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Impact of International Financial Reporting Standards on Firm Performance: Evidence from Pakistani Non-Financial Firms

by

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Dedicated to my lovely parents and my siblings who always encourage and support me. My Uncle (Muhammad Ali), my special friends Rizwan Ali, Arslan Khalid and my brother (late) Usman Haider, who always encourage me for my academic goal.

CERTIFICATE OF APPROVAL

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"Then which of the Blessings of your Lord will you deny"

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Abstract

The objective of this study is to investigate the relationship between capital structure, IFRS and firm performance of all non-financial firms listed in Pakistan during the period 2001-2019. This study also investigates the impact of macroeconomic variable GDP on performance of non-financial firms. The data obtains from firms Financial Statement Analysis published by The State Bank of Pakistan. Panel data analysis is used to examine the financial performance of all non-financial firms. This study considers the IFRS adoption in 2005 as a dummy variable that influences the financial performance of firms. There is no indication that IFRS adoption has influence on the firm performance. On the other hand, there is evidence that the adoption of IFRS, as a significant regulation shift in the stock market, can have a favorable impact on main financial indicators including the information asymmetry and financial dispersion cost of capital. So this study attempts to fill this gap by analyzing IFRS and firm performance. The hypotheses of the study are accepted that capital structure and IFRS adoption has an impact on firms financial performance. The findings show a positive relationship between capital structure and firm performance. GDP also has a positive impact on performance of firm. In addition, adoption of IFRS improves the firms performance. Further study can be applied to the financial sector to study these variables in both developing and developed countries to see what the effects are from different perspectives and levels of development in different countries.

Keywords: Capital Structure; Firm Performance; IFRS Adoption; Non-financial Firms; GDP

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Abbreviations

AFA	Annual financial Analysis
CS/TDR	Capital Structure
FE	Fixed Effect
FP	Firm Performance
GAAP	General Accepted Accounting Pricipals
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
IASB	International Accounting Standard Board
IAS	International Accounting Standards
Ke	Return on Equity
LEV	Leverage
MM	Modigliani and Miller
OLS	Ordinary Least Square
POT	Packing Order Theory
PSX	Pakistan Stock Exchange
RE	Random Effect
ROA	Return On Assets
SBP	State Bank of Pakistan
SME's	Small Medium Enterprises
WAAC	Weighted Average Cost of Capital

Chapter 1

Introduction

Chapter 1 includes the Introduction, Research Gap, Problem Statement, Supporting Theory, Research Questions, Objectives, Significance and Contribution of this Study.

1.1 Background of the Study

In today's dynamic economy, firms must smooth their cash flows by carefully making investing, operating and financing decisions. Financing decisions are the most important of them because they determine whether or not a company will survive. Financing decisions refer to the sources from which a company obtains funds, such as debt and equity financing.

To finance investments, firms can use internal financial sources like retained earnings or external finance sources (debt-equity) if they want to survive and grow. Combination of preferred stock, debt, and ordinary equity is utilized to finance assets of firm (Brigham and Ehrhardt, 2017).

Capital structure refers to a mix of debt and equity of company utilized to fund its assets (Ronald and Edgar, 2016). The capital structure (CS) of a company consists of debt and equity, the proportion of which varies by industry. However, a mix of debt and equity (Akhtar et al., 2019) is thought to be the optimal capital structure (Kanwal et al., 2017). In the field of financial management, the financial

structure is a delicate topic because it has an impact on profitability (Tailab, 2014). According to the definitions available, financial structure is defined as the integration of financial sources that finance the business operations. Over the last few years, Jordan's economy and capital market have experienced a series of severe external and internal obstacles.

Furthermore, according to Nazha (2018), the General Controller of Jordanian Enterprises, 28 companies have lost more than 75% of their capital. Furthermore, ASE Chairman of the Board of Directors Dr. Jawad Al-Anani stated that 78 of the 195 listed businesses on the Amman Financial Market lost money in 2018 (Al-Anani, 2019). The most crucial cause for Jordanian companies failing is a deficiency in financial decisions (Nazha, 2018).

One of the most significant financial decisions is deciding on a financial structure. This is an important part of shareholder interest both inside and outside of a company because they affect the company's performance and can lead to bankruptcy if improper financial structure decisions are made (Shahreza & Ghodrati, 2014).When external finance is required, internal financing (retained earnings) is favored over external financing, and debt is preferred over equity (Zaheer et al., 2011).

As a result, deciding on the debt-to-equity ratio is a critical decision that has a major impact on firms financial performance (FP) (Akhtar et al., 2019). Referring to the pecking order theory, debt is favored because it provides a tax shield (Akhtar et al., 2019), as interest on debt is deducted before taxes are calculated. Excessive reliance on debt, on the other hand, can be problematic for businesses.

On the other hand, each company has a set amount of authorized capital from which it can issue shares to raise equity funding. Excessive reliance on equity funding can lead to liquidity problems in businesses (Basit & Hassan, 2017). As a result, selecting the best CS is critical, as an improper combination of debt and equity negatively impact the FP (Akhtar et al., 2019).As a result, financial managers should exercise caution when making decisions about optimal CS, as this can lead to the maximization of shareholder capital (Abbas et al., 2013). In general, CS refers to the many methods by which businesses structure their finances, including

as debt and equity (Nawaz et al., 2011). Good financial structure decisions, on the other hand, increase a value of company (Alipour, Mohammadi, & Derakhshan, 2015). As a result, financial performance is regarded as an early indicator of a company's impending insolvency.

The capital structure, which is made up of equity and debt , with its potential impact on corporate performance, is one of the most important concerns in finance and accounting. A variety of hypotheses exist in theory to explore the association between between CS and performance of firm. The theory of Modigliani-Miller (MM), which claims that capital structure has no bearing on a value of firm, is regarded as the foundation theory (Hoffmann,2014). Nonetheless, the MM theory's core assumptions are predicated on idealized capital market conditions that in the real world are deemed to be virtually un-observable.

In their renowned 1958 paper, Modigliani Miller questioned that viewpoint. They contended that the market values, the combined market value of a firms debt and equity, and that the earning power of real assets of firms, is independent of its capital structure decision if the capital investment program of company is held constant and some other assumptions are met.

Since Modigliani and Miller's capital structure irrelevancy study, a lot of attention has been paid to the appropriateness of these "other assumptions," which include the absence of taxes, bankruptcy costs, and other real-world defects. There are many different kinds of finance, each with its own set of qualities. Large companies typically require long, medium, and short-term financing to continue their operations. In terms of nature, these finances could be external or internal (Modigliani & Miller, 1958).

The capital structure and performance of firms relationship has gained a lot of attention in the finance literature. Scholars have been trying to figure out how important concentration of control is for the kind of investors or firm performance that exercise that influence for a long time. Prior study has explored a link between capital structure and corporate governance, one of the most pressing issues confronting state-owned firms. This will assist us understand the potential challenges in performance and capital structure by studying the effects of capital structure

or firm performance.

To explain an imperfect capital market, various established theories like pecking order theory, trade-off theory and agency cost theory have been offered in the subject. Despite the fact that these theories have diverse justifications, they all agree that capital structure affect the value. It's vital to remember, however, that no single theory can fully clarify the specific link between both the capital structure and companys performance.

Prior empirical research in both developing and developed economies show some support for the link between capital structure and performance of company. No research has looked into the influence of the shift to the International Financial Reporting Standards (IFRS) on that relationship. Since there are various arguments exist about the benefits of adoption of IFRS on the information environment, it is worthwhile to investigate this study subject.

The International Financial Reporting Standards are part of the accounting infrastructure that assists emerging countries in promoting economic progress (Larson & Kenny, 1996). As a result, adoption of IFRS should result in improved economic development in adopting countries. According to Lambert, Leuz, and Verrecchia (2007), Ball (2006), and Barth, Landsman, Leuz and Verrecchia (2000), and Lang (2008), IFRS adoption increases financial statement transparency and disclosure.

Improved disclosure and transparency should lower the level of agency costs, estimation risk information asymmetry, uncertainty, and capital costs while improving accuracy, comparability, credibility, information quality, corporate governance, accounting quality, capital market efficiency and market liquidity (Ball, 2006; Jermakowicz, 2004; Jermakowicz & Gornik-Tomaszewski, 2006; Armstrong et al., 2008; Lambert et al., 2007; Barth et al., 2008; and Leuz & Verrecchia, 2000;).

Furthermore, bonding theory argues that better disclosure and accounting standards convey to investors an improvement in financial statement quality (Coffee, 2002). Better financial statements boost openness, attracting more investors and promoting efficient capital markets (Drabek & Payne, 2002; Leuz & Verrecchia, 2000; Ball, 2006; Jermakowicz, 2004; Jermakowicz & Gornik-Tomaszewski, 2006; Barth et al., 2008; Lang, Lins, & Miller, 2003; Lambert et al., 2007). According

to Lee (1987), efficient capital markets aid economic progress. As a result, the adoption of the IFRS should have a favorable impact on the countrys economic growth and firms that adopt IFRS.

The influence of adoption of IFRS on a firm's economic growth has long been a point of contention among academics, accountants, and regulatory agencies. There have been numerous arguments stated in favor and against the adoption of the IFRS and its impact on the economic growth of adopting firms; however, little empirical research has been done in this field to test the validity of these arguments. Despite the fact that various research look into the impact of adoption of IFRS at the business level, only three studies looked into the economic ramifications of IFRS implementation in adopting firms.

The geographical reach of studies in this field is limited, as is the sort of economic development of the countries and firms included in the sample. Such as, research on Asian African (Larson, 1993), Woolley, (1998), and developing countries has been conducted (Larson & Kenny, 1995). These studies may not be generally applicable to nations with various features because they are limited to countries from a specific region or at a specific degree of economic development.

Furthermore, the meaning of IFRS adoption varied. Larson (1993), Daske, Hail, Leuz, and Verdi (2007), Larson and Kenny (1995), Daske et al., (2008) and Armstrong et al. (2008), use the term "adoption" to refer to the wholesale IFRS adoption; however, Larson (1993), Armstrong et al. (2008), and Daske, Hail, Leuz, and Verdi (2007), Adapting IFRS to match the economic, social, political, cultural, and other environmental characteristics of the adopting firms, according to the researchers.

Furthermore, according to Ball (2006), Implementation of IFRS is the process of narrowing the gaps between a firm's accounting rules and the IFRS. The literature's use of a variety of definitions of IFRS adoption restricts the comparability of the findings. Furthermore, past research findings may be out of date because they looked at IAS acceptance rather than IFRS adoption. The IFRS Rules are more extensive than their counterparts and are thought to be a better set of standards (Deloitte, 2010; Hicks, 2010). If IAS is seen as less comprehensive and, in general,

of lesser quality than current IFRS, it is possible that their adoption had little or no impact on a firm's economic growth. Because IAS is of lower quality than IFRS, it may have had a limited impact on the market of adopting firms, as a result, on general economic growth. The IAS impact on the quality of the financial accounts produced would explain the contradictory outcomes on economic development in adopting firms.

