized in a way that second sectionexplains the methodology,sample, dataset, measurements and explanation of variables along with hypotheses development. Third sectionpresents the results and discussion while the final section concludes the study.

2. MATERIALS AND METHODS

2.1: Sample, Dataset and variables

We have used a sample of 158 non-financial firms listed at Karachi Stock Exchange for period 1998 to 2009.Only those firms are included in sample which remain listed and performed operations during the study period and the data was available for all of the years. The data is extracted from the financial statements of these firms using the Balance Sheet Analysis published by State Bank of Pakistan. Market prices of shares are downloaded from business recorder website.Constructs used in this paper, related to corporate strategies, financial structure and firm performance are given below in Table 1 along with their respective measurements.

Table 1: Measurement of Variables

Constructs	Variables	Code	Measurement
Corporate Liquidity Strategy	Liquidity	LIQ	LIQ = Cash+ Marketable Securities / Book Value of Assets
Corporate Growth Strategy	Growth Potential	GP	GP = MV of Assets/ Book Value of Assets
Corporate Growth Strategy	Sales Growth	SG	SG = (Current Year's Sales - Last Year's Sales) / (Last Year's Sales) *100
Financial Structure	Debt Ratio	DR	DR = Total Liabilities / Total Assets
Firm Performance	Return on Asset	ROA	ROA = Profits After Tax + Depreciation / Total Assets
Firm Performance	Free Cash Flow Per Share	FCF	FCF = (Net Profits After Tax + Depreciation – CAPEX +/- Change in Working Capital) / No. of Shares Outstanding
Control Variable	Firm Size	FS	FS = LN (Total Assets of Firm)

To calculate the market value of assets, the difference between market value of equity and book value of equity of the firm is captured which is then added to the book value of assets.

2.2: Hypotheses

Following are the hypotheses that are being tested to analyze the relationships between corporate strategy, financial structure and firm performance.

Corporate Strategy and Financial Structure

Firms that have strong liquidity position tend to use less debt financing (Baskin, 1987). However, firms having high growth potential will use more debt in order to finance the future growth (Vivani, 2008; Sheikh and Wang, 2010; Hongyan, 2009). Increase in sales growth will also increase the utility of acquiring debt in order to finance the growth (Akinlo, 2011; Charitou et al., 2010; Asimakopoulous et al., 2009). This will lead to hypothesis 1:

H_1: It is expected that there is liquidity is inversely related to debt ratio along with growth potential and sales growth has a significant positive impact on debt ratio of the firms ceteris paribus.

$$DR_{it} = \beta_o + \beta_1 GP_{it} + \beta_2 SG_{it} + \beta_3 LIQ_{it} + \beta_4 FS_{it} + \varepsilon_{it}$$

Here, growth potential (GP), sales growth (SG), liquidity (LIQ)are independent variables and firm size (FS)is a control variable whereas debt ratio (DR) is used as dependent variable.

Corporate Strategy and Firm Performance

Firms that practice a high sales growth strategy will bring a positive impact on its performance due to economies of scale (Hill and Jones, 1995) whereas; growth potential will increase the profitability of the firm (Serrasqueiro et al., 2007). Firms having high liquidity position will lead the firm towards low performance due to idle resources (Chatoth and Olsen, 2007). Performance in terms of accounting is measured by return on asset. This leads to hypothesis 2:

H_2: It is expected that sales growth strategy and growth potential have a positive impact on the firm performance while strong liquidity position of a firm has negative impact on profitability of the firm ceteris paribus.

$$ROA_{it} = \beta_o + \beta_1 SG_{it} + \beta_2 GP_{it} + \beta_3 LIQ_{it} + \beta_4 FS_{it} + \varepsilon_{it}$$

Here (ROA) symbolizes return on asset used as dependent variable, (SG)is sales growth, (GP) is growth potential, (LIQ) is liquidity strategy are independent variables and (FS) is the size of firm used as control variable.

H_3: It is expected that growth potential of the firm has negative impact on free cash flow per share along with liquidity strategy of the firm has significant positive impact on free cash flow per share ceteris paribus.

