THE CASE STUDY OF CAPITAL STRUCTURE IN AFFECTING RETURN ON EQUITY (ROE) AMONG CHINESE COMPANIES

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Abstract

The case study for the capital structure research had been crucial to address the financial performance for the business. In the recent trend of business, the strategic development of the business growth had been dependent on the capital structure funding where the ratio between the debt and equity often become the pillar to determine the financial performance for the business. This triggered the study to develop the quantitative method research to explore the relationship of debt equity ratio representing the capital structure funding for business against the return on equity (ROE) representing the financial performance of the business. The target study will be based on the public listed companies in China mainly from Shanghai
The results and findings from the quantitative study had found the significant positive relationship existing between the debt equity ratio and ROE which aligned with the initial assessment from the literature review. This had been crucial contribution for the investors to understand the potential earning derived from the ROE inducing the understanding where the higher debt funding will encourage better return on the equity investment which will become more important consideration among the investors.

**Keywords:** Investors, China, Capital Structure, Financial Performance

**Citation:**

**INTRODUCTION**

A company's capital structure describes how it uses various sources of financing to finance its operations and growth. It represents the breakdown of a company's debt, including equity and debt, which become the two main sources of capital financing for an organization (Graham, Leary, and Roberts, 2015). According to the accounting definition, a company can raise cash through debt, which is defined as money borrowed from third parties such as banks, financial institutions, or bondholders (Alipour, Mohammadi, & Derakhshan, 2015). It requires a set number of principal and interest payments spread over a specific period of time. According to Graham, Leary and Roberts (2015), debt can be long-term or short-term, such as corporate bonds or bank loans. While excessive debt can increase financial risk and interest costs, debt financing has the advantage of being tax deductible and allowing a company to reduce its operations (Kieschnick & Moussawi, 2018).

A company's capital structure is determined by the ratio of debt to equity used to finance its assets and operations (Hang et al., 2018). The industry, company size, stage of growth, profitability, cash flow, risk tolerance and cost of capital are some of the variables that influence this ratio. To maximize shareholder returns while reducing the cost of capital, an organization's strategy must be clearly defined by its basic capital
financing structure (Naseem et al., 2017). Therefore, it is considered the main factor in the growth of the company’s profitability. This is a result of the factors that improve financial performance, with the capital structure ratio playing a large role in how the financing structure is provided and how it affects the company's prospects and potential (Hang et al., 2018). The likelihood of a positive or negative impact on the contribution to a company's profitability depends on the equity and debt ratios, which can be either high or low.

The value of the equity contribution within the company's capital structure had a significant impact on how return on equity (ROE) was measured. According to a simple prediction, the higher equity should lead to a higher return on business investments (Ramli, Latan and Solovida, 2019). However, there is some evidence from previous studies that a high equity leverage ratio may have an adverse impact on financial performance and ROE, as a high equity ratio could lead to an excess of equity financing, making it difficult to achieve a significant return on capital (Ngoc, Tien & Do, 2021). Furthermore, Oyedokun (2018) emphasized that debt financing appears to be a more cost-effective financing as large companies usually provide high debt financing to finance significant projects, which results in a higher return on equity based on the net profit earned by the company.

According to Kamar (2017), if the company uses equity financing as a long-term source of financing, it does not have to make payments on the equity capital raised. According to Yanto, Christy and Cakranegara (2021), strategic planning of the use of funds means that the equity raised tends to be a more effective resource for increasing company returns. This opinion was supported by Amanda (2019), who noted that the longer-term investments for the company are supported by the higher equity financing in the capital structure, as opposed to the shorter-term sources of financing such as debt and borrowings from accounts payable. which have an impact on the expansion of ROE. Affandi, Sunarko, and Yunanto (2019) disagree with this particular viewpoint and argue that high equity levels in working capital will result in excess capital that will eventually become redundant and have an inefficient impact on return on equity.

Furthermore, previous research found that ROE is likely to appear higher when the debt ratio tends to be higher (Juwita and Diana, 2020). This is due to the higher contribution of debt financing through the injection of additional cash flow to increase the profitability of the company, while measuring ROE does not take into account debt financing, resulting in a tendency to achieve a higher ROE over time (Siagian, Wijoyo
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and Cahyono, 2021). In other words, a higher equity-to-debt ratio indicates the true return on equity, as a small amount of debt is unlikely to give you enough leverage to generate more cash flow to invest in the expansion and growth of your business. According to Kusmawati and Ovalianti (2022), ROE is potentially determined by the impact of the peak and trough of the leverage ratio but is not apparent when the equity and debt ratios become noticeably out of balance.