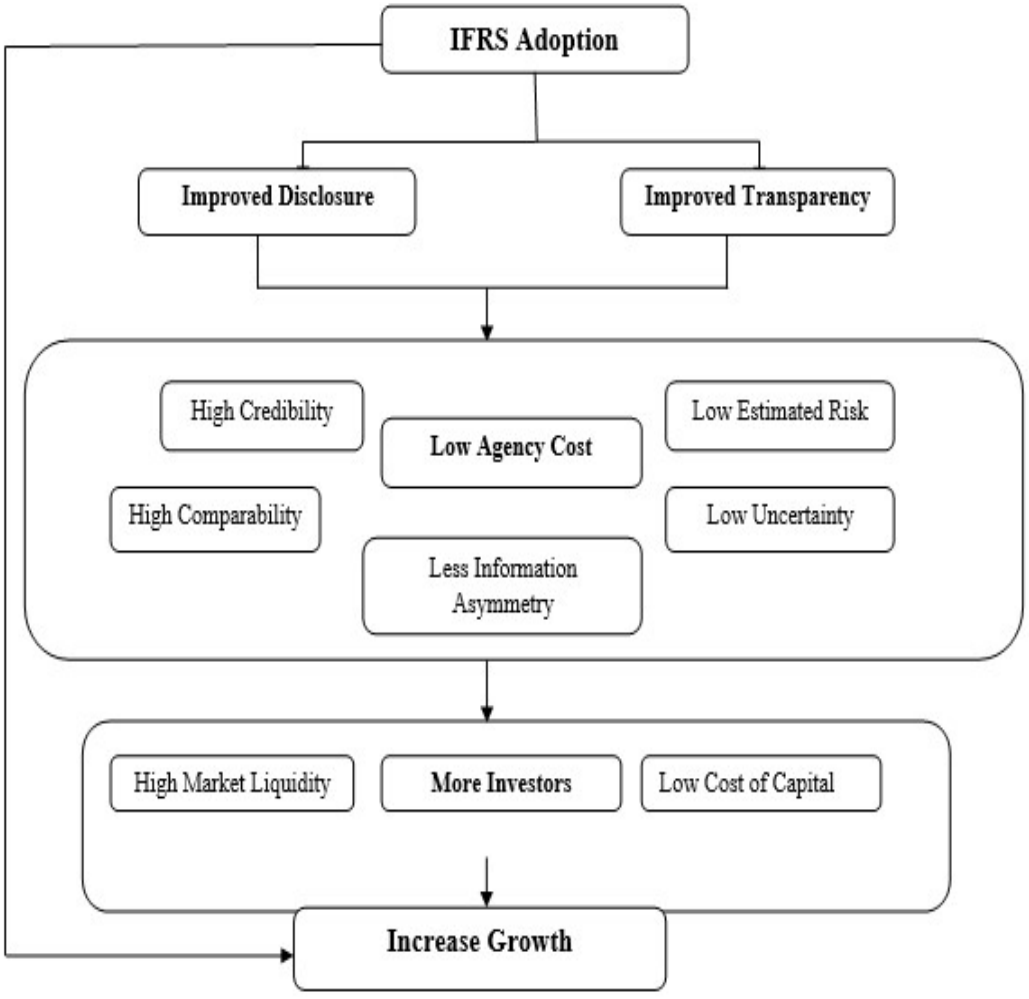

FIGURE 1.1: Impact of IFRS Adoption

In this regard, IFRS, which are being adopted in various economies and serve as a moderator for effective investment by improving the transparency and comparability of accounting data (Barth, Landsman et al. 2008); (Lee 2011). In 2004, the IASB improved IAS, resulting in enhanced accounting quality, increased mar-

ket liquidity, and lowest capital cost. IFRS main goal is to provide only useful information for investment decision-making, and IFRS provides that information in a timelier manner than domestic GAAP. As a result, we expect that firms that adopt international financial reporting standards will have a higher chance of overall efficient investment because their investors will be able to more closely monitor the firm's management regarding efficient investment decisions (Lu and Trabelsi 2013).

According to financial economic theory, information asymmetry between firms and capital providers about how much of the remaining resources the firm allocates to investment opportunities drives the optimal investment process of a firm (LaFond and Watts 2008).

Furthermore, accounting conservatism aids in avoiding opportunistic management actions, which leads to a rise in firm's value through selection of efficient investment-based initiatives. Accounting conservatism is a basic fundamental principle in accounting-based policies that has been used for the last three eras, Accounting conservatism is regarded the most useable feature for financial information, but its acceptability for economic and investment gains is a point of contention among politicians and academics (Whittington, 2014).

Since 2001, an independent group known as the IASB has been upgrading IAS to allow users of financial statements to compare their accounts with those of other countries. Pakistan has made numerous revisions to its accounting standards to conform to international standards such as the International Financial Reporting Standards (IFRS). In this regard, SECP has urged enterprises to comply with IAS / IFRS in accordance with IACP's directive under section 234 of the Companies Ordinance 1984.

The implementation of IFRS is seen as an adequate set of IAS. Pakistan is one of few economies that has been using the revised International Accounting Standards (IAS) since 2003. ICAP, which is in charge of all accounting rules and regulations, has mandated that all public companies listed on the PSX prepare their financial statements in accordance with the updated IAS, while IFRS is being adopted without any changes in such updated standards, with the exception of IFRS 1

and IFRS 6, since 2007. IFRS 1 and 14 have not been adopted in Pakistan, while IFRS 9 has been postponed until June 30, 2021. Companies must adhere to IAS 39 criteria throughout the exemption period.

This study considers the influence of adoption of IFRS in 2005 in examining the companys performance in the setting of a developing country like Pakistan. Changes in financial legislation, like the IFRS adoption by stock markets, may affect the firm performance. The International Accounting Standard Board (IASB) developed IFRS codes in an attempt to unify accounting information around the world. The goal is to create a standard language for business that everyone can comprehend (Das,2015).

For the reason that it mandates more disclosure in a company's financial statements, IFRS adoption is thought to improve earnings quality and reduce information asymmetry (Gassen and Sellhorn,2006). Furthermore, IFRS improves the overall ratio of performance measurement (Abiodun and Asamu,2018; Devalle, et al. 2010). As a result, when doing research, the impact of IFRS implementation should be considered.

1.2 Problem Statement

In Pakistan, there is disagreement about whether IFRS adoption makes financial statements more transparent and comparable and whether it has a beneficial or bad impact on earnings management. This has never been empirically verified.

1.3 Supporting Theory

Many hypotheses have been proposed by financial executives and experts to explain financial methods. One of these is Donaldson's Pecking Order Theory, which he proposed in 1961. (Myers, 2001). A management of company has a financing source hierarchy, in which retained earnings is in top of the list according to the Pecking Order Theory. Internal funds are favored over debt because of the lower cost of generating funds by the new shares issuance (Myers & Majluf, 1984).

As a result, this sends a signal to investors that the company is in good financial condition and will be able to meet its obligations. One key idea that explains the relationships within corporations is the Agency Theory. The information asymmetry is the key cause for the emergence of such a hypothesis. Owners may not have access to the information that the administration has, as a result, it might be used for management. Given this, the Agency Theory suggests that the agency problem arises as a result of the separation of ownership and management (Jensen & Meckling, 1976). Due to conflicts of interest and diverse attitudes toward the risk of management action, which is contradictory to the company's purpose of maximizing owners' wealth, this could lead to management acting against the owners' interests (Eisenhardt, 1989).

According to the Agency Theory, its the responsibility of managers to manage a financial structural capacity of company and ability of debt repayment in order to preserve the required capital for the operations and activities of company. As a result, the existence of issues and difficulties in this area will have an impact on investors' impressions of the company, so influencing its performance. Dahlquist and Robertsson (2001), on the other hand, believe that asymmetric information is the most important aspect in corporate identification.

Foreign institutional investors, according to Aggarwal, Erel, Ferreira, and Matos (2011), are linked to stronger corporate governance since their presence removes ineffective CEOs from management. Good company governance is greatly aided by foreign investors. As a result, as indicated by lower conflict of interest rates foreigners are better at controlling and monitoring enterprises. (D'Souza et al., 2005).

Foreign investors, according to Young et al. (2008), are an important part in improving governance in emerging economies. Furthermore, Sappington (1991) recommended the formation of incentives for managers that lead to a rise in firm value in the demarcation of interests between shareholders and managers from the Agency Theory‘s standpoint.

Due to the increased alignment of interests between shareholders and managers as a result of managerial ownership, managerial incentives will encourage agents to

generate further surpluses, reducing opportunistic behavior (Jensen & Meckling, 1976). As a result, it's easy to see how more share ownership for managers leads to higher expenses in the event of failure.

1.4 Research Questions

Following are the Research Questions of this Study:

Research Question 1

What is the impact of capital structure on firm performance in Pakistan?

Research Question 2

What is the impact of IFRS adoption in 2005 on firm performance?

Research Question 3

What is the impact of GDP on firm performance?

1.5 Research Objectives

This study has the following Research Objectives:

Research Objective 1

To find the impact of Capital Structure on Firm Performance in Pakistan.

Research Objective 2

To find the impact of IFR's adoption on Firm Performance.

Research Objective 3

To find the impact of GDP on Firm Performance.

1.6 Significance of the Study

Academicians, policymakers, regulators, and investors have given a lot of weight to financing choices and their right mix to improve firm performance throughout the previous five decades. The majority of the research concentrates on the

direct effect of companys capital structure on its performance. By adding more extensive capital structure metrics and alternative performance measures, this study will examine the leverage-performance relationship. Furthermore, the current study contributes in two ways to the existing literature. This is the first study in Pakistan, to the author's knowledge, to look into the influence of IFRS on firm efficiency. Second, this study aims toinvestigates the impact of the adoption of IFRS and the link between capital structure and firm performance. Policymakers, investors, creditors, and the general public will all benefit from this study. This study will determine the best capital structure to maximize shareholder wealth. This study's empirical information will aid all stakeholders in selecting the optimal organization for their investment purposes.

Study investigating the accounting standards used by Pakistani-based businesses in order to determine their exact financial status, which will be beneficial to stakeholders. This study examines each sector of the economy and their attitudes toward accounting standards in order to determine which sector of the economy makes the best use of accounting standards such as IFRS in the formation of final reports. Accounting standards such as the IFRS are the greatest accounting standards for producing truthful and fair outcomes.

If a company adheres to the International Financial Reporting Standards (IFRS), its financial reports will be superior to those of companies that do not. The current study can also help managers remember the IFRS while deciding on debt/equity combinations and their impact on the firm's performance. The most important indices of economic progress are GDP growth rates, which may also be used to measure a country's economic output. Increased GDP has a favorable impact on customer purchasing power, resulting in higher demand for the company's goods. This is a good indicator because it means the company's revenue will rise as well. As a result, the bigger the GDP, the higher the firm's performance (ROA) will be.

1.7 Contribution of the Study

The conclusions of this study will contribute to research and aid many firms that are adopting the IFRS for the first time. In two ways, the current study varies from

past research. In various countries, to begin, a huge amount of research will look at how capital structure effects the performance of company. However, there is no indication that major financial regulatory reforms, for example the adoption of the IFRS, have had any meaningful impact on the company's performance. Adoption of IFRS in general is mainly supposed to progress the information environment of firms. In two ways, the current study varies from past research. To begin with, a substantial amount of research has looked at how capital structure affects company performance in various countries.

On the other hand, there is no indication that major financial regulatory reforms, for example the adoption of the IFRS, have had any meaningful impact on the performance of firm. The implementation of the International Financial Reporting Standards (IFRS) is widely thought to develop the information environment in broad. Secondly, this study's sample size is vast; covering a significant number of observations over a long period of time, and the sample is separated into two sub-samples, pre and post adoption of IFRS. Previous research, on the other hand, has largely focused on the link between capital structure and performance of firms for a short period of time and over a firms lesser sample (Jouida,2018; Chechet and Olayiwola,2014; Berger and Di Patti,2006; Vo and Ellis,2017).

1.8 Scheme of the Study

The literature review from previous literature and research hypothesis are explained in Chapter 2. The study's data collection, variable descriptions, and econometric models are discussed in Chapter 3. The analysis of data and discussion of empirical results are covered in Chapter 4. The study's conclusion, recommendations, and limitations are covered in Chapter 5.

Chapter 2

Literature Review

Chapter 2 includes the variables review of literature from the previous studies, theoretical review and hypotheses development.

2.1 Introduction to Literature

A capital structure of firm is a combination of equity and debt that it uses to finance the assets of company. The precise connection between CS and company performance may vary depending on the context. The impact of capital structure on company performance has been investigated through several theories and studies, with conflicting and inconsistent results (Leonard, Mwasa, Maina & Ishmail, 2014).

