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Determinants Of Corporate Capital Structure A Study of Textile Sector in Pakistan

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	Abstract
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Keywords:	Corporate Financial Policy, Textile Sector, Corporate Capital Structure, Capital Structure Theories



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Introduction

Capital structure is the combination of various kinds of financial securities and includes bonds, debentures, banks loans, commercial papers, preference and common equity shares. In capital structure, firms combine these sources of financing to attain the target level to achieve their business goals (Ahmad et al., 2010). It can also be referred as the relationship between debt and equity. There are other factors which also contribute to the corporate financial decisions which include corporate governance, corporate and personal tax system, government laws, equity and debt markets.

The role of firm level firms is crucial in corporate's financial policies i.e capital structure, working capital management, dividend payout and capital budgeting. Firm level effect arises when changes occur in individual's behavior that is driven by firm levels. In past, researchers have put their extensive effort to find out whether there is any impact of firm level in financial decisions or policies of a firm (Anwar & Akhtar; 2018). Moreover, firms devise similar kind of financial policies when they are socially connected (Fracassi; 2016). Authors such as Foucault & Fresard; 2014, also argued that investment decisions of competitors are also triggered by firm levels.

Liang; 2016, referred to firm level effect as the learning which an individual acquire as a result of mutual group behavior. The author further argued that managers of a specific firm cannot determine the optimal capital structure for the organization without going through the capital structure of their firm level group and hence the firm's capital structure is affected by its firm levels. Graham & Harvey; 2011, evidenced that CFOs of a firm cannot devise capital structure policy for their firms with independence of firm level groups. Moreover, the average of capital structure of an industry is crucial for its respective firms when determining its capital structure policy (Mackay & Phillips; 2005.)

The work of Karim et al., 2019, investigated whether there is an effect of firm level on a firm's capital structure. After introduction of Modigliani and Miller propositions, much of the work has been carried out by several researchers regarding trade-of and pecking order theory of capital structure. In trade-of theory, a firm is supposed to have a capital structure in which there is a balance of several financial cost including tax cost, financial distress. However, in pecking order, the firm follow a chain of financial entities for financing to be used in capital structure. A study carried out by Leary Roberts; 2014, who investigated non-financial firms in U.S found that industry firm levels impact a firm's capital structure.

Research Gap:-

Researchers have highlighted the role of Tangibility, Profitability, Firm Size and Return on Assets in determination of a firm's capital structure in the finance sector of Pakistan. A firm level of capital structure can be a response to these variables. This current study will take the Pakistan textile sector as its firm level for capital structure decision. Since the non-financial sector has been ignored exclusively the textile sector, which has significant contribution in the economy of Pakistan. Exploration in the area can be beneficial both for government and textile firms to set their target optimal capital structure.

Research Objectives: -

This study will seek to study the following research objective;

To find out the impact of tangibility on corporate capital structure

To know that profitability does have an impact on corporate capital structure.

To find out relationship between ROA and corporate capital structure

To know the impact of firm size on corporate capital structure

Research Questions: -

What is the impact of tangibility on corporate capital structure?

How does probability affect corporate capital structure?

What is relationship of ROA with corporate capital structure?

What is the impact of firm size on corporate capital structure?

Literature Review

Capital Structure

The capital structure is the mix of external financing which comes through the use of debt instruments and equity which is the claim of shareholders in a corporation (Stewart C Mayers; 2001). Corporations report this capital structure on the liabilities side of their firm's balance sheet. For getting the optimal capital structure, there are numerous theories which a firm should focus on while shaping its capital structure. The Modigliani and Miller (1961) theorem suggests the optimal capital structure, the pecking order theory focuses on the priority of internal financing and the trade-of theory has given emphasis to tax shield which will be achieved by designing a firm's capital structure. However, the optimal debt to equity ratio has become the central part of the researchers. Some researchers such as (Malitz et al., 1985) found that firms with low debt ratios have reported numerous growth opportunities.

Moreover, studies in the past have been carried out to find out whether debt ratios have any impact on profitability of the firm. Growth firms go the least for debt financing and hence reported a link between profitability and debt ratios, where profitable firm mean having low debt (Wald; 1999). Researchers such as Zampolli et al. 2011; found that a reasonable percentage of debt in capital structure lead the organization to recorded growth in business. The researchers further argued that when debt exceeds the optimal capital structure of a business, this will lead the business to a situation where survival might be questioned. Firms claim bankruptcy with financial crisis when they have excessive level of debt and increasing debt ratios (Reinhart & Rogoff; 2009). Therefore, firms when devise their capital structure must do in depth examination of the overall impact on its financial performance.