Firms that have a higher potential to grow will decrease free cash flow (Chathot and Olsen, 2007) whereas liquidity of a firm has a positive impact on free cash flow per share (Kim et al., 1998).

$$FCF_{it} = \beta_o + \beta_1 GP_{it} + \beta_2 LIQ_{it} + \beta_3 FS_{it} + \varepsilon_{it}$$

Here (FCF) is free cash flow per share is used as dependent variable, (GP) is growth potential, (LIQ) is liquidity strategy used as independent variable and (FS) is the size of firm used as control variable.

Financial Structure and Firm Performance

Higher level of debt will have a negative impact on return on assets due to interest payments that have to be made other than principal amount (Akinlo and Asaolu, 2012). This leads to hypothesis 4:

H_4: A negative impact of debt level is expected on performance of firm measured by return on assets of the firms ceteris paribus.

$$ROA_{it} = \beta_o + \beta_1 DR_{it} + \beta_2 FS_{it} + \varepsilon_{it}$$

Here (ROA) is return on asset, (DR) is debt ratio and (FS) is firm size.

Corporate Strategy, Financial Structure and Firm Performance

This hypothesis will test that how corporate strategy and financial structure affect return on asset, an accounting measure of profitability. This leads to hypothesis 5:

H_5: Corporate Strategy and financial Structure are expected to explain a significant amount of variance in return on assets.

$$ROA_{it} = \beta_o + \beta_1 GP_{it} + \beta_2 SG_{it} + \beta_3 LIQ_{it} + \beta_4 DR_{it} + \beta_5 FS_{it} + \varepsilon_{it}$$

Here (ROA) is return on asset, (GP) is growth potential, (SG) represents sales growth, (LIQ) is liquidity strategy (DR) is debt ratio and (FS) is the size of firm used as control variable.

Hypothesis 6 is a final model with respect to free cash flow as dependent variable.

H_6: Corporate Strategy and Financial Structure are expected to explain a significant amount of variance in free cash flow per share.

$$FCF_{it} = \beta_o + \beta_1 GP_{it} + \beta_2 LIQ_{it} + \beta_3 DR_{it} + \beta_4 FS_{it} + \varepsilon_{it}$$

Here (FCF) is free cash flow per share, (GP) is growth potential, (LIQ) is liquidity strategy, (DR) is debt ratio and (FS) is the size of firm used as control variable.

2.3: Research Methodology

Panel data methodology has been used in this paper. This methodology is considered as an appropriate estimation for heterogeneous data. It controls heterogeneity which usually arises due to number of factors. In panel analysis, heterogeneity is being captured by using various models. In this paper we have employed, panel estimation with common coefficient setting referring that there is neither significant firm nor significant time effect exists. Purpose of using panel data is to explain the direction of relationships according to their theoretical nature. In this paper, we have used SPSS and EVIEWS software for estimation purpose.

3. RESULTS AND DISCUSSION

Previous chapter has aimed to describe the research methodology i.e. Panel data estimation with common coefficient setting in order to test the co-alignment between strategies, financial structure and firm performance in non-financial listed firms of Pakistan.

The descriptive statistics including mean, standard deviation, minimum and maximum values of all variables used in the model for the period of 1998 to 2009 are given in following Table

Table 2: Descriptive Statistics of Variables for 158 (1896 Obs.) Non- Financial Firms

	N	Minimum	Maximum	Mean	Std. Dev	LLC TEST
LIQ	1896	-0.0006	0.8504	0.099686	0.1402124	-34.70*
GP	1896	0.1331	5.9258	1.077387	0.5835484	-32.04*
SG	1896	-100.00	1622.9	17.80095	64.9585491	-49.51*
DR	1896	0.0139	2.5070	0.583654	0.2513447	-27.61*
ROA	1896	-1.9393	3.0981	0.087384	0.1612910	-34.27*
FCF	1896	-212.11	218.9799	5.435315	30.3037780	-41.75*
FS	1896	3.6323	11.9405	7.174623	1.4364355	-14.74*

*Significant at 1%

Source of Table: Based on financial data extracted from Balance Sheet Analysis (BSA) published by State Bank of Pakistan (SBP). Note that in the above table, LIQ represents Liquidity, GP represents Growth Potential, SG represents Sales Growth, DR represents Debt Ratio, ROA represents Return on Asset, FCF represents Free Cash Flow and FS represents Firm Size, a control variable. Here LLC represents Levin, Lin and Chu Test.