The majority of such studies focused on tax advantages and financial structure. Financial structure ability is described as a companys ability to utilize its capital to expand its business through capital market operations conducted by shareholders and investors (Najjar, 2013). The ability of a firm's financial structure to provide the necessary sources of finance to function in a competitive environment and achieve required returns is defined as its ability to supply the necessary sources of finance to operate in a competitive environment and achieve required returns (Abor Biekpe, 2005). The ability of firms financial structure to get external funding is important because in case of bankruptcy it demonstrates to lenders that they will be able to minimize their losses (Butzbach & Sarno, 2019).

A good financial structure has a favorable impact on a company's performance. A financial structure's performance is harmed by increased debt (Nawaz and Ahmad, 2017). Due to the possibility of the company not being able to repay, creditors will demand higher interest rates if the financial structure has a lot of debt. As a result, increasing debt has a detrimental impact on a company's performance in this situation (Le & phan, 2017). In emerging or transition economies, the debt effect in the financial structure on performance of firm have been studied. Financial health is comprised of more than just leverage and liquidity.

Equity is another essential aspect in determining a company's financial structure. Shareholder obligations and equity, in particular, can be viewed as an alternative source of financial backing for a company as well as a corporate governance instrument (Miravitlles Mora & Achcaoucaou, 2018).As shareholders have diverse investment aims and strategies that affect corporate performance, equity should be regarded a shareholder attribute. As a result, the current study looks at financial structure through the lenses of four variables: financial structure capacity, debt repayment ability, management ownership, and foreign ownership.

Ohaka et al. (2020) explored the impact of debt financing on a Nigerian firm's financial performance. The panel data was analyzed using panel econometric techniques in this research. Results of this research revealed that the firm's size, as well as long-term debt and short-term debt has a favorable and important impact on the listed Nigerian firms' financial performance in the capital market. The research revealed that debt financing has a significant impact on a company's financial performance. In a similar line, (Khemiri and Noubigh, 2019) use the panel smooth transition regression method to study data for five Sub-Saharan African nations to see if there is a threshold on the debt performance connection. Debts have a favorable impact on firm performance in Sub-Saharan African firms, according to their research.

Furthermore, Sahari et al. (2019) look into the association between capital structure and value performance of firms across Malaysian food refining enterprises from 2007 to 2016. This study's panel data analysis revealed that there is a substantial link between debt ratio and company performance. The impact of business capital structure options on performance was investigated by (Akomeah et al. 2018). The

study looked at 20 Ghanaian firms that were listed on the Ghana Stock Exchange from 2010 to 2016. Results of the study show that decisions related to capital structure have a significant impact on performance of firm.

Rehan et al. (2019), Meanwhile investigated the link between CS and performance of Pakistan Stock Exchange listed cement companies. The data was gathered from ten cement companies in Pakistan. Between 2011 and 2018, the report used secondary data for eight years. The findings reveal that capital structure is adversely related to performance, implying that an increase in debt capital leads to a fall in collective output and vice versa. Aziz and Abbas, (2019) objectively evaluated the impact of debt finance on non-financial sector performance in Pakistan. For nine (9) years, from 2006 to 2014, data was collected from fourteen (14) different industries (Pakistan Stock Exchange).The outcome of the correlation study, which was used to assess the relationship's strength, shows that capital structure and financial performance of firms in Pakistan have an adverse relationship.

In addition, Olajide et al., (2017) used the Generalized Method of Moments technique to examine the CS and companys performance relationship in emerging Nigeria. The research is based on data gathered from the Nigerian Stock Exchange between 1996 and 2014. The findings demonstrate that negative and striking relationship exists in capital structure and company performance in emerging Nigeria In a similar vein, Kipesha and Moshi (2014) use a panel data study of 38 banks to explore the impact of capital structure on banking business performance in Tanzania over a period of five-year. The study's findings established the existence of a negative relationship, and therefore the correlation, between debt use and company performance.

Tanzanian businesses also choose to employ more short-term loans, according to the survey. The study studied a negative link between bank capital structure and business value performance. Similarly, Lucy, (2014) investigate the presence of a link between capital structure and business value performance. For forty-two non-financial firms in Kenya, the study used an explanatory non-experimental approach. The research was conducted over a seven-year period (2006-2012). The

study found a statistically significant negative relationship between capital structure and enterprise performance. In conclusion, past empirical research in developing nations has yielded mixed results (i.e., a positive and negative influence of debt financing on company performance). As a result, this study concludes that borrowed financing has a favorable impact on companys growth in developing Africa.

The company's resilience in the face of economic cycles, as well as macroeconomic and microeconomic factors, reflects its performance and risk. In other words, macroeconomic and microeconomic factors influence the company's performance and hazards. Domestic general interest rates, tax laws, inflation rates, special government policies affecting certain companies, foreign interest rates, foreign exchange rates, economic cycles, and international economic conditions are all economic factors that can have a direct impact on stock prices and company performance. Firms and capital markets function in a macroeconomic environment to address operational needs as well as transactions for revenue generation. Management's capacity to comprehend and foresee future macroeconomic conditions will be critical in making operational decisions that affect the company's success.

Some macroeconomic indicators that can assist in decision-making should be considered by the firm's management. Interest rate variations, inflation, the rupiah exchange rate, money supply, and GDP growth are all macroeconomic indicators that are frequently linked to financial performance. The most frequent economic statistic used to analyze a country's economic situation is the Gross Domestic Product. GDP indicates the market value of all products and services produced in a certain time period as an overall measure of a country's total economic productivity. A growth in GDP has a favorable impact on consumers' purchasing power, resulting in increased demand for the company's products. This is a favorable indicator because the company's revenue is increasing.

The study attempted to establish a link between macroeconomic conditions, market metrics, and overall equity market growth. Tanaka, Bloom, David, & Koga (2019) evaluated 25 years of data from 1000 significant Japanese enterprises to investigate the relationship between GPD and the performance of these firms. It

was deduced that the GDP has a strong favorable impact on Japanese enterprises' investment and growth performance.

Another study looked into the impact of macroeconomic variables on the performance of Nigerian manufacturing enterprises (Egbunike & Okerekeoti, 2018). The influence of changes in the exchange rate, inflation, interest rate, and GDP on the financial performance of Nigerian enterprises was explored in this research. The results were deduced using an ex post facto design, and it was found that there is a considerable association between GDP and business financial performance, with GDP having a major impact on Return on Assets. Other macroeconomic variables, such as the exchange rate and the interest rate, have no substantial link with performance (Egbunike & Okerekeoti, 2018).

According to a study of GDP in Pakistan from 1960 to 2008, changes in power pricing and usage have a one-way impact on GDP (Jamil & Ahmad, 2010). Commercial, manufacturing, and agricultural activity all have an impact on consumption patterns, which in turn has an impact on GDP. An increase in growth due to increased industrial activities indicates a major impact on company performance.

Ihsan & Anjum (2012) found that excessive liquidity injections operate the country leads to increased inflation and interest rates. Both macro factors are significant when compared to GDP, however their coefficients are negative. It means that an overabundance of money does not increase company productivity and has negative consequences for Pakistan's GDP (Ihsan & Anjum, 2012).

Pakistan has an agriculture-based economy with a large impact on GDP, however the nature of that impact differs between agricultural subsectors (Chandio, Yusansheng, & Magsi, 2016). They also discovered that forestry receives little government attention and is small in terms of GDP, although the rest of the subsector is quite significant. The national productivity produced by both the service and industrial sectors is reflected in GDP.

According to a study on Pakistan's service sector, the service sector is the primary engine driving global economies in the modern era (Rathore, Shahid , Ali, & Saeed, 2019). The authors used data from 1990 to 2017 to discover that FDI and trade

by services firms had a positive impact on the services sector's percent GDP, but population increase has a negative impact.

Another study looked at the degree of the causal association between FDI and BRICS countries' economic development (GDP). The study will run from 1992 to 2013 and will look into the reasoning for the causal link between the two variables. Gupta and Singh (2016) come to different conclusions in this study. First, Johansen cointegration demonstrates a long-term link between FDI and GDP for India, China, and Brazil.

Second, the results of the VECM (vector error correction model) show that FDI and GDP have a long-run unidirectional causal relationship in China, Brazil, and India. According to the conventional Granger test, FDI and GDP in South Africa and Russia move separately, with no long run or short run causal link (Gupta & Singh, 2016). These findings demonstrate a strange pattern of GDP behavior across countries when compared to the same macro measure.

The impact of GDP on different sectors has also been studied in the literature. For the period 1972-2008, a study on Bangladesh's economy looked at the causal influence of GDP on the service, agricultural, and industrial sectors. Rahman and Bing (2011) discovered a bidirectional causal link between the sample sectors and GDP in this empirical study. It also demonstrates that the agriculture and manufacturing sectors have a substantial impact on the GDP growth of Bangladesh.

Finally, while the service sector has no impact on GDP, it does have a considerable impact on GDP. Policymakers will utilize the study's empirical evidence as input for better economic decisions. The contribution of the service sector to GDP is investigated further in connection to oil company revenue. The analysis uses GDP from the service sector as a dependent variable and oil revenue as an independent variable, and the results show a positive significant influence for the period 2000-12, with a magnitude of variation of 78 percent (Hassan & Abdullah, 2015).

For the period 1970-2013, the causal relationship between India's GDP and its manufacturing sector was explored. The results of the vector error model show that per capita GDP has an impact on the manufacturing sector, with the magnitude increasing over time (Singariya & Sinha, 2015). The findings also suggest that the

agriculture sector has a large impact on GDP, and that GDP has a strong impact on India's manufacturing sector. Rodrik (2009) did empirical study on the manufacturing sector and discovered that it accounts for a considerable portion of GDP. His post-crisis work emphasizes the value of contemporary industries, particularly manufacturing firms, and their contribution to national GDP. Because of its interconnections with other industries, such as the service sector, the manufacturing sector plays a significant role in national growth (Tregenna, 2007). In his work, he emphasizes the relevance of GDP and its good impact on South Africa's manufacturing industry.

2.2 Theoretical Review

The MM concept was first to study relationship between firm value and capital structure, and it was named after its founder (Modigliani and Miller, 1958). According to concept, Capital structure has little impact on business value. To put it another way, the portion of debt or stock issued had no impact on the firms value. The level of assets is more likely to be the cause. This claim states that value of any possible debt-equity combination is irrelevant. Despite this, the MM approach is based on a number of assumptions (Bandyopadhyay and Barua, 2016; Le and Phan, 2017; Ahmeti and Prenaj, 2015).

Theory of MM supposes a perfect capital market, with no bankruptcy, taxes, or transaction costs, that market information is not fully reported, that borrowing costs are the same for everyone that investors expect a profit of firm to be the same, that all managers want to maximize value, and that risk levels are consistent for similar organizations. Furthermore, (Miller, 1977) believes the tradeoff between the benefit of company tax and the disadvantage of personal debt tax, concluding that capital structure is unimportant if a diversity of investors exists with different marginal personal tax rates.

The reason for this is that in equilibrium, the project financing cost remains constant. In this situation, regardless of capital structure changes, the WACC should remain constant. In other words, a companys value is influenced by the relative

mix of debt and equity in its capital.

The reality that the modern company finance theory begins with the irrelevance proposition of capital structure that is the best approach to define M & M The Corporation Finance, the Theory of Investment, and Cost of Capital (1958). (Eckbo, 2008). In addition, the author emphasizes how important their work was in establishing the doctrine of modern financial theory. M & M (1958) attempted in their paper to answer the questions concerning to corporate finance.

