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SMALL AND MEDIUM SIZE ENTERPRISES (SMES) IN MALAYSIA: A CONCEPTUAL UNDERPINNING OF CAPITAL STRUCTURE DECISIONS AND FIRM PERFORMANCE

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Abstract:
This research emphasises the conceptual underpinning of capital structure decisions and firm performance among Small and Medium Size Enterprises (SMEs) in Malaysia. The capital structure of a firm can be partitioned into two major groups, particularly debt and equity financing. Equity financing arises when a firm offers some of its ownership rights to raise capital for further growth, expansion and investment activities. However, the definition of capital structure is the proportion of debt and equity to the total capital carried by a firm. The study found that the relationship between growth opportunity and firm performance is positively related to firm performance. It explains most of the SMEs whom with better growth opportunities will have greater access to finance and more sources in selecting financing options compared to low growth firms in Malaysia. The finding also justifies that the oldest of the firm age, the higher creditworthiness and better historical records that provide a more considerable reputation and trust to financial institutions. In investigating the relationship between asset tangibility and firm performance among SME in Malaysia, this study proves a positive relationship between the asset tangibility and firm performance. Finally, the number of literature on SMEs capital structure in Malaysia is relatively limited. Therefore, the recommendation for future research to study on other determinants of capital structure decisions which did not utilise in this study, for example, liquidity, non- debt tax shield and financial flexibility to examine the impact of capital structure decisions of SMEs.

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Keywords: conceptual underpinning, capital structure decisions, firm performance, small and medium size enterprises (SMEs), Malaysia

1. Introduction

Capital is fundamental and recognizes as a pool of fund available for a firm (Azam and Moha Asri, 2015; Tham et al., 2017; Udriyah et al., 2019; Al Shehhi and Azam, 2019a; Tao et al., 2019). It is equally vital to every firm regardless of its firm size, sector and age. Capital represents a substantial financial value, assets and wealth, which includes cash, fund, equipment, and investment portfolio and production plants. The capital structure of a firm can be partitioned into two major groups, particularly debt and equity financing. Equity financing arises when a firm offers some of its ownership rights to raise capital for further growth, expansion and investment activities. However, the definition of capital structure is the proportion of debt and equity to the total capital carried by a firm (Schlosser, 1989). It is characterized as containing debt, equity or hybrid securities like a convertible bond issued by a firm, according to Brealey and Myers (1991). Bos and Fetherstion (1993) defined capital structure as the total debt to total assets at firm book value that impacts both profitability and business risk of the firm.

An ideal capital structure is an essential choice of a financial decision in any firm (Haque et al., 2014; Rachmawati et al., 2019; Tarofder et al., 2019; Al Shehhi and Azam, 2019b). The choice of debt or equity is not just to increase shareholder wealth, but it has also affected the firm's capacity in financial management. In the past 60 years, capital structure theory was associated with the firm's financial decision and argued the impact towards the firm performance significantly with several determinants. Shigehiro Shinozaki, the financial specialist, reported that SMEs contribute 97.3% of total businesses in Malaysia. Financially, capital structure refers to the numbers of percentage or proportions of two forms of capital consist of equity capital provided by the owner and shareholders; whereby debt capital is the borrowing from banks and financial institutions.

Nonetheless, the recent global financial crisis resulted in a further harsh climate for SMEs with a lesser demand for goods and services, adoption rigorous credit risk assessment by banks and other financial institutions. The challenges of SMEs facing today is not only limited to the ability to secure finance, but also an insufficient human resource, incapable of embracing technology and limited opportunity on future markets in as a world which sometimes can be hostile and very aggressive (Azam et al., 2014; Haur et al., 2017; Tarofder et al., 2017; Katukurunda et al., 2019; Chong et al., 2019). Hence, this study considers the prospect of combining capital structure hypotheses firm's value and shareholder returns to achieve the optimal level. As presented, the firm can utilize an internal source of finance like retained earnings as the best policy, aligned with trade-off and pecking order theories examined the debt financing is the second-best policy and equity financing is the last one to consider. This study also tends to contribute to empirical studies on the determinants of capital structure decisions towards firm performance in the context of SMEs in Malaysia.

This study has a significant role to play in filling gaps in understanding of how capital structure impacts on their financial performance and profitability. It serves as a reference for entrepreneurs and financial managers in the SME industry with knowledge of the potential financial problems, as well as determining their optimal level of capital structure to achieve the firm's profitability. It also offers useful insights for entrepreneurs and financial managers in related to an effective financial decision to boost the firm performance by leveraging the ratio of debt and equity financing. Therefore, this study will further clarify and provide additional information about the capital structure of SME in Malaysian that leads the entrepreneurs or financial manager in deciding the corporate financing policy.