Above table shows that non-financial firms have an average sales growth of 17.8%, whereas average value of the firm's liquidity is 0.0997 or 9.97% which shows that non-financial firms used to maintain very low liquidity. Mean value of financial leverage indicates that firms are using optimal level of capital structure as ratio is closer to 50%. However, profitability in accounting terms is 8.7% which is the minimum with a larger standard deviation of 16.1%. Average growth potential of firms is greater than 1 which shows that firms used to pursue growth opportunities whereas profitability with reference to free cash flow is 5.435 which reflect a sound position of performance of firms.

The sample of firms has been taken from different non-financial sectors and every sector has specific characteristics, strategies and policies. Therefore, due to heterogeneity standard deviation for all variables is relatively high. Moreover, results of Levin, Lin and Chu (LLC) test show that all variables have no unit root and they found to be stationary at first difference.

3.1Correlation Analysis

To test the co-alignment between strategies, financial structure and firm performance, it is essential to analyze their independent relationships and associations among all variables. For this sake, Pearson Correlation Coefficients are used. Correlation matrix is computed by using data of 158 non-financial listedfirms with 1896 observations for the period of 12 years. Computations are presented in the Table 4.2for seven variables.

Table 3: Pearson Correlation Coefficient of Seven Variables for 158 (1896 Obs.) Non-Financial Firms**.**

		LIQ	GP	SG	DR	ROA	FCF
LIQ	Pearson Correlation	1					
	Sig. (2-tailed)						
GP	Pearson Correlation	.057*	1				
	Sig. (2-tailed)	.013					
SG	Pearson Correlation	.037	.036	1			
	Sig. (2-tailed)	.104	.120				
DR	Pearson Correlation	-.280**	.121**	.035	1		
	Sig. (2-tailed)	.000	.000	.122			
ROA	Pearson Correlation	.169**	.193**	.057*	-.239**	1	
	Sig. (2-tailed)	.000	.000	.013	.000		
FCF	Pearson Correlation	.180**	.142**	.009	-.087**	.265**	1
	Sig. (2-tailed)	.000	.000	.702	.000	.000	

*. Correlation is significant at the 0.05 level (2-tailed).
**. Correlation is significant at the 0.01 level (2-tailed).

Source of Table: Based on financial data extracted from BSA published by SBP. Note that in the above table, SG represents Sales Growth, LIQ represents Liquidity, DR represents Debt Ratio, GP represents Growth Potential, FCF represents Free Cash Flow and ROA represents Return on Asset.

As the table shows, sales growth proved to have no significant correlation with all variables except return on asset which also proved to beweak.This shows that in context of Pakistani non-financial firms, sales growth is notindependently associatedwith any variable.Corporate liquidity proved to have significant positive correlation with all variables except with leverage for(-0.280)which indicates that it has a negative but weak association.Financial leverage proved to have negative correlations(-0.087)(-0.239)with free cash flow and return on asset respectively which suggest that increase in debt cause downward impact on profitability however, values show that there exist weak relationships. However, for all correlations discussed above, there exist weak correlations as all values of Pearson Correlation are below 0.3 so it is also proved that there is no multi-linearity among all variables.

3.2Regression Analysis

This section provides the regression results by using panel data estimation for the hypotheses developed in previous section. By applying the common coefficient model,the results are reported in table 4.2.