The M & M theorem employed a variety of ambiguous issues as the foundation for their assumptions, such as whether changing the mix of securities would raise the firm's worth. Before coming up with two primary ideas, Modigliani and Miller investigated a wide range of challenges. After propositions of Modigliani and Miller (1958), there were introduced further assumptions to try to complement the first assumptions in the following years.

According to (Papescu and Visinescu, 2011), several people see the M&M theory as the first widely acknowledged capital structures theory; thus, before the Modigliani and Miller theorem, no theory of capital structure was widely accepted (Luigi & Sorin, 2011). M & Mbegan their proposal by presuming that the corporation has a precise set of expected cash-flows at its disposal.

The main reason for dividing cash flows between investors once a firm chooses to finance its assets is dividing cash flows between investors using a certain proportion of debt and equity. Homegrown advantage is feasible if M&M assumes that firms and investors have equal access to financial markets.

According to (Luigi & Sorin, 2011), there are a variety of methods that investors can gain from removing any leverage that the firm has taken on that they did not desire. Furthermore, consequently, the firm's worth will not be harmed by its leverage, according to writers. Modigliani and Miller's assumptions are further explained by Bose (2010).

According to the author, Modigliani and Miller claim that simple change in debt-equity ratio has no influence on the capital cost in the same risk class. Modigliani and Miller made the following observations in their essay published in 1958, which were demonstrated by Bose (2010):

- There is no relationship between the firm's worth and its capital structure's capital cost.
- The cutoff rate for investment purposes is unrelated to the type of financing that will be used. (Bose, 2010)

For the first and most influential theory in the subject of CS, university professors and Nobel Laureates Franco Modigliani and Merton Miller collaborated to produce in 1958 (Pagano, 2005). The M&M theory after its release was quickly changed into the major capital structure theory (Pan, 2012). Three important premises can be inferred from M&M's Publications in year of 1958; 1961 and 1963, which form their theorems basis (Breuer and Grtler, 2008):

Proposition 1: Company's total market value is unaffected by its capital structure.

Proposition 2: As debt-to-equity ratio rises, the cost of equity rises.

Proposition 3: The entire market value of a company is not affected by its dividend policy.

The capital structure of a corporation has little influence on its market value, according to MM theory. There are no imperfections in any capital market where securities are traded.

Furthermore, investors have all necessary knowledge,can freely buy and sell securities, and are aware of all information andchanges; there are no costs associated with buying and selling securities and if firms and investors want to borrow against securities they are on an equal footing (Bose, 2010). M & M investigate and analyze two organizations with distinct capital structures, one with debt and the other without debt. They also concluded to the conclusion that a company's financial actions have no bearing on its market value, providing that both businesses get the same amount of cash flow (Brigham & Ehrhardt, 2010).

In general, M & M consider that among corporate investors, in accordance with the CS expected cash flow is allocated equally, but the firms value remains unchanged (Popescu & Sorin, 2011). Modigliani and Miller (1958) assume that the asset profitability and risk determine the companys worth not the capital structure. M

& M investigate and analyze two organizations with distinct capital structures, one with debt and the other without debt. They also concluded to the conclusion that a companys financial actions have no bearing on its market value, providing that both businesses get the same amount of cash flow (Brigham & Ehrhardt, 2010). Many researchers have questioned M & M's assumption in presenting proposition I.

According to Modigliani and Miller's first tax argument, interest is not taxed and firms are more valuable firms having a larger market value or more debt in their capital structure than enterprises without debt in their capital structure. Because of the taxation system, corporations with debt in their capital structure pay less tax than companies without debt (which excludes interest paid on loan) that directly impacts the market value of firms (Alifani & Nugroho, 2013).

Many researchers have questioned M&M's assumption in presenting proposition I. It's tough to say that all of M&M's proposal are available in a single market. The M & M proposal I, as Breuer and Grtler (2008) point out, ignores any arguments based on capital market flaws. The authors also critique M&M proposition 1 for proofing propositions using the "same risk class" assumption (Breuer & Grtler, 2008, p. 5). Is there really a thing as a perfect market, in other words? Given the current circumstances and uncertainty, it's tough to believe in today's market.

According to this reasoning, when the debt-to-equity ratio in a firm's capital structure rises the equity cost also grows. According to Breuer and Grtler, despite the fact that all propositions from I through III are termed the same, they differ substantially (2008). According to Villamil (2000), the second M&M argument is that a firm's WACC is unaffected by its debt. Therefore, M&M reasoning II state that as the debt-to-equity ratio raises the cost of equity of firm raises in a linear manner.

M & M (1958) propose that, because investors are rational, the expected return on equity (Ke) is precisely proportionate to the increase in gearing (D/E). The WAAC remains unchanged because the lower debt finance benefit compensates for the expected return on equity (Alifani & Nugroho, 2013). When corporation taxes are removed from the model, the WACC is unaffected by the capital structure in

the preceding figure, and hence the firms values unaffected by the capital structure. Therefore, financial decisions decrease the impact on the value of firms or shareholder equity under this circumstance. In this approach, any form of capital structure could be used.

M&M took into account the influence of taxes in their work in 1963. The corporation tax ratio, according to M&M, is equal to the tax savings current value. As a result, enterprises can lower their WAAC by raising the debt percentage in their capital structure, and the tax shield phenomenon allows them to pay less tax (Brigham &Ehrhardt, 2010). When taxes are taken into account, companies may profit from a larger debt-to-capital-structure ratio as a result of the tax break; as a result, the WAAC will fall while the firm's value would grow. (Source: Pan, 2012).

Several countries or markets have different tax policies, according to Breuer and Grtler (2008), hence no two markets are comparable (states or countries). If a country changes its tax policy or law the entire proposition will be nullified. This proposition explains that dividend policy does not changed the firms overall market value. In study of M&M (1961), growth, dividend policy, and shares valuation published in the Journal of Business; claim that the dividend policy has no bearing on the firms worth.

Similarly, M&M's third assumption claims that its payout policy has no impact on the company's market value (Villamil, 2000). According to M&M (1961), firms earnings power and the risk of its underlying assets determine the market value. In an ideal market, M&M think that a company's dividend policy does not affect the value of firm (Miller & Modigliani, 1961). M&M proposition III is nothing more than net present value (Breuer & Grtler, 2008).

Breuer and Grtler (2008) further highlight that the firm's financiers have the ability to make firm's investment independent decisions. In the domain of financial economics, M&M have made significant contributions. According to M&M, development of financial economic theory effected by the most well-known propositions of M&M (such as capital structure is irrelevant for the organization) (Stern & Chew 2003; Stern & Chew, 2003).

Furthermore, the authors attempted to show that M&M's influence extends beyond the propositions themselves. The dividend irrelevance argument, which is the most well-known M&M argument, claims that changes in payout policy have little impact on company valuations.

However, as Stern and Chew (2003) point out, today's markets have resulted in significant price fluctuations as a result of their rapid expansion. Furthermore, experts have claimed that reality has provided enough evidence to indicate that changes in capital structure and dividend have an impact on business valuations over the last 30 years. Despite the lack of analytical soundness of M&M arguments, scientists continue to evaluate their significance in current finance economic theory.

M&M made two significant contributions to finance economics, both of which are considered fundamental. Despite its age, Breuer and Grtler (2008) claim that the "law of one price" is one of the first formal formulations of a no-arbitrage argument in modern finance studies. The writers also emphasized the importance of the debt mechanism, describing it as "important".

According to Modigliani and Miller (1958) and Breuer & Grtler (2008), the fact that M&M theorems or statements have been used to support the case for the insignificance of failure regarding assumptions is crucial. As a result, they claim that taxes are neutral and that the capital market imposes no extra costs such as bankruptcy costs, transaction costs, agency cost etc. (Breuer and Grtler, 2008).

Firms and investors are on an equal footing and have equal access to credit markets like borrowing at the same rate; the firms financial information reveals nothing. Apart from the revolutionary contribution, many economists are skeptical, or at the very least do not believe the M&M arguments are viable.

- Risk classes are essential, and they are depending on them.
- It implies objective rather than subjective prospect distribution over the possible outcomes.
- Partial equilibrium analysis, rather than general equilibrium analysis, was used to make assumptions (Stiglitz, 1969).

The following assumptions were called into question:

(i) same market rate could be borrowed by businesses and individuals; and

(ii) bankruptcy would not be a threat. Practice has shown, according to Stiglitz (1969), that there are, or at least appear to be, market rate constraints for individuals vs. corporate borrowing.

As new conditions emerge as a result of market movements, other scholars have provided new capital structure theories. Baker and Wurgler (2002) proposed their "market timing theory of capital structure" idea recently (Luigi & Sorin, 2011). According to the previous research, market time means that corporations issue new shares when they believe their stock is overvalued and repurchase their own stock when they believe it is undervalued. Other authors have generated their own assumptions and ideas about market timing and issuance behavior, but Baker and Wurgler (2002) reveals that capital structure affected by market timing (Luigi & Sorin, 2011).

Critics who have been managing and dealing with M&M recommendations have reacted to Modigliani and Miller. Despite embracing constructive critique, M&M (1959) pointed out that their technique was not fully recognized and understood by critics, and that it was a broad concept. Their goal was to start looking at a topic (the cost of capital) that had not been fully researched and analyzed before. M & M contribution for the article of finance The cost of capital, corporation finance, and the theory of investment, published in 1958. M & M were awarded with the Nobel Prize in Economics (1985/1990) for their contribution in the body of knowledge is appreciated by many economists. M & M concepts challenged conventional corporate finance thinking, allowing businesses to look beyond the capital structure for the variables that add actual value to their operations.

On the other hand, research cannot conclude that financial decisions or capital structure are wholly unrelated to the firm's value based on the M&M Theorem's findings. All of these assumptions imply that the world imagined by M&M is a controlled environment, that the real world appears to be significantly different from the world on which M&M propositions are founded, or that, as various authors have pointed out, cannot be observed anywhere in the world (Gifford,

1998). The given the M&M propositions were developed in a non-"exact actual world," it's no surprise that many economists and finance experts still question these assumptions.

By those propositions despite the fact that M&M's assumptions were founded on artificial market conditions, they offer the potential for future development and expansion of new theories in response to two problems posed. With the perspective that "everything is irrelevant," it is necessary to analyze the things are relevant. As Merton H. Miller put it, "showing what doesn't matter can also indicate, by inference, what does". According to agency cost theory, the conflict of interest exists between stakeholders, like agents and principals that ended up in the firm's agency costs (Jensen, 1986; Hart and Moore, 1994; andJensen and Meckling, Eisenhardt, 1989).

As a result, if an optimum capital structure can reduce aggregate agency costs, the company's value tends to rise. (Jensen and Meckling, 1976) defined two types of agency costs: debt agency costs and equity agency costs. The former is caused by the disagreement between shareholders and managers, while the latter is brought about by a conflict between stockholders and debt holders.

Managers prioritize their own aspirations over shareholder and company value growth because of the agency cost of equity (Jensen, 1986; Jerzemowska, 2006).In the case of high leverage, managers are under pressure to focus more on profitable assets in order to generate sufficient cash flow to cover interest payments (Jerzemowska, 2006; Jensen, 1986).

More debt persuades principals to perform better and lowers agency costs of equity in the interests of shareholders, according to Margaritis and Psillaki (2010) and Berger and Di Patti (2006). Managers are less able to focus on their self-interests in this way (Guizani, 2017). As a result, leverage is expected to have a positive influence on firm value by minimizing agency costs of stock. Debt, on the other hand, can depreciate a company's worth by increasing the debt agency cost (Becker and Stromberg, 2012). Lenders seek higher interest rates, according to Myers (1977), to compensate for the enormous risks associated with huge business leverage.

Furthermore, agency theory implies that capital structure and corporate performance are intrinsically tied. According to the principal-agent theory of the interaction between principals (owners) and agents, owners designate managers to administer the firm on their behalf (managers). A firm's existence is possible, according to the stakeholder perspective, because of a system of compromises described as a "nexus of contracts," in which the interests of numerous people are agreed upon.