Capital Structure Theories:-

This research is based on several financial theories. The theories are related to optimal capital structure of a firm and include Pecking order theory, Trade-of theory and M&M proposition.

Pecking Order Theory:-

The pecking order theory of capital structure states that firms when finance will first go for internal source of financing either to use retained earnings or excess liquid assets instead of external sources. The firm then will go for external source of financing when internal source is not enough to meet its requirements. The firm when choose external



Advance Journal of Econometrics and Finance

Vol-4, Issue-1, 2026

financing, it will choose in a way to minimize the cost of asymmetric information (Akerlof; 1970). In pecking order financing the following chain will occur; first to choose internal financing, second to choose low cost of debt and finally to choose share financing.

Miller and Modigliani Theory:-

The first theory of capital structure was introduced by Modigliani and Miller in 1958 with the assumption that the firm would have a set of cash flows and this cash flow will be divided among equity holders and debt holders when the firm wants to include a portion of debt in its capital structure (Sorin et al. 2009). The second assumption which the theory is based is there will be equal access to both investors and firms allowing for homemade leverage. The theory also states that when choosing a specific investment policy under different capital structure, it will not affect the returns to investors and the share price as well (Modigliani and Miller; 1961). This concludes that both capital structure and dividend policy do not matter in perfect capital market.

Trade-of Theory:-

The trade-of theory of capital structure compares tax benefits of debt and expected bankruptcy cost (Miller; 1977). Firms also go for recapitalization in a situation when its benefits outweighs its cost (Ficsher et al., 1989). The theory further argued that there is a positive relationship between profitability and leverage ratios but as evidenced by Whited; 2005 and Strebulaev; 2007 that there can be a negative relationship between profitability and leverage ratios in case of adjustment cost. However, Mayer's definition of trade-of theory cover the following three aspects; first, that the optimal capital structure target is not observable but is the one which is imputed from evidence. Second, the theory assumed an easy tax code but it is complex in real world and finally, that the bankruptcy cost must be a deadweight loss and may not be transferred to another party.

Textile Sector:-

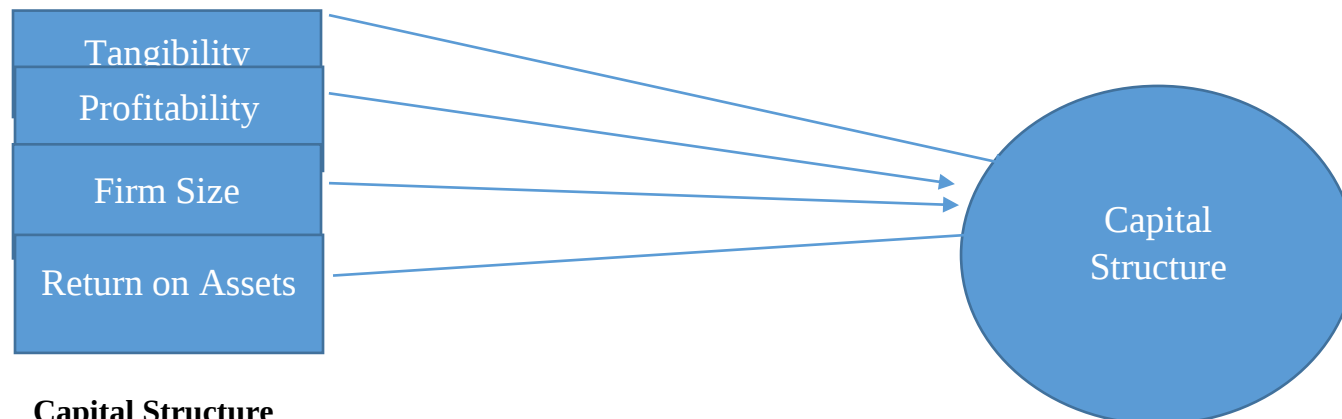
Textile sector of Pakistan has a significant contribution to the income and GDP of the country. This significant contribution has been triggered by the crop of cotton which makes the textile sector the most influential. In the export earning of the country, it almost contributes more than half of the export earnings. Pakistan textile sector constitutes more than 40% of the manufacturing industry, employed a labor force of more than 30% of the manufacturing industry and has up to 10% shares in the country's GDP. The textile sector of Pakistan has been ranked as 9th world largest exporter and 5th largest producer of textile. Memon et al., 2015, found that the textile sector of Pakistan is facing various challenges including under optimal capital structure. The poor selection of the optimal capital structure by the textile firms has negatively affected the textile sector of Pakistan and are operating under the low economies of scale.

