Review of Literature on the Determinants of Capital Structure

A. Baroon[a,b] and D.A.I. Dayaratne[c]

[a] *Faculty of Graduate Studies, Sabaragamuwa University of Sri Lanka, Belihuloya, Sri Lanka*
[b] *Department of Accountancy, Sri Lanka Institute of Advanced Technological Education*
[c] *Department of Accountancy and Finance, Sabaragamuwa University of Sri Lanka, Belihuloya, Sri Lanka*
alabaroon@yahoo.com

Capital structure decision of a firm plays a vital part in maximizing the firm's value. The mix of the diverse funds obtained by the firm defines its capital structure. The problem of how firms choose and adjust their strategic financing mix has attracted a great deal of attention from corporate financial economists and has been a source of intense debate. In the traditional finance theory, an individual is considered to be rational and the effect of the decision maker's personality is neglected. The better management of a firm understands the dynamics of macroeconomic factors on capital structure. Most of the developing countries have become an emerging market with a lot of potential investments that appeal to investors and get managers to rethink about the influencing factors of using debt and their extent of influence over firms. Most of literature reviews on the determinants of capital structure have failed to explain the different viewpoints at once and the purpose of this study is to review the determinants of capital structure. Authors have identified, from the review of literature, that some finance theories (MM theory, Trade off theory, Agency cost theory, Pecking order theory and Market timing theory), economic factors (Inflation, Tax rate, GDP growth, Lending rate), psychological factors (Overconfidence, Optimism, Loss aversion, Anchoring) and firm characteristics (Profitability, Firm size, Tangibility, Depreciation, Growth opportunities, Liquidity) decide the capital structure of a firm. In addition this study will develop conceptual framework for the determinants of capital structure in different perspectives.

Keywords: capital structure, economic and psychological factors, finance theory, firm characteristics