Some additional costs, known as agency costs, must be expended to keep agency disputes to a minimal. They can be described in a number of different ways. When ownership and control are divided, more expenses are incurred by the corporation's owners as a result of conflict situations among stakeholders, according to Ross, Westerfield, and Jaffe (2005). (Moyer, McGuigan, Kretlow, 1992).

They believe that agency costs, are the costs incurred as a result of interest conflicts among bondholders, shareholders, and executives. They can be considered the costs of resolving these conflicts. They include costs associated with rewarding and monitoring managers in order to maximize shareholder value, as well as costs associated with protecting bondholders from shareholders. Agency fees are always the responsibility of stockholders (Ross, Wester field, Jaffe, 2005).

According to Jensen and Meckling (1976) agency costs are;

- The total monitoring expenses of principal,
- The bonding expenses of agent,
- The residual loss.

When an entrepreneur dilutes his ownership, he suffers a residual loss, or a drop in the value of the company. This is the most crucial expense, according to Williamson (1988), because the other two are only incurred to the extent that they result in cost-effective residual loss reductions. Dilution of ownership causes a movement out of earnings into managerial discretion, which results in this loss.

Expenses for monitoring and bonding can help bring back performance to pre-dilution levels. At its simplest level, the irreducible agency cost is the total of

these three components. The effectiveness of managerial monitoring and the use of managerial incentives could help to solve the problem of agency costs.

Corporate governance mechanism to shareholder compensation is an incentive solution. In this sense, the interests of these two groups are unified. Executives may receive stock, stock options, or both as a substantial part of their income. The second method is to establish controls to keep track of managers' activities (Kim Nofsinger).

A sort of transaction cost linked with a company's business operations is agency cost. They are actual costs that are determined by a range of things such as legal laws and people's willingness to sign contracts. They exist in every organization and at every level of management, and they are always borne by present shareholders, as previously stated (Ross Westerfield Jaffe, 2005).

The main objective of regulating them is to ensure that capital supplies should be the best interests for managers. Potential shareholders incur costs by paying lower per-share prices, while creditors incur costs by asking higher interest rates. As a result, assuming all other factors remain constant, there is the lower the firm's market value, the higher the expected governance expenses, and the higher the interest rate.

Agency costs can emerge in two ways as real expenses (Damodaran, 1997). To begin, if bondholders believe there is a significant danger that shareholder actions will harm them, they might reflect this risk into bond pricing by demanding much higher debt interest rates. Second, if bondholders can protect themselves by enacting restrictive covenants, there are two costs: direct social contract monitoring costs, which rise as the covenants become more restrictive and detailed; and indirect covenant monitoring costs that can increase in result of the company's inability to invest in specific projects, use specific types of funding, or alter its dividend. Samuels, Wilkes, and Brayshaw (1995) states that there is controversy

about whether the agency costs is more associated with debt than those associated with equity. Jensen and Meckling (1976) define agency costs as "extra expenses, direct or indirect, associated with ensuring that agents act in the best interests of principals and loan providers."

The existence of these costs derives from the possibility that if managers were not regulated in some way, they would be allowed to adopt policies that are unfavorable to debt suppliers. Myers and Majluf (1984) proposed the Pecking Order Theory, which states that leverage improves the market's perception of value, resulting in a rise in company's performance.

In this scenario, firms follow a strict financial hierarchy, with internal finance taking precedence over external financing and debt taking precedence over stock (Shubita and Al Sawalha, 2012). To put it another way, businesses prefer to issue stock only when they are unable to borrow money. This is owing to the reduced information costs of debt issue compared to stock offerings (Lemmon and Zender, 2016). When it comes to maximizing value, the theory favors debt over equity, but it fails to define the optimal leverage ratio.

2.2.1 Pecking Order Theory and Information Asymmetry

Pecking Order Theory is just to define that the information among stakeholders are not fully reported (Myers and Majluf 1984). Financial policy employed by business leader that emphasizes internal funding over external investment to avoid the costs related to asymmetric information, notably adverse selection.

POT theory assumes the following hierarchy: self-financing, level of risk is lower, high-risk debt issuance, and equity selling as a last resort. This type of behavior limits dividend payout to maximize cash flow, avoids a stock price decrease, and lowers the cost of capital by limiting loan availability as much as possible. A good organization can create much internal funds.

Asymmetric information drives the debate over debt vs. equity. The boards decision to issue debt demonstrates that it believes an investment will pay off and that the current stock price is low. Lack of interest of stakeholder regarding stock market resulted in share price is higher. Consequently, if stock is issued, the value of the share will decrease. However, it is unlikely to apply to intangible assets.

SME's or those belonging to a group are covered by POT (Holmes & Kent (1991); Ang (1991); and Kremp & Philippon, (2008)). SMEs do not strive for the best

financial structure; instead, they prioritize debt over equity and internal funding over external financing.

Internal funds costs may be negligible, but fresh share issuance costs are greater, whilst debt expenses are somewhere in the middle. Managers of SMEs want to maximize their own financial position while maintaining control over management in relation to other parties. As a result, they will prioritize internal funds, if funds are not available, they will prefer to borrow rather than issuance of shares.

The sequence asserted by (Myers and Majluf, 1984) is inverted in the case of a specific asset(intangible): cash flow, equity, and debt. Firms often issue equity when they should not, according to Leary and Roberts (2010), whereas mimicking could account for up to 70% of a firms financing activity (Leary & Roberts, 2012).

The characteristics of SMEs are similar to TCE and behavioral finance lessons at times. On the one hand, due to the choice made by the owner-manager, the owner-managers rationality is limited, and the danger of error is larger for SMEs. In contrast, SMEs first and foremost aim to serve the interests of the former shareholders and owner-manager. SMEs have limited access to the financial sector due to a lack of equity.

2.2.2 Trade Off Theory

Alternatively, trade-off theory suggests that firms can use debt issuance to establish an optimal capital structure that optimizes firm value. However, the reason for this is different, and it is because of the tax benefits of debt. A firm's costs and advantages of debt are compromised in order to improve firm value, according to the notion (Myers, 1984; and Kraus & Litzenberger, 1973).

The advantages of debt in a capital structure last until the optimal capital structure is reached (Al-Kahtani and Al-Eraij, 2018). The tax shield is the initial advantage of debt, implying that businesses can reduce their taxable income by paying interest (Modigliani and Miller, 1963). Previous studies have provided actual evidence to back this up (Graham, 2000; Arzac and Glosten, 2005; Titman and Wessels, 1988; Saona and San Martin, 2018).

According to Leland (1994), and Kim (1978) the level of debt may increase the financial risk which subsequently leads the organization to bankruptcy. In summing up, trade-off theory states that the difference in value between unlevered and levered enterprises is due to the tax shield minus the expenses of the financial crisis. This theory follows in the footsteps of Modigliani and Miller (1958), they contribute in the body of knowledge by considering perfect financial market, in which all costs are zero.

As a result, corporations have an incentive to use debt rather than stock because interest is deducted from taxable profits. The leveraged companys value is larger because the tax break benefits just the company, saving personal money (Miller, 1977). Ang (1991) SME's already benefit from a low tax rate, which limits any leverage program that is predicated on a rebate on interest costs at some time. The presence of bankruptcy costs necessitates a trade-off between the firm's worth and the tax advantage; when the marginal benefits of the tax refund equal the marginal costs of bankruptcy due to leverage; theoretically that leads to an optimal debt level (Stiglitz, 1969). Similarly, they reject the concept of no agency cost allows for the possibility of an optimal capital structure.

The agency hypothesis in study of Jensen & Meckling, (1976) states that the principle (shareholders) and the agent (company managers) has competing interests, resulting in agency costs that enact funding. Shareholders and creditors have competing interests because the latter has priority over the former in the event of bankruptcy. When agency costs are kept to a minimum, an ideal debt ratio is attained.

Unless the firm is part of a group, SME's have zero or low agency costs between management and shareholders as they are frequently confused. Owners and lenders, on the other hand, can have agency conflicts. The agency conflict arises between principal and agent when their interests are different from each other in this case information is not fully reported which resulted in agency conflict (Cieply, 1997).

2.2.3 Empirical Evidences

The dispute over whether capital structure influences business performance has been going on since 1958, when the MM theory was originally proposed. In the actual world, where markets are imperfect, it is widely recognized that leverage has an impact on corporate performance or value, and different theories in the literature support this. The empirical evidence, on the other hand, yields a variety of findings about this link. The precise relationship between capital structure and company performance, according to Ardalan (2017), can vary depending on the context. Specific conditions such as the country's degree of development and the size of the company, as demonstrated in the present research, tend to influence the nature of the relationship between capital structure and business success. The aim of this research is to find a pattern in the data by comparing sample nations based on their level of development and enterprises based on their size. Many studies demonstrate that in economically or financially developed countries, capital structure has a beneficial impact on corporate performance (Margaritis and Psillaki, 2007; Adair and Adaskou 2015; Fosu,2013; Jouida, 2018; Berger and Di Patti, 2006). Chechet and Olayiwola, (2014); Berger and Di Patti, 2006; Salim and Yadav, (2012); Vo and Ellis, (2017); Le and Phan, (2017); Tong and Green, (2005), for example, have all looked into the link in developing countries and found a negative and significant relationship between firms leverage and performance. Furthermore, Jaisinghani and Kanjilal (2017) and Bandyopadhyay and Barua (2016) found in newly industrialized country like India that both negative and positive effects of capital structure on business performance. As a result, they asserted the presence of a nonlinear relationship.

2.3 Hypotheses Development

On the basis of literature and theories, this study developed following hypotheses:

2.3.1 Relationship between Capital Structure and Firm Performance

The capital structure of firms is a mix of debt and equity used to fund its assets. Depending on the situation, the exact relationship between capital structure and corporate performance may differ. Current literature shows that, specific conditions such as the country's development level and the size of the company have an ability to influence the relationship nature between capital structure and success of business.

A study conducted in United States and France the relationship between capital structure and firm performance found a favorable association (Obradovich and Gill (2013) and Margaritis and Psillaki (2010). However, Akingunola, Olawale, and Olaniyan (2018) found that debt ratio negatively impacts the performance of firm in South Africa.

They suggested that a firm's underestimation of bankruptcy expenses of liquidation could lead to increased debt; as a result, a high debt in the financial structure would reduce the firm's worth. Furthermore, in emerging economies, as a monitoring mechanism, the role of debt to improve company value has not been examined (Le & phan, 2017). As a result, in emerging markets, managers may act in their own best interests when faced with big cash flows, negatively impacting firm performance. The objective of this research is to detect a pattern in the data by contrasting sample nations based on their level of development. Many studies demonstrate that in economically or financially developed countries, capital structure has a beneficial impact on corporate performance (Jouida, 2018; Berger and Di Patti, 2006; Fosu, 2013; Adair and Adaskou 2015; Margaritis and Psillaki, 2007). Le and Phan, (2017); Chechet and Olayiwola, (2014); Salim and Yadav, (2012); Vo and Ellis, (2017); Tong and Green, (2005), all studied the link in developing countries and found a significant negative association between leverage and performance of firm.

Furthermore, in India, which is considered a freshly industrialised country, Jaisinghani and Kanjilal (2017) and Bandyopadhyay and Barua (2016) observed both negative and positive influences of capital structure on business performance. As a

result, because debt in the capital structure lowers a company's financial capacity, managers must preserve the financial structure's ability to meet financial obligations in order to avoid bankruptcy and protect stakeholders' interests. Therefore, this study formed a hypothesis based on the findings and reasons given above.

H1: There is an impact of capital structure on firm performance in Pakistan.

2.3.2 International Financial Reporting Standards Impact on Firm Performance

Performance of firm may be impacted by financial legislation changes, for example IFRS adoption by stock markets. IFRS codes were created by the IASB in an attempt to harmonize accounting information around the world.