Conceptual Framework: -

This research is being carried out to test hypotheses on the following variables. The dependent variable of the study is Corporate Capital Structure. The independent variables include; Firm size, Profitability, Firm growth, Return on Assets Tangibility and Book to Market ratio. The conceptual framework schematically is;

Independent Variables

Dependent Variable



Capital Structure

It is the combination of different sources of funds which it used to finance its activities. It is the mix of debt and equity. Capital structure of a firm is as much important as the firm's survival. Saad 2010; argued that firms should give special emphasis to capital structure in order to deal effectively with prevailing economic conditions.

Tangibility

Tangibility refers to the fixed assets having the characteristics of being touched. It includes, plant, building and equipment. Hameed et al., argued that firms' with higher tangibility can attract lenders at cheaper rate because these firms have enough assets to collateralize. Higher tangible asset firms can also issue equity at reasonable price because higher tangibility can attract investors' confidence as well. The author suggested a positive relationship between firm's leverage and tangibility.

Profitability

Return on Equity is used as a proxy of profitability. It tells how much profit a company makes after using investment of shareholders.

Firm Size

Firm size is a major determinant of financial performance because firms with large size have large economy of scale and diversified in nature. Firm size is important in considering default risk. Large firm size and which are diversified can secure debt financing and can attract investors to have share in the firm in comparison with smaller size firms. Aryeetey et al., 2004; argued that firms larger with size have no trouble in getting debt while firms with small size are more inclined to equity financing as they hardly find opportunity for debt financing.



Advance Journal of Econometrics and Finance

Vol-4, Issue-1, 2026

Return on Asset

Return on Assets is used as a proxy of firms' performance. Higher return on Assets of a firm indicate that the firm is effective and is performing well. ROA indicates how effectively the firm is utilizing its assets in order to generate earnings as higher earnings are associated with the attraction of debt and equity. Higher ROA leads to lower cost of capital as it helps to achieve the optimal level of capital structure

Methodology

Population and Sample

The current study was carried out on the textile sector of Pakistan. A total of 28 textile firms were selected as a sample of the study. The firms were selected by using probability sample size subject to availability of their data. This research study opted for secondary data from textile sector of Pakistan. This industrial sector was chosen because of its great influence on the industrial sector of Pakistan due to its large size. The data collection came from financial statements published annually by the selected textile firms listed on PSX both on dependent and independent variables.

S. No	Category	No. of Firms	Source
01	Textile Composite	51	PSX Portal
02	Textile Spinning	59	PSX Portal
03	Textile Weaving	9	PSX Portal
Total Firms		119	
Selected Sample		93	

The author has followed the above systematic way for selection of 93 firms on convenient basis from total population of 119 listed firms dealing in Textile activities from Textile Composite, Textile Weaving and Textile Spinning. Moreover, firms having missing values have been excluded while data have been collected from audited financial statements of remaining 93 firms available both on PSX Portal and State Bank of Pakistan' website.

Baseline Regression Model

$$CCS = \alpha + \beta_1 Tangibility + \beta_2 Profitability + \beta_3 Firm Size + \beta_4 ROA + \epsilon_{ijt}$$

Analyses and Results

Table-1 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
CapitalStructureDE	917	.335	1.009	-2.358	15.294
Tangibility	917	.569	.524	0	8.192
ProfitabilityROE	917	-13.894	725.78	-21589.893	3449.607
FirmSize	917	21.922	1.609	16.46	26.71
ROA	917	-.022	.469	-7.785	1.674

Table-1 shows descriptive statistics. The study has 917 firm year observations. Descriptive statistics talk about characteristics of data. It show descriptive statistics for firm specific characteristics. Capital Structure has a mean value of .335 with a minimum and maximum values of -2.358 and 15.294 respectively. The mean value demonstrates on average change in capital structure independent variables. Further, the mean value of .335 represents the amount of average changes in capital structure by firm specific factors. The descriptive statistics further states that the mean values of the variable firm size is higher than any other characteristics. It has followed by tangibility and ROA. Previous studies i.e. Rashid & Said, 2021; have also demonstrated similar results. It further means that when deciding capital structure by manager of a firm, more attention is given to firm specific factors rather than other determinants that affect a firm's capital structure.