Table No. 4.2: Regression Results For 6 Models for Non-Financial Listed Firms of Pakistan

Eq. No.	Equation	F-Stat	R^2	Adj R^2	Coefficients	Prob
1	DR=b0+ b1*GP +b2*SG+b3*LIQ+b4*FS	57.14349	0.107840	0.105952	C= 0.456162 GP= 0.051186 SG= 0.000178 LIQ=-0.556423 FS= 0.017373	0.0000 0.0000 0.0347 0.0000 0.0000
2	ROA=b0+b1*SG+b2*GP+b3 *LIQ+b4*FS	33.05203	0.065346	0.063369	C =0.039768 SG= 0.000107 GP= 0.052117 LIQ= 0.189339 FS= -0.004085	0.0336 0.0539 0.0000 0.0000 0.1170
3	FCF=b0 +b1*GP+b2*LIQ+b3*FS	33.51842	0.050465	0.048960	C= -9.486920 GP= 6.608839 LIQ= 35.97335 FS= 0.587614	0.0072 0.0000 0.0000 0.2331
4	ROA= b0+ b1*DR+b2*FS	59.47411	0.059121	0.058127	C= 0.140677 DR= -0.154710 FS=0.005158	0.0000 0.0000 0.0398
5	ROA= b0+b1*GP+b2*SG+b3*LIQ +b4*DR+b5*FS	50.22810	0.117293	0.114958	C=0.110403 GP=0.060043 SG=0.000134 LIQ=0.103179 DR=-0.154846 FS=-0.001395	0.0000 0.0000 0.0127 0.0001 0.0000 0.5837
6	FCF= b0+b1*GP+b2*LIQ+b3*DR +b4*FS	27.04272	0.054108	0.052107	C=-5.940167 GP=7.009148 LIQ=31.72118 DR=-7.694604 FS=0.718189	0.1143 0.0000 0.0000 0.0070 0.1463

Source of Table: Based on financial extracted from BSA published by SBP. Here GP represents Growth Potential, SG represents Sales Growth, LIQ represents Liquidity, DR represents Debt Ratio, FCF represents Free Cash Flow, ROA represents Return on Assets and FS represents Firm Size.

Negative relationship between liquidity and debt ratio strongly supporting the hypothesis and is in confirmation with previous studies. It is found that Pakistani non-financial firms also formulate their strategy on the basis of this key relationship of debt and liquidity that they acquire debt, when they are in short of liquidity. Furthermore, those firms having strong liquidity position used to haveless reliance on debt financing due to fact that highly liquid firms utilize their internal resources by following pecking order hypothesis instead of using debt financing(Eriotis, 2007; Chathoth and Olsen, 2007; Baskin, 1987; Sheikh and Wang, 2010; Kim et al., 1998; John, 1993). On the other hand, growth potential proves to have a significant positive impact on financial leverage where, p-value 0.0000 with coefficient 0.051186. As confirmed by Viviani (2008), Sheikh and Wang (2010), Chen (2004), who argued that if firms have growth opportunities available, they pursue it by acquiring debt in order to boost up their business if the firm is tangibly intensive for collateralization (having more tangible assets for mortgage).This has also been proved from the evidence of Chinese Small and Medium Enterprise (SME). These firms employ more debt into their financial structure when they have more growth opportunities (Hongyan, 2009). Sales growth also found to have significant positive impact on financial leverage which indicates that Pakistani firms finance their

growth through debt financing. The studies conducted by Akinlo, 2011; Charitou et al., 2010; Asimakopoulos et al., 2009 also found similar result for sales growth and financial leverage.

Therelationship between growth potential and return on asset has been studied for the first time and is showing a significant positive relationship which implies that profitability of the firm may improve if a firm is efficiently pursuing its growth opportunities prevailing in the environment. Liquidity also proved to have significant positive impact on return on asset which is in confirmation withSaleemandRehman, (2011) who also found a significant impact of liquidity over return on asset in context of Pakistani oil and gas companies. In reality, all stakeholders of the firm, whether they are shareholders, suppliers, customers or employees, all are concerned to the liquidity position of the firm to know whether company is able to meet the obligations of its stakeholders or not. If company has sound liquidity position, productivity by all stakeholders will increase which in turn will positively affect the profitability of the firm. Liquidity of the firm also proved to have significant positive impact on free cash flow which supports the hypothesis and the literature (Su and Vo 2010;Chathoth and Olsen 2007) on the ground that by adopting liquidity strategy for the firm, the strategy turns to boost up the operating cash flow. Growth potential also proved to have a significant positive impact on free cash flows which indicates that if firm pursues its growth opportunities, it brings positive impact on the profitability of the firm in terms of free cash flow. However, this result contradicts (Su andVo 2010,Chathothand Olsen 2007) who argue that pursuing growth will increase the capital expenditure of the firm which diminishes the free cash flow of firm. Reason behind this contradiction is that book value of debt is equals to the market value of debt in context of Pakistani firmsbecause debt is obtained from Pakistani capital markets. Hence, it has biased the measurement of growth potential due to which growth potential does not produce the expected results.