The objective is to create a common corporate language that everyone understands (Das, 2015). Gassen and Sellhorn, (2006) IFRS adoption is expected to improve profits quality and reduce information asymmetry by requiring more disclosure in financial statements.

Furthermore, the International Financial Reporting Standards (IFRS) improve the complete performance measurement ratio (Abiodun and Asamu, 2018; Devalle, et al. 2010). As a result, this study formed a hypothesis based on the findings and reasons given above:

H2: There is an impact of IFRS adoption in 2005 on firm performance.

2.3.3 Relationship between GDP and Firm Performance

Firm growth contributes significantly to national GDP, particularly for businesses that export. Firms must priorities exporting to stable economies since they have strong resistance against macroeconomic variables, according to Rathore, Shahid, Ali, and Saeed (2019). Rodriguez, Eldrige, Roldan, Millan, & Guiterrez (2015) claim, those expenses on skills, innovation, and policies are deriving factors that enhance productivity through competitiveness on GDP growth. These empirical studies show two alternative perspectives on productivity, both of which are tied

to macro variables. In the same vein, Rodriguez, Eldrige, Roldan, Millan, and Guiterrez (2015) contend that there is limited literature on the positive effects of growth for small and emerging businesses.

As a result, he develops empirical evidence that small and emerging firms with financial operations with international banks have higher growth rates than large firms with financial businesses with domestic and government-owned banks. Because global banks have substantial capital structures and the ability to absorb maximum risks, interest rate policy and other macro variables may be a contributing factor.

According to a study by Xuesong, Xiaosu, and Rujing (2010) on Chinese SOEs, the government intervenes in SOE investment decisions in order to sustain or promote GDP growth. According to the study, government interventions connected to GDP rise in regions with a slow rate of marketization, and SOEs in these areas are directed to choose overinvestment strategies for future growth. Government interventions in SOE investment decisions to impact GDP are an important macro variable, according to the study. The study of Arab equity market ownership concentration and performance reveals that ownership is an endogenous variable with little impact on business performance (Omran, Bolbol, & Fatheldin, 2008).

However, market measurements, which are influenced by a number of macro variables, have an impact on business productivity, which in turn affects GDP. Interest rate variations, inflation, the rupiah exchange rate, money supply, and GDP growth are all macroeconomic indicators that are frequently linked to financial performance. The most frequent economic statistic used to analyze a country's economic situation is the Gross Domestic Product. GDP indicates the market value of all products and services produced in a certain time period as an overall measure of a country's total economic productivity.

A growth in GDP has a favorable impact on consumers' purchasing power, resulting in increased demand for the company's products. This is a favorable indicator because the company's revenue is increasing. As a result, when examining the firm performance, the influence of GDP could be taken into account. So, this study

formed a hypothesis based on the findings and reasons given above:

H3: There is an impact of GDP on firm performance in Pakistan.

2.4 Research Gap

There is no indication that IFRS adoption has influence on the firm performance. On the other hand, there is evidence that the adoption of IFRS, as a significant regulation shift in the stock market, can have a favorable impact on main financial indicators including the information asymmetry and financial dispersion cost of capital. Previous studies are based on firm specific variables. This study used macro-economic variables on firm performance.

Van Beusichem, et al., (2016) looked at the IFRS impact on Dutch listed companies. Their findings reveal that transparency has significantly increased under IFRS, with very little variance in the determinants of openness following the implementation of IFRS. Research by (Gassen and Sellhorn, 2006 and Abad, et al., 2018) experimentally shown that adoption of IFRS reduces information asymmetry by lowering the cost of capital. Likewise, (Turki, et al. 2016,2017) stated that adoption of IFRS has significantly reduced financial dispersion and capital costs.

Chapter 3

Research Methodology

Chapter 3 includes the methodology of the study that explains population, sample, data description, description of variables, source of data collection, and econometric model used for this study.

3.1 Data Description

The fragment of the study presents from where the data has collected.

3.1.1 Population

Population of this study consists of Pakistan's on-financial firms, listed on PSX.

3.1.2 Sample

The sample consists on all listed non-financial firms from 2001 to 2019 in the Pakistan Stock Exchange. This research considers all firms listed in Pakistan because since January 1st, 2005, as firms are required to prepare financial statements according to IFRS, while non-listed companies can choose IFRS or IASB.

According to Vo and Ellis (2017), Le and Phan (2017), and Al-Najjar and Hussainey (2011) business operations and capital structures of financial firm are totally different than non-financial firms. So, Real estate, banks, insurance firms and se-

curity and investment are excluded from sample. Furthermore, firmsaccounting data is also excluded that is not available for the entire period.

The balanced panel type is used of panel data. With the aim of achieve the objectives of the study, both cross sectional and time series data is used in this particular research and data collected for the period of one to nineteen the sample period will be namely as 2001-2019, to capture the influence of adoption of IFRS on the relationship between performance of firms in Pakistan.

3.1.3 Sources of Data

This research is based on secondary data that included government and private publications, financial reports of companies from the website of The State bank of Pakistan.

Data for this study is obtained from published Annual financial statement Analysis by the SBP of non-financial firms and macroeconomic variables data is obtained from Statistical Bureau of Pakistan.

3.2 Description of Variables

3.2.1 Firm Performance

In this study, firm performance is used as a dependent variable. Return on assets (ROA) is used as an accounting proxy to measure the performance of firm.

In the literature, these measures are widely used (Jouida, 2018; Abor, 2005; Ibhagui and Olokoyo, 2018; Tong and Green, 2005;Lins, et al. 2017); Kalkan, et al. 2014; and Gok and Peker, 2017).

Furthermore, as a market measure, the stock price of the firm performance is used. Return on Assets is measured by taking the ratio of income after tax over the total assets.

3.2.2 Return on Assets

"Return on Assets or economic profitability is also called operating profit with their own capital and foreign capital that is used to generate such profits and expressed as a percentage (Husnan, 2004)."

$$ROA = \frac{NetIncome}{TotalAssets} \tag{3.1}$$

3.2.3 Capital Structure

This study's main explanatory variable is capital structure in terms of leverage. Total debt to total assets, long-run debt to total assets, and short-run debt to total assets were all employed in the literature to measure capital structure.

On the basis of prior researches (Bandyopadhyay and Barua,2016; Fosu, 2013; Margaritis and Psillaki,2010 Ibhagui and Olokoyo,2018;), the book value of total debt to the book value of total assets is measured by using leverage. "Capital structure is a combination of debt and asset that a company holds to fund its assets (Geske, et al. 2016).

$$CapitalStructure = \frac{TotalDebt}{TotalAssets} \tag{3.2}$$

3.2.4 Gross Domestic Product

"The market price of all legitimately documented final goods and services manufactured within a country in a year or a given period time is called GDP (output)." It is calculated by implying weighted average method under aggregation rule.

Since the data related to GDP is readily made available by SBP, statistical bureau of Pakistan, and other regional and international agencies, least square growth rate method is applied by World Bank due to presence of data in long time series.

3.2.5 Control Variables

The goal of this research is to see if the capital structure decision improves business performance. To accurately capture that association, this study account for a variety of factors in multivariate regression model, with the goal of controlling for company characteristics, as recommended by the literature. (Jouida,2018;Bandyopadhyay and Barua,2016; Le and Phan,2017; Basit and Hassan,2017). GDP and growth rate are the control variables. IFRS is dummy variable that is used as controlled variable to check the changes in the Pakistani stock market's financial and accounting regulations.

The period before the adoption of the IFRS = 0

The period after the adoption of the IFRS =1

TABLE 3.1: Description of Variables

Variable	Name	Measurement	Description
Dependent	ROA	Financial performance	Net income/total assets
Explanatory	Capital Structure	Leverage	Total debt/total assets
Explanatory	GDP	Market price of all legitimately documented final goods and services manufactured within a country in a year	Gross Domestic Product (out)
Control	Growth	Sales growth	Current period sales previous period sales/ previous period sales
Control	Liquidity	Firm Liquidity	Cash/Total Assets
Control	Total Assets	Firm size	In (total assets at year-end)
Dummy	IFRS	Financial regulatory change	Before and after Jan. 1st, 2005

Table 3.1 contains information about the variables utilized in the study, as well as their calculating formulas and measures. In general, research expects that and growth rate to have a significant impact on performance of firm. Margaritis and Psillaki, (2010) stated that more profitable and larger companies are usually more efficient and well-managed.

3.3 Econometric Model

3.3.1 Panel Data Analysis

Panel data set consists on both time-series data and cross-sectional data; same has applied to this study. A balanced panel is one in which each cross-section of a variable has the same set of time observations while, the term "unbalanced panel" refers to a panel that has a series of time observations that differs among cross sections.

$$Y_{it} = \beta_o + \beta X_{it} + \mu_{it} \tag{3.3}$$

3.3.2 Different Method of Estimation

There are three important measures to analyze the panel data.

3.3.2.1 Common Coefficient Model

The first model of panel data is common coefficient model. It has constant intercept across all cross sections and time period.

The general equation of Common effect model is as follows:

$$Y_{it} = \beta_o + \beta(X)_{it} + \mu_{it} \tag{3.4}$$

3.3.2.2 Fixed Effect Model

This model describes that intercept for all cross sections are different.

$$Y_{it} = \beta_i + \beta_i(X)_{it} + ... + \beta_k(X)_{kit} + \mu_{it} \tag{3.5}$$

3.3.2.3 Random Effect Model

In random effect model, intercept considered as error term and it do nothing with the cross sections (companies). RE model make clear the different firms variation and offers following benefits:

- It has fewer parameters to estimate as compare to fixed effect model.
- Additional independent variables with same number of observations are considered.

The RE model's equation is as follows:

$$Y_{it} = \alpha + \beta_1(X)_{1it} + \beta_2(X)_{2it} + ... + \beta_k(X)_{kit} + (v_i + \mu_{it}) \tag{3.6}$$

This research model follows Wahba, (2014) and Le and Phan, (2017), who proposed the following equation as a linear link between capital structure and performance of firm:

$$FP_{it} = \alpha + \beta LEV_{it} + \gamma X_{it} + \varepsilon_{it} \tag{3.7}$$

Where FP_{it} is a firm i's financial and market performance at time t, LEV_{it} is firm i's leverage ratio at time t, and X denotes a control vector (liquidity, growth, and IFRS as a dummy variable), while ε_{it} denotes the stochastic error term.

This study uses multiple regression analysis on the panel data to look at the direction and relationship level between the variables. After the companys qualities have been constrained, this is done. For panel data estimation, the pooled FE, RE, OLS estimation procedures are commonly used (Vo and Ellis, 2017; Dawar,

2014; Chadha and Sharma, 2015). If the residuals are independent of the vector of control and explanatory variables, OLS estimators are consistent and unbiased.

Non-experimental studies, on the other hand, frequently reveal firm-specific effects (Le and Phan, 2017). At the company level,specific error components are considered as RE and FE models are more successful than pooled OLS in this situation. The Hausman specification test is commonly used to determine which model between RE and FE is the best. The RE and FE models, on the other hand, cannot solve the potential difficulties of autocorrelation and heteroscedasticity.