Table-2 Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)
(1) CapitalStructu~E	1.000				
(2) Tangibility	-0.041	1.000			
(3) ProfitabilityROE	-0.032	0.028	1.000		
(4) FirmSize	-0.248	-0.204	0.022	1.000	
(5) ROA	-0.330	-0.003	-0.001	0.234	1.000

Table-2 represents correlational matrices for focal firm characteristics. Correlation matrix talks about association of variables in statistical terms. The correlation analysis shows that there is negative correlation between Corporate Capital Structure and firm specific factors. The result further states that both tangibility and profitability have a negative yet weak correlation with capital structure. In contrast, firm size has also a negative correlation with capital structure, however, it is comparatively stronger than the correlation of tangibility with capital structure. Above all, ROA has a stronger negative correlation with a firm capital structure. It indicates that firms with larger size and stronger ROA tends to have lower capital structure thus increasing shareholders cash flow and earns investors' confidence to invest in Pakistan textile sector.



Advance Journal of Econometrics and Finance

Vol-4, Issue-1, 2026

Table-3 Regression Result

Capital Structure	Coef.	St.Err.	t-value	p-value	[95% Conf Interval]	Sig
Tangibility	-.171	.044	-3.84	0	-.258 - .084	***
Profitability	0	0	-0.37	.708	0	
Firm Size	-.145	.044	-3.30	.001	-.232 - .059	***
ROA	-.471	.05	-9.33	0	-.57 - .372	***
Constant	3.603	.97	3.71	0	1.698 5.507	***

Mean dependent var	0.335	SD dependent var	1.009
R-squared	0.132	Number of obs	917
F-test	31.488	Prob > F	0.000
Akaike crit. (AIC)	1611.810	Bayesian crit. (BIC)	1635.915

*** $p < .01$, ** $p < .05$, * $p < .1$

Table-3 shows fixed effect regression result for the relationship between capital structure and firms specific factors. The coefficients of firm specific factors represent a statistically significant relationship between capital structure and firm specific factors. The negative coefficient of -.171 of tangibility shows a negative relationship between a firm capital structure and its tangibility. It elaborates when a firm increases the ratio of debt in its capital structure it also pledges fixed assets to be transferred to in case of its inability to repay the debt, therefore, decrease the volume of tangible assets in its ownership. Similarly, Firm size and ROA has inverse relationships between with a firm's capital structure in the textile sector of Pakistan. It tells when a firm size is larger it has enough resources available to invest from internal sources and thus earns higher ROA when ultimately reduces the firm's need to finance from external sources. However, our result of regression shows profitability does not bring significant changes in a firm's capital structure.

Our result further shows the relationship is significant as the p-value is less than the conventional threshold of 5%. This significant negative relationship asserts that firms in the textile sector of Pakistan gets affected from the volume of tangibility, firm size and ROA when devising its capital structure In contrast, profitability has insignificant relationship with corporate capital structure in the textile sector of Pakistan. Moreover, the R-squared value states that 13.2% changes in corporate capital structure is because of the firm specific factors.. Overall, the model states that these variables do bring significant variations in corporate capital structure in the Textile Sector of Pakistan. However, profitability has insignificant relationship with corporate capital structure and shows that when a firm goes to finance from external sources it do not pay much heed to its profitability power.

Conclusion and Recommendation

Conclusion

The aim of this research study is to examine the literature on existing firm factors affect on its financial decisions i.e. capital structure decision, dividend payout decision, cash holding and investment decisions. We reviewed the extant available literature on firm factors and their impact on capital structure decision. Throughout literature we noticed that majorly these studies have been primarily conducted in developed economies i.e. the US and China, whereas, such research studies have also carried out in developing economics like Pakistan, however, limited to few sectors of Pakistan stock exchange and majore sectors i.e. textile sector has been ignored so far. Moreover, investigating firm factors affect in developing countries may have varying perspectives than developed ones due to different governance structure and mechanisms and corporate culture. Moreover, we practically tested the three prominent theories of capital structure. The weak relationship between profitability and capital structure shows that Modigliani and Miller theory and pecking order theories do not work in the textile sector of Pakistan. The theories assert that firms may go to finance homemade leverage or utilizing internal sources instead of going to finance from external sources. As both tangility and profitability do not reflect stronger changes in the capital structure of textile firms, it depicts that both the theories do not work in the textile sector of Pakistan.

Likewise, this study explored how a firm's financial policy i.e. capital structure is influenced by firm factors. Past studies have proved that the relationship exists because change in capital structure is primarily driven by change in firm specific factors. Corporate managers and finance executives should focus on firm specific factors i.e. tangibility, profitability, firm size and ROA for decision making including financial decisions rather than other factors.