Ho: There debt equity ratio has no significant positive impact towards the return on equity (ROE) for the business.

H1: There debt equity ratio has significant positive impact towards the return on equity (ROE) for the business.

RESEARCH METHOD

The research methodology for the current study was created to be consistent with the structure of the quantitative analysis study, where the quantitative study will use quantifiable and measurable data (Apuke, 2017). According to Sharela (2016), the advantage of a quantitative study is that it can provide results and insights that are more objectively based on statistical data than qualitative studies, while avoiding introducing subjectivity into researchers' evaluation. Additionally, quantitative analysis allows research to examine the larger scope of sample data, allowing for greater coverage of the study's target population (Apuke, 2017).

Due to the high relevance of the study and the reliance on numerical data, a second argument was put forward in favor of quantitative analysis over qualitative analysis (Nan and Sansavini, 2017). This will support efforts in the right direction to reach the study's conclusions. According to the relevance of the study, the data included for its purposes will be concentrated in a cross-sectional study, in which the collected data will be concentrated at a specific point in time in order to avoid the data being influenced by different points of temporal displacement measurement of the data (Stockemer, Stockemer & Glaeser, 2019).

The secondary data market, which refers to the data that was previously used through the primary source but remained available in the secondary data market, will be the main focus of the data collection process for the current study data (Sekaran and Bougie, 2016). The secondary data market provides greater convenience in the data collection
process and gives the method of secondary data collection greater leverage in terms of time and resources (Apuke, 2017).

Another advantage of using secondary data is that it appears to fit better with research design, which places a strong emphasis on analyzing historical data to predict the future trend of a company’s profitability metrics. The available annual financial statements of the business reports of the selected companies are used as a source for the secondary data. The secondary data source will play a key role in conducting the study by helping in calculating the crucial financial ratios such as leverage ratio and profitability ratios. To carry out a quantitative study analysis using the statistical method, the numerical data obtained from the financial statements prove to be well suited.

When two or more variables are statistically compared, correlation analysis is used to determine how closely they are related to each other. It is helpful for researchers and analysts to understand the relationship between changes in one variable and changes in another. According to Queirs, Faria, and Almeida (2017), correlation analysis often takes a significant toll in quantitative methods as it helps to identify the significant presence of both positive and negative relationships between the two variables included in the research framework. If the hypothesis is tested, which is essential to the conclusion of the study, it will be highly relevant to the process. The Pearson correlation coefficient, measured as part of correlation analysis, quantifies the linear relationship between two continuous variables (Basias & Pollalis, 2018). According to Stockemer, Stockemer, and Glaeser (2019), the range is between -1 and 1, with the negative and positive integers indicating the direction of the relationship between the two variables.

In the future, regression analysis will continue to be an important statistical tool to draw conclusions about the significance of the relationship between the independent variables of the leverage ratio and the dependent variables for profitability performance and to lead to hypothesis testing, as recommended in the literature review (Sekaran and Bougie, 2016). According to the frame of reference, the independent variable is tested against each individual dependent variable using the single regression analysis created (Apuke, 2017). According to Stockemer, Stockemer, and Glaeser (2019), the p-value significance of 5% will be the standard for hypothesis testing, allowing regression analysis to incorporate the results into quantitative analysis.
RESEARCH RESULT

Table 1: Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>ROE</th>
<th>Debt Equity Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE</td>
<td>1</td>
<td>0.539610862</td>
</tr>
<tr>
<td>Debt Equity Ratio</td>
<td>0.539610862</td>
<td>1</td>
</tr>
</tbody>
</table>

The Table 1 introduced the quantitative analysis method by demonstrating the application of the correlation analysis. As mentioned in the research methodology, the measurement for the correlation analysis will be determined by the Pearson Correlation Coefficient where the Table 1 had recorded the value at 0.53961 which is between the range of 0.4 to 0.6 that represent the moderate strength of the correlation between the two variables. This indicate that the movement of the debt equity ratio is likely to yield the similar movement observed through the ROE financial performance of the business. The existence of the positive correlation between the two variables can be summarized as significant and relevance linking the potential capital structure importance to determine the equity return for the investors.