Furthermore, Roberts and Whited, (2013) asserted that endogeneity as the FE and RE model does not account for the problem of endogeneity that is the most critical and ubiquitous issue confronting empirical finance research. The following multivariate regression models are used to study the relationship between capital structure and performance of firm, and the findings are then analyzed:

$$\begin{aligned} ROA_{it} = \beta_o + \beta_1 TDR_{it} + \beta_2 GROW_{it} + \beta_3 Liquidity_{it} \\ + \beta_4 LGDP_t + \beta_5 IFRS_t + \varepsilon_{it} \end{aligned} \tag{3.8}$$

$$\begin{aligned} ROE_{it} = \beta_o + \beta_1 TDR_{it} + \beta_2 GROW_{it} + \beta_3 Liquidity_{it} \\ + \beta_4 LGDP_t + \beta_5 IFRS_t + \varepsilon_{it} \end{aligned} \tag{3.9}$$

Where ROA_{it} is the return on assets ratio and ROE_{it} is the return on equity ratio used to measure a firms financial performance in year t; ln P_{it} is the stock price per share natural log, which is used to measure the performance of firm I in year t on the stock market; $GROW_{it}$ is the Δ in total sales for firm i between year t and t1; whereas $TDR_{i,t}$ is the book value of total debt to the book value total assets at time t for firm i. TDR's lagged value helps to address any potential inverse causality between CS and financial performance of firm (Bandyopadhyay and Barua, 2016). IFRS is a dummy variable that assigns a value of 0 to the per-

iod before the adoption of the IFRS and 1 to the period after the adoption of the IFRS; for the purpose to better capture the impact of adoption of IFRS on performance of firm; Δ shows the variables annual change; and ε_i is the random error term.

Chapter 4

Results and Discussion

Chapter 4 explains the results and discussion of this study that included descriptive statistics, correlation matrix, common effect model, random effect model, fixed effect model.

4.1 Descriptive Statistics

The objective of descriptive statistics is to represent the characteristics of data. Table 4.1 shows the descriptive statistics of dependent, independent and control variables which are used in this study. The data represents all non-financial firms listed in PSX for the period of 2001 to 2019. Descriptive statistics are interpreted below:

The ROA is a dependent variable that represents the financial performance of firm. The average value of ROA is 0.0993 and its standard deviation is 0.593632. The maximum value of ROA is 7.47 and minimum value is -12.8. The ROE is a dependent variable that represents the financial performance of firm.

The average value of ROE is 4.1287 and its standard deviation is 1.614836. The maximum value of ROE is 9.35 and minimum value is -1.39. The IFRS is used as a dummy variable and average value is 0.5314 with the maximum and minimum of 1.0000 and 0. 0000.Its standard deviation is 0.4991. The TDR that is capital structures used an independent variable of non-financial firms. The average value

of TDR is 0.1204 with 0.2742 value of standard deviation. Its maximum values 1.19 and minimum values -1 respectively.

The average value of LIQUIDTY is 0.1036 with the maximum value of 0.6100 and minimum value -0.0094. Its SD is 0.1034. The Growth shows the change in sales growth of non-financial firms listed in Pakistan. The mean value of GROW is 0.0077 with maximum value of 0.8100 and minimum 0.0000. Its SD is 0.0400. The LGDP is log of gross domestic products that is a macroeconomic variable. The mean of LGDP is 16.3146 with the maximum value of 17.3599 and minimum is 12.5361. Its SD is 1.1105.

4.2 Correlation Matrix Analysis

The correlation matrix is a useful tool for analyzing whether or not sample variables are multi-collinear. Table 4.2 enlightens the correlation among variables. Pearson correlation test adopted to explain the direction and strength of the relationship. The results demonstrate that none of the correlations between the explanatory factors appear to be at a worrisome level. The correlation level is observed between ROA, and IFRS, which is 0.2356. it shows that the positive correlation between ROA and IFRS exists. The ROA correlation coefficient with TDR is positive that is 0.1623. The results of study show that CSand firms performance is positively correlated.

The results show that the growth is positively associated with firm performance with reference to book value of total assets. The value of growth is 0.1275, whether the liquidity of a firm is negatively correlated with firm performance that is -0.0281 and LGDP is also negatively correlated that is -0.0032.

4.3 Results of Hausman Test

Hausmen test is performed for firm performance(ROE) and IFRS adoption for the period of 2001 to 2019. Redundant fixed effect test applied for the selection of the fixed, random and common effect model. The p-value of cross-section F and Chi-

Table 4.1: Descriptive Statistics

	ROA	ROE	TDR	IFRS	LGDP	GROW	LIQUIDITY01
Mean	0.0993	4.1287	0.1204	0.5314	16.3147	0.0077	0.1037
Median	0.1200	4.1100	0.1150	1.0000	16.5147	0.0000	0.0729
Maximum	7.4700	9.3500	1.1900	1.0000	17.3599	0.8100	0.6100
Minimum	-12.8000	-1.3900	-1.0000	0.0000	12.5362	0.0000	-0.0094
Std. Dev.	0.5936	1.6148	0.2743	0.4991	1.1106	0.0400	0.1034
Skewness	-7.4788	0.0723	-0.0477	-0.1259	-2.2007	10.9123	1.7561
Kurtosis	157.0990	3.4318	6.1185	1.0158	8.1092	155.4820	6.4158
Observations	2452	2452	2452	2452	2452	2452	2452

Table 4.2: Correlation Matrix Analysis

	ROA	**ROE**	**TDR**	**IFRS**	**LGDP**	**GROW**	**LIQUIDITY01**
ROA	1.00000	0.23562	0.16236	0.08459	-0.00323	0.12752	-0.02814
ROE	0.23562	1.00000	0.08573	0.18667	0.05544	0.33920	0.00803
TDR	0.16236	0.08573	1.00000	0.05941	-0.08235	0.00755	0.04864
IFRS	0.08459	0.18667	0.05941	1.00000	0.03960	0.01999	0.00306
LGDP	-0.00323	0.05544	-0.08235	0.03960	1.00000	0.00202	0.00293
GROW	0.12752	0.33920	0.00755	0.01999	0.00202	1.00000	-0.00207
LIQUIDITY01	-0.02814	0.00803	0.04864	0.00306	0.00293	-0.00207	1.00000

square is (0.0000), which is significant because less than 0.05 so fixed effect model will be applied. The p-value of cross-section random is (0.0000). In case of IFRS adoption, the p-value of cross-section random is 0.0005. It also indicates that FE model will be applied.

4.3.1 Hausman Test of ROE

Hausmen test is performed for firm performance (ROA) and IFRS adoption for the period of 2001 to 2019. Redundant fixed effect test applied for the selection of the fixed, random and common effect model.

TABLE 4.3: Hausman Test of ROE

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section Random	99.1314	5.0000	0.0000

The p-value of cross-section F and Chi-square is (0.0000), which is significant because less than 0.05 so fixed effect model will be applied. The p-value of cross-section random is (0.0000). In case of IFRS adoption, the p-value of cross-section random is 0.0005. It also indicates that FE model will be applied.

4.3.2 Hausman Test of ROA

TABLE 4.4: Hausman Test of ROA

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section Random	56.2909	5.0000	0.0000

4.4 Regression Analysis

This model of study based on the dependent, independent and control variables. Ordinary Least Square (OLS), fixed, and random effect estimation techniques are used to estimate these models. The results of the study are shown in Table 4.5.

TABLE 4.5: Impact of IFRS on Common (ROE Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	2.3837	0.4456	5.3491	0.0000
LGDP	0.0784	0.0271	2.8891	0.0039
IFRS	0.5605	0.0603	9.2968	0.0000
TDR	0.4631	0.1100	4.2087	0.0000
GROW	13.5263	0.7501	18.0331	0.0000
LIQUIDITY01	0.0538	0.2903	0.1853	0.8530
R-squared	0.1558			
Adjusted R-squared	0.1540			
F-statistic	90.3247			
Prob(F-statistic)	0.0000			
Durbin-Watson	0.2351			

4.4.1 Common Effect Model ROE

The above Table shows the results of OLS, which is used to find the impact of CS and IFRS on financial performance of firm in which ROE as a dependent variable and Capital Structure as an independent variable with IFRS is used as a dummy variable and growth and liquidity are used as control variables. The percentage difference in the profitability caused by the capital structure is seen in the regression statistics table by the value of R square.

In this model, the R square value is 0.1557 that is 15.57%. The results of this model shows that capital structure positively and significantly impacts on firm performance that is measured by ROE. One unit change in debt over asset would lead to a change in ROE of 0.4630 unit. The IFRS dummy positively and significantly effects the performance of the firm. This reveals that adoption of IFRS leads to increase the performance of firm measured by ROE of non-financial firm in Pakistan.

The control variable growth is positively and significantly impact on the performance of firm. The value of growth is 13.52. It means that one unit change in growth brings 13.52 unit change in firm performance measured by ROE. The value of liquidity is 0.0538 that is insignificant. The results of this study are similar with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005).

4.4.2 Common Effect Model ROA

The below Table shows the results of OLS, which is used to find the impact of CS and IFRS on financial performance of firm in which ROA as a dependent variable and Capital Structure as an independent variable with IFRS is used as a dummy variable and growth and liquidity are used as control variables. The percentage difference in the profitability caused by the capital structure is seen in the regression statistics table by the value of R square.

In this model, the R square value is 0.0489 that is 4.89%. The results of this model shows that capital structure positively and significantly impacts on firm performance that is measured by ROA. One unit change in debt over asset would

TABLE 4.6: Impact of IFRS on ROA (Common Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-0.0411	0.1738	-0.2362	0.8133
LGDP	0.0037	0.0106	0.3476	0.7282
IFRS	0.0862	0.0235	3.6636	0.0003
TDR	0.3450	0.0430	8.0317	0.0000
GROW	1.8508	0.2925	6.3267	0.0000
LIQUIDITY01	-0.2059	0.1133	-1.8171	0.0693
R-squared	0.0489			
Adjusted R-squared	0.0470			
F-statistic	25.1589			
Prob(F-statistic)	0.0000			
Durbin-Watson stat	1.8173			

lead to a change in ROA of 0.3450 unit. The IFRS dummy positively and significantly effects the performance of the firm. This reveals that adoption of IFRS leads to increase the performance of firm measured by ROA of non-financial firm in Pakistan.

The control variable growth is positively and significantly impact on the performance of firm. The value of growth is 1.8508. It means that one unit change in growth brings 185.08% unit change in firm performance measured by ROA. The value of liquidity is -0.2058 that is weakly significant. The results of this study are similar with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005).

4.4.3 Fixed Effect Model ROE

The below table shows the results of Fixed Effect Model, which is used to find the impact of CS on firm performance and impact of IFRS in which ROE as dependent variable, IFRS is used as dummy variable, LGDP, growth, and liquidity are used as control variable. The percentage difference in the profitability that is dependent variable caused by CS that is independent variable in the regression statistics table by the value of R square. In this model the value of R square is 0.7681 that is 76.81. The results of this model shows that CS negatively and significantly impacts on firm performance measured by the ROE. One unit change in debt over asset ratio would lead to bring -0.0651 unit.

The IFRS dummy is positively and significantly effects the firm performance. This indicates that adoption of IFRS leads to increase the performance of firm measured by ROE of non-financial firms listed in Pakistan. The results of LGDP positively and significantly impacts the firm performance. It indicates that one unit change in LGDP will bring 0.0927 unit change in performance of firm. The results show that IFRS play a major role to effect the firm performance. The control variable growth is positively and significantly impacts the firm performance. The value of growth is 5.9523. it means that one unit change in growth brings 5.9523 unit change in performance of firm measured by ROE. The results of liquidity are negatively insignificant. Value of liquidity is -0.2058 that is weakly significant.

TABLE 4.7: Impact of IFRS on ROE (Fixed Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	2.4371	0.2433	10.0169	0.0000
LGDP	0.0928	0.0147	6.2901	0.0000
IFRS	0.2887	0.0335	8.6075	0.0000
TDR	-0.0651	0.0622	-1.0472	0.2951
GROW	5.9523	0.5847	10.1793	0.0000
LIQUIDITY01	-0.1454	0.2693	-0.5400	0.5892
R-squared	0.7681			
Adjusted R-squared	0.7519			
F-statistic	47.4730			
Prob(F-statistic)	0.0000			
Durbin-Watson	0.5888			

To sum up the above results, there is a positive relationship between the Capital structure and firm performance. The results supported the hypothesis of this study that there is positive relationship between capital structure and firm performance of non-financial firms in Pakistan. The results of this study are similar with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005); Basit & Hassa, (2007); Nasimi & Nasimi, (2018).

