An Analysis on the Relevance of Capital Structure Theories in Relation to Firm Specific Variables

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The decision on capital structure relates to the combination of the company's debt and equity, which may have significant implications for the value of a firm and the cost of capital. This is a crucial decision because the wrong choice of capital structure can lead to financial distress and even to bankruptcy. Based on the theorems of Modigliani and Miller (1958) and empirical evidence of financing decisions, two competing capital structure theories have been developed and these two theories are Trade-Off Theory and Pecking Order Theory, which seek to explain the shift in leverage ratio by focusing on cost-benefit function and position of transaction costs of borrowing, mostly dependent on observable firm attributes. As a consequence, differences in capital structure theories emerge in their definitions of tax significance and changes in information, transaction and agency costs. The predictions of traditional capital structure models have been well established primarily in the context of developed economies. However, the applicability of theoretical principles to capital structure decisions by companies in emerging and developing countries persist minimal. Many of the research conducted on the analysis of Capital Structure Theories do not concentrate on the applicability of Capital Structure Theories considering firm unique variables. The purpose of this study is to theoretically assess the relevance of Trade-Off Theory and Pecking Order Theory in relation to firm-specific variables. The analysis included firm-specific elements such as profitability, size, liquidity, tangibility and growth in order to review the relationship with the above two theories and to validate the objective of the study. The study concludes that there is an interaction with capital structure, firm-specific variables, and relevance of Trade-Off Theory and Pecking Order Theory.

Keywords: *Capital structure, Firm-specific variables, Pecking order theory, Trade-off theory*