There is a chunk of available studies that have concluded the impact of determinants of capital structure on a firm's financial decision. However, authors have not carried in depth analysis whether firm factors have an impact on corporate financial decisions in developing market like Pakistan. The current study, which has been carried out in Pakistan by selecting Textile sector as the dominant sector, has established literature on the effect of financial decisions i.e. capital structure decisions. The study investigates different capital structure determinants by testing different variables for firm level firm characteristics. Multiple statistical tests for panel data have been employed throughout the study. We analyzed whether a firm's capital structure gets affected by firm characteristics. Moreover, we rejected all hypotheses and conclude that relationship exists between firms factors and corporate capital structure. We accept that larger firms and higher ROA bring significant changes in capital structure in firms operating in the textile sector of Pakistan. We also accepted that firm tangibility and profitability also bring change in corporate capital structure, however, this change is insignificant and does not attract the attention of financial managers while devising their firms capital structure.

Significant Contribution

The current study has significant contribution to the scanty extant literature. This study also fills some of the research gaps that past studies have not investigated so far. Various studies in the area have already been conducted in both developed and developing economies. In developed countries. Various studies in the past have also significantly contributed to the area by investigating firm specific characteristics of capital structure determinants. Study by Ullah et al. 2017; Safeer et al. 2019; & Ahmed and Siddique 2019; significantly concluded the impacts of some firm level independent variables i.e. ROA, profitability, tangibility, firm size and firm growth on firms' capital structure while overlooking its firm level affect.



Advance Journal of Econometrics and Finance

Vol-4, Issue-1, 2026

Given the potential gap in the present literature in a developing economy context, the current study has also explored firm factors affect in corporate capital structure in the textile sector of Pakistan and established a new form of capital structure research in Pakistan having emerging economy which can also be utilized in similar developing economies. This study also contributes to the textile sector of Pakistan about the impact of various capital structure determinants on corporate capital structure. This study will also be used by future researchers as part of literature if aspire to study the firm level effect in financial policies in other dominant sectors of Pakistan economy. The current study was held in Pakistan so it was important to consider Pakistani firms and therefore, the author took textile sector as the area of study.

In addition to Textile firms, the practical implications of the study also carry enduring benefits for other firms operating in same industries who are seeking for effect of firm level factors on financial policies and may help them to maintain a target level of capital structure. It is also helpful for finance executives to consider the role of firm level factors in determination of financial policies i.e. capital structure. The current study was carried out in Pakistan but its results can be applicable to firms in similar developing economies.

Policy and Practical Implications

The current study carries some interesting practical implications for corporate managers and finance executives which they should adopt when devising financial decisions of their organizations.

Limitations and Future Research Recommendations

Despite meaningful findings and practical implications of the study, it has also limitations which leave room for future researchers. The current study was carried out while considering non-financial firms only and excluded financial firms. This has created the issue of generalizability on financial sector of Pakistan. The current study is not applicable to financial firms listed on PSX. The study also lacks other sectors of the KSE-100 and included only the dominant textile sector due to time constraints. For more comprehensive results, future researchers should include other sectors of KSE-100 for in depth analysis of firm level effect. Moreover, this study was carried out by considering yearly data of textile firms over a period of 11 years from 2013-2023, which make it vital for future researchers to broaden the time frame and frequency of data. In addition, future researchers should also include financial firms in determining relationship between capital structure and its determinants as it will also have interesting findings and managerial implications due to its different mechanism and structure from the non-financial firms. Opportunity also exists for future researchers to carry comprehensive studies to find the impact of firm characteristics on corporate financial policies i.e. capital structure, by including other firm level variables i.e. R&D expenditure, cost of goods sold and Earning per Share (EPS) and Macro-economic variables which this study has excluded due to time constraint. Macroeconomic determinants i.e. interest rate, corporate tax rate, GDP growth, Inflation and stock market return can also be included.

Apart from these variables, one may also include behaviors of CEOs during financial decisions i.e. dividend payments, to test empirically the prominent theories of capital structure. There are also suggestions for future researchers to carry an empirical investigation on cost benefit analysis of firms. The author also sees opportunity for future researchers to do a cross-country analysis of capital structure determinants. Finally, the author of the study also suggest future researchers to extend their studies to other industries by taking samples from both financial and non-financial firms operating in Pakistan over a comprehensive period of time. This will help overcome the limitation of generalizability on the financial sector of the current study which has been carried out on non-financial sector.

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