4.4.4 Fixed Effect Model ROA

The below table shows the results of Fixed Effect Model, which is used to find the impact of CS on firm performance and impact of IFRS in which ROA as dependent variable, IFRS is used as dummy variable, LGDP, growth, and liquidity are used as control variable. The percentage difference in the profitability that is dependent variable caused by CS that is independent variable in the regression statistics table by the value of R square.

In this model the value of R square is 0.1824 that is 18.24%. The results of this model shows that TDR positively and significantly impacts on firm performance measured by the ROA. One unit change in debt over asset ratio would lead to bring 0.2583 unit change in financial performance.

The IFRS dummy is positively and significantly effects the firm performance. This indicates that adoption of IFRS leads to increase the performance of firm measured by ROA of non-financial firms listed in Pakistan. The results of LGDP are positive but insignificant. The results show that IFRS plays a major role to effect the firm performance. The control variable growth is positively and insignificantly impacts the firm performance. The value of growth is 0.6709. The results of liquidity are positively insignificant. The value of liquidity is 0.1135.

To sum up the above results, there is a positive relationship between the Capital structure and firm performance. The results of this study are similar with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005); Basit & Hassan, (2007); Nasimi & Nasimi, (2018).

TABLE 4.8: Impact of IFRS on ROA (Fixed Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-0.0568	0.1679	-0.3381	0.7353
LGDP	0.0050	0.0102	0.4934	0.6218
IFRS	0.0501	0.0232	2.1656	0.0304
TDR	0.2538	0.0429	5.9140	0.0000
GROW	0.6710	0.4035	1.6631	0.0964
LIQUIDITY01	0.1136	0.1859	0.6108	0.5414
R-squared	0.1825			
Adjusted R-squared	0.1254			
F-statistic	3.1965			
Prob(F-statistic)	0.0000			
Durbin-Watson stat	2.0838			

4.4.5 Random Effect Model ROE

Below Table shows results of RE, which is used to find the impact of CS on firm performance and impact of IFRS in which ROE as a dependent variable and Capital structure (TDR) as an independent variable with IFRS and is used as dummy variable and growth and liquidity are used as control variables.

The percentage difference in the profitability caused by the capital structure is seen in the regression statistics table by the value of R square. In this model, the value of R-square is 0.0906 that is 9.06%.

The result of this model shows that capital structure insignificantly impacts the firm performance measured by ROE. The IFRS dummy is positively and significantly impact the firm performance. This indicates that adoption of IFRS leads to increase the performance of firm measured by ROE of non-financial firms in Pakistan.

The control variable Growth is positively and significant affect the firm performance. The value of Grow is 6.511, it means that one unit change in Growth brings 6.511 unit change in firm performance measured by ROE. The liquidity is insignificant which means liquidity has no impact on firm performance. LGDP is also positively significant which shows that LGDP has an impact on firm performance measured by ROE. One unit change in LGDP brings 0.0922 unit change in firms performance.

To sum up the above results, there is an insignificant relationship between the Capital structure and firm performance but significant and positive relationship with LGDP, IFRS and Growth. Results of the study are similar with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005); Basit & Hassan, (2007); Nasimi & Nasimi, (2018).

4.4.6 Random Effect Model ROA

The Table 4.10 shows results of RE, which is used to find impact of CS on firm performance and impact of IFRS in which ROA as dependent variable and Capital

TABLE 4.9: Impact of IFRS on ROE (Random Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	2.3715	0.2571	9.2256	0.0000
LGDP	0.0923	0.0147	6.2597	0.0000
IFRS	0.3001	0.0335	8.9562	0.0000
TDR	-0.0388	0.0621	-0.6245	0.5324
GROW	6.5113	0.5741	11.3414	0.0000
LIQUIDITY01	-0.0861	0.2601	-0.3309	0.7407
R-squared	0.0906			
Adjusted R-squared	0.0888			
F-statistic	48.7889			
Prob(F-statistic)	0.0000			
Durbin-Watson stat	0.5319			

TABLE 4.10: Impact of IFRS on ROA (Random Effect Model)

Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-0.0468	0.1673	-0.2795	0.7799
LGDP	0.0042	0.0102	0.4143	0.6787
IFRS	0.0708	0.0228	3.1023	0.0019
TDR	0.3071	0.0419	7.3267	0.0000
GROW	1.5365	0.3236	4.7476	0.0000
LIQUIDITY01	-0.1143	0.1304	-0.8767	0.3808
R-squared	0.0344			
Adjusted R-squared	0.0324			
F-statistic	17.4073			
Prob(F-statistic)	0.0000			
Durbin-Watson stat	1.9275			

structure (TDR) as an independent variable with IFRS is used as dummy variable and growth, LGDP and liquidity are used as control variables. The percentage difference in the profitability caused by the capital structure is seen in the regression statistics table by the value of R square. In this model, the value of R-square is 0.0343 that is 3.43%. The result of this model shows that capital structure significantly and positively impacts company performance as measured by ROA. The IFRS dummy is positively and significantly impact the firm performance. This indicates that adoption of IFRS leads to increase the performance of firm measured by ROA of non-financial firms in Pakistan. A control variable Growth is positively and significant effect firm performance. The value of Grow is 1.536, it means that one unit change in Growth brings 1.536 unit change in firm performance measured by ROA. Liquidity is insignificant which means liquidity has no impact on firm performance. LGDP is also insignificant which shows that LGDP has no effect on ROA-measured business performance. To sum up the above results, a significant positive relationship between the firm performance and capital structure, IFRS and Growth and insignificant relationship with LGDP and liquidity. Results of the study are parallel with research of Javed & Younas, (2014); Abdullah & Tursoy, (2019); and Abor, (2005); Basit & Hassan, (2007); Nasimi & Nasimi, (2018).

4.5 Redundant Fixed Effect - Likelihood Ratio

4.5.1 Likelihood Ratio of ROE

The likelihood-ratio test analyses the goodness of fit of two competing statistical models using the ratio of their likelihoods, one calculated by maximisation over the entire parameter space and the other achieved via constraint.

Table 4.11: Likelihood Ratio of ROE

Effects Test	**Statistic**	**d.f.**	**Prob.**
Cross-section F	39.0677	-1552293	0.0000
Cross-section Chi-square	3171.1100	155.0000	0.0000

Likelihood ratio sometimes also called chi-square test. This test is basically used to choose best model between two of them. This test is used to determine which of the two models, common effect and fixed effect, is the best.

4.5.2 Likelihood Ratio of ROA

Table 4.12: Likelihood Ratio of ROE

Effects Test	**Statistic**	**d.f.**	**Prob.**
Cross-section F	2.4152	-1552291	0.0000
Cross-section Chi-square	3171.1141	155.0000	0.0000

Chapter 5

Discussion and Conclusion

This part of the study includes the conclusion, policy recommendations, limitations and future directions. This section oversees the ends and recommendations based on the study's outcomes, as opposed to the previous section's investigation of the study.

5.1 Conclusion

The main goal of this research is to provide analytical data on the relationship between capital structure and firm performance in Pakistan, considering the implementation of the IFRS. The data is obtained of non-financial firms from 2001 to 2019, from Annual Financial Analysis (FSA)published by the SBP. Descriptive statistics, correlation, and panel data analysis approaches were used to examine the data collected.

For company's profitability, they must have optimal CS. For this reason; company management selects a CS that is consistent with maximization of shareholder wealth. According to a review of the existing literature, the number of studies was conducted in emerging and developed economies, like China, Germany, the United Kingdom, and Turkey. However, there is a scarcity of empirical evidence in developing countries, particularly in Pakistan. The majority of these researches have looked at the impact of CS on company performance in Pakistan without taking into account an impact of IFRS adoption. As a result, in order to cover

the observed gap, this study is conducted to gain a deeper understanding of the relationship between CS and FP and impact of IFRS adoption. As a result, this research focused on emphasizing the impact of CS on firm performance by adopting IFRS.

The analytical models' findings confirm a favorable relationship between capital structure and financial performance in Pakistani non-financial firms. Over the time 20012019, study found out that a 1% rise in overall debt ratio corresponds to a 19.96 percent increase in ROA. However, the results of study revealed that CS has a negative impact on stock price. This problem highlights the critical need for clear policies on debts provided to businesses.

Furthermore, because of the impact on business value, it is important for Pakistan government to pursue policies and create legislation that promotes investors. The results of this study consistent with these studies (Abdullah & Tursoy, 2019; Jouida,2018; Ohaka et al. 2020; AB Musa, BT Matemilola, 2021). Study also found that the introduction of IFRS as a major regulatory reform in the Pakistan financial system has a negative impact on capital structure effect. Various claims may be used to justify the findings of this article.

All of these view points are that taking on a lot of debt would put a lot of pressure on management to focus more on profitable acquisitions in order to raise enough cash flow to cover interest costs and avert bankruptcy. When it comes to investment decisions, the negative impact of debt ratio on a company's stock performance might mean that Pakistan investors favor the securities of less volatile firms.

This Study found that Pakistani companies are heavily leveraged, with debt financing accounting for over 50 percent of their investments on average, with the goal of avoiding high taxes. Although in general, the adoption of the International Financial Reporting Standards (IFRS) is widely thought to improve the information environment. This study conducted in Pakistan and revealed that this regulatory transition strengthens the relationship between CS and performance of the firm.

The findings of study support the pecking order theory and suggest that internal funding (retained earnings) should be preferred over external finance. This study will eventually benefit finance managers in determining an ideal structure, as well as the research community by offering new information on capital structure's effects. Other big economies can be examined with a variety of other industries to see how capital structure formation differs.

5.2 Policy Recommendations

The main reason behind this study is to know the role of adoption of IFRS on the decision of capital structure and performance of firm.

From the empirical study recommends that:

- Investors and lenders should keep in mind the capital structure of firms while deciding the investment decisions.
- The firms need to bring changes in capital structure to see the impact on the firm performance.
- The firms also need to choose best combination of CS to maximize performance of firm.
- The firms also need to use retained earning instead of increasing debt structure to maximize the firm performance and minimize the cost of capital.
- The investors need to evaluate the firm before investment either the firm is fully used the accounting principles that are recommended by IFRS.
- If a firm using IFRS then their financial reporting will present fair pictures of the firm.

5.3 Limitations

Following are the limitations of the study:

- This study is limited to only Pakistan, it means that the application of this study is just for Pakistan, it is not applicable for the other countries.
- Further limitations are the differences in rules and business conditions between financial and non-financial organizations, which resulted in the financial sector being excluded from the sample and every country has different behavior regarding the IFRS adoption.
- Future study may be possible to analyze the Asian countries behavior towards IFRS. Due to unavailability of the data and short span of time this study not taking all non-financial firms of the PSX.

5.4 Future Directions

- This study explores the effect of adoption of IFRS on performance of firm.
- The future study can be possible by considering more factors on the relationship.
- This study also suggests some points for future research.
- Further study can be applied to the financial sector to study these variables in both developing and developed countries to see what the effects are from different perspectives and levels of development in different countries.
- Future study can be possible by consider the IFRS effect on the firm performance by analyze separate sector of non-financial firms to know that which sectors is most effected by accounting principles and which sectors of the non-financial firm is fairly using IFRS.
- In addition, other performance factors of firm for example market share and other financial structure variables such as debt market value and internal ownership can be utilized to reflect the financial structure.
- Future study also possible by including more countries to see the impact of IFRS on the relationship.

- Due to non-availability of the data, it was not possible to take all non-financial firms that listed on PSX, future search may be conduct by taking both financial and non-financial firms at the same time to see the impact.

- Future research can be also conducting by taking macro-economic variables impact on the relationship. Also examine the ownership structure decision impact on the firm performance.

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