Table 2: Regression Analysis

<table>
<thead>
<tr>
<th></th>
<th>Coefficients</th>
<th>Standard Error</th>
<th>t Stat</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.078257376</td>
<td>0.028128318</td>
<td>2.782156267</td>
<td>0.011876073</td>
</tr>
<tr>
<td>Debt Equity Ratio</td>
<td>0.03026479</td>
<td>0.010832986</td>
<td>2.793762387</td>
<td>0.011579906</td>
</tr>
</tbody>
</table>

The Table 2 showed the regression analysis testing the original research framework as proposed for this research exploring the significant in the relevance in the relationship between the debt equity ratio of the companies against the development of the achievement in ROE for the business. Based on the results in the regression analysis in Table 2, it is clear that the p-value recorded at 0.0116 which is below the 5% tolerance level benchmark as demonstrate for the study. This is crucial to address the significant in the impact of the determination in the debt equity ratio to influence the financial performance in ROE for the business. Moving on, the results from the quantitative analysis will be used to assist to perform the hypothesis testing for the study. Based on the outcome for the study, the correlation analysis and regression analysis had come into an agreement to determine the existence of the significant positive
relationship between the debt equity ratio against the ROE for the business. In other words, the determination of the capital structure funding for a company will likely to explain the potential financial performance for the equity investment for the investors. With this, there is sufficient evidence is related to the findings to the initial expectation of the research derived from the literature review leading to the acceptance of the alternate hypothesis in H1 and rejecting the null hypothesis as mentioned in H0.

Ho: There debt equity ratio has no significant positive impact towards the return on equity (ROE) for the business.
H1: There debt equity ratio has significant positive impact towards the return on equity (ROE) for the business.

Furthermore, Oyedokun (2018) highlighted that large companies often provide high levels of debt financing to finance significant projects, resulting in a higher return on equity based on the net profit earned by the company. Apart from Yanto, Christy and Cakranegara (2021), strategic planning of the use of funds leads to raised equity becoming more effective resources to increase the company’s returns. This was supported by Amanda (2019) who showed that the higher level of equity in the capital structure will help the company in long-term investments where the strategic decision on the investment tends to give a higher return compared to shorter-term modes of financing such as debt and Loans from liabilities that impacted ROE growth. Both the correlation analysis and regression analysis agreed that the debt ratio had a significant positive impact on the company’s ROE, and the current results of the study provided enough support to account for this finding.

According to the previous literature review, the organization’s capital structure will determine how it obtains equity financing, where the equity capital is used to generate income for the company. As a result, the value of equity is used to determine the company’s return on investment, with higher debt financing leading to lower equity financing and a higher value of return on equity. In other words, the idea of using debt to increase ROE may be true and viable from a business perspective. This was a crucial address for the investors as the higher leverage ratio proved that the higher leverage ratio will have a positive impact to provide a higher return on the equity investment which was the primary concern for the investors. Therefore, it is not surprising that investors would prefer the company to expand its financing through debt rather than equity. However, debt financing for the study would create additional concerns as the debt value brings higher financial risk to the company as the high debt commitment...
would lead to financial resource uncertainty as additional resources would be required to deal with the presence of the obligation in the increasing debt value in the financial statements.

CONCLUSION

The results of the study had a significant impact on the way the corporate organization was managed, as they identified the financing of the capital structure as a key element of a sustainability strategy for the industry. Capital structure, as commonly understood, refers to how an organization allocates its debt and equity financing to invest in its assets and generate profits. However, the actual business reality is that an organization's capital structure determines its cost of capital as well as the way it directs its return-generating strategy. According to the results of the study, the company's management will keep in mind the debt equity strategy to enable raising debt capital while improving ROE, which will result in higher return and return for investors, the main objective and interest of the company.

The study's specific focus on the Chinese consumer industry environment meant that its conclusions were limited to China and may not be applicable to consumer industry companies in other countries. This is due to the fact that the different cultural and economic contexts of the study undoubtedly emerged as a key variable that, despite a similar title, will influence possible variations in the results of the study. In addition, China, a representative of Eastern countries, is likely to have significant differences from Western countries in terms of the prospects for a possible capital structure strategy. This means that there may still be a gap in academic research studies.

The aim of the current study was to determine whether there is enough data to test whether there is a relationship between the financial performance of Chinese companies and capital structure financing. To reflect the potential link for business organizations in other countries, the study did not adequately compare the evidence. The quantitative study can be extended to examine the assessment of the impact of capital structures on financial performance of other countries. This could be crucial to provide evidence in future research to monitor outcomes in other countries' settings. This can be included as part of the recommendation for future studies. To test possible differences in capital structure practices and strategy between different countries, the economic situation and differences in management culture between the two could be assessed.
REFERENCES


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