Financial leverage proved to be negatively associated with return on asset in consistency with agency cost hypothesis. It argues that debt financing will increase the agency cost which ultimately affects the firm performance negatively. This result has been found consistent with Weill (2003), Akinlo and Asaolu (2012). This result proposes that Pakistani firms should not acquire more debt in order to boost up their profitability. Necessarily they must select such level of debt which set aside cost and benefits that are associated with debt financing. From leverage aspect, free cash flow of firms will be decreased if firm is highly levered because of payments of interest that has been made on regular basis to lender (Jensen 1986).

4. Conclusion

This paper has attempted to fill the gap in the literature as the combined effect of these constructs has not studied so far in context of Pakistani non-financial listed firms. Data is taken for 158 non-financial listed firms of Pakistan during the period of 1998 to 2009. Panel data analysis has been made using common coefficient setting whereas, in past literature cross sectional analysis was made by Chatothand Olsen, (2007) and Su and Vo, (2010).

Sales growth proved to have a significant positive impact over leverage, and also onfirm performance in terms of return on assets. This implies that, if mangers want to practice growth in terms of sales, profitability of the firm will be enhanced but on the other hand it may also increase the need to acquire debt. So, firm should check their affordability of debt while choosing sales growth strategy.

Growth potential also proves to have a significant positive impact with all constructs. This implies that if firms want to pursue growth opportunities prevailing in the market, firms might require debt in order to finance the growth but on the other hand growth will bring profitability to the firm in terms of high return on assets as well as free cash flows.

Corporate liquidity strategy proves to have a negative impact on financial leverage.Itsignifies that if firms are more concerned about their liquidity position, then they should avoid debt financing because this will lead the firm towards high cash outflows which will decrease the liquidity. On the other hand, corporate liquidity proves to have positive impact on profitability and on average descriptive statistics show that Pakistani non-financial firms are highly concerned about their liquidity.Asthey maintain a high proportion of liquid assets into their total assets.It reveals that Pakistani stakeholders take liquidity position into consideration.Keeping in view the high rate of bankruptcy in Pakistan (Abbas and Rashid, 2011), stakeholders are usually concernedabout firm's ability to meet its short term obligations.

Financial leverage has been measured and found to have a significant negative impact on profitability which suggests that if firm wants to increase their profitability then, they should avoid debt.However, if they are in need then they have to sacrifice their profitability for which firms must equip themselves for future consequences.

Lastly, corporate strategies and financial structure proves to have a significant impact on profitability of the firms.So, Pakistani non-financial firms should make their strategic as well as financial decisions keeping in view the arguments made above, on the basis of empirical findings.

Thispaperalso provides insight to practitioners as well as decisionmakers who are associated with management of firm. The co-alignment among corporate strategy, financial structure and firm performance constructs provide base to the decision makers, while developing their financial as well as strategic decision.Financial decisions should be given additionalimportancein order to add value to their firms. Level of debt should be maintained keeping in viewthat it will affects the profitability of the firm as tested and confirmed in the present paper. As far as strategic decisions are concerned, managers are usually worried about maintaining strong liquidity position. Instead, they must also pursue growth strategies because they also add value to the firm.

The focal point of this paper is internal forces that affect firm performance. However, macroeconomic factors and economic risks are ignored. Beside this, for measuring performance of firm, market measures may also be incorporated like, dividend yield, earnings per share and price earnings ratio. Sector-wise analysis can also be performedin order to analyze the behaviors of different sectors separately.

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