2. Literature Review

SMEs make up the foundation of the Malaysia economy and represent 97.3% of total business establishment in the nation, contributed 36.3% of total GDP, 65.5% of total workforces and 17.6% of total export in 2015 (SME Corp. Malaysia, 2016). In Malaysia, service, manufacturing and construction sectors are mainly contributed by SMEs at 98.2%, 95.4% and 87.1% respectively. These numbers present the importance of SMEs not just embrace the substantial number of establishments; however, it serves as the primary sources of contributions and development to the economy in Malaysia.

2.1 Capital Structure

Traditionally, the definition of capital structure was described as a combination of long-term finance utilized by the firm, which is additionally known as firm's capitalization initially with accentuated the percentage of each finance sources (Keown *et al.*, 1985). Conversely, Rajan and Zingales (1995) disputed the definition of capital structure, and it should rely on upon the financial goals. For instance, capital structure possibly to be evaluated by the firm's total debt ratio for research related to the agency problem. Debt financing can be apportioned into different elements such as quantify in terms of book value or market value of the firm.

As per Coleman (2006), capital structure alludes to bend of debt and equity utilized by firms to fund their resources on a long-term basis. Moreover, the capital structure is the management of the firm's financing behaviours includes equity, debt and intermediate securities (Brounen *et al.*, 2006). According to Ross *et al.* (2009), the market value of debt and equity defined the total of a firm's value by making the most of stockholders' benefits. A well-managed capital structure is to assure the firm operations and projects are funded. The strategic priority of management is to assess the difference between expenses and advantage related to the utilization of debt and equity financing, as highlighted by Karadeniz *et al.* (2009). As indicated by these scholars, Karadeniz *et al.* (2009) asserted that an ideal capital structure could capitalize on the firm's value by taking into account all the financial strategies and financing accessible according to the least costly finance sources.

Saad (2010) hold the view of the capital structure requires a firm to fund its resources and business operations through the composition of debt, equity and hybrid securities. This view is supported by San and Heng (2011) who wrote that capital structure indicates the company monetary skeleton which embraces of the debt and equity employed to fund the firm. Also, the capital structure is closely associated with the firm's capacity to prosper their shareholders' wealth. A study by Cortez and Susanto (2012), the mix of debt, equity and hybrid securities to fund the firm's business activities are called capital structure, which agreed by other researchers (Anderson & Reeb, 2004; Abor, 2005; Gill & Mathur, 2011; Tugba, 2012; Shubita & Alsawalhah, 2012; Ahmad & Rahim, 2013; Hamid *et al.,* 2015). According to Owolabi and Inyang (2012), capital structure outlines as a balanced group between debt and equity. Instead, a small scale of study by Modugu (2013) showed the firm's capital structure comprises of different sources of finance, which stated under equity and liabilities of the balances. In his research, Kuria (2013) explained that the capital structure is characterized as the creation of a considerable number of securities the firm issues with funding its operation to gain the most significant value. Zabri (2013) asserted the blend of all financing options that shows on the right-hand side of the firm's statement of financial position, which is balance sheet are capital structure. Pandey (2004) specified that the capital structure is a subset of financial structure, whereas including short term liabilities to capital structure constructs the financial structure. Table 1 summarizes the difference between capital structure and financial structure in a comparison chart.

Table 1: The Comparison Chart between Capital Structure and Financial Structure

Difference	Capital Structure	Financial Structure
Description	Composition of long-term finance sources raised by the firm	Composition of short term and long-term finance sources denote the financial structure of the firm
Balance Sheet	Under shareholder fund and non-current liabilities	Entire equities and liabilities
Instruments	Long term debt, retained earnings, equity capital, debentures and so on	Short term & long-term debt, retained earnings, equity capital, debentures, account payable and so on
Correlation	Partial of financial structure	Includes capital structure

Source: Pandey (2004).

2.2 Capital Structure Decisions

The study of capital structure decision is to achieve the optimal capital structure of the firm with higher financial returns. The combination of fixed capital and its insolvency together with costs imposed could be resolved through the debt tax shields advantages in the reality of optimal capital structure. As a general rule, the optimal capital structure is hard to decide, and firms need to issue different securities in an endless combination that can utmost the overall wealth which implies optimal capital structure with a base of the weighted average cost of capital. Ross *et al.* (2005) described the joined impacts of taxes and insolvency costs can create an optimal capital structure by shifting the firm capital structure transforms the pays out the method in its cash flow such as disburse lesser tax with higher levels of debt. Moreover, debt financing reduces the substantial value with its high cost of insolvency. As highlighted by Miao (2005), the traditional way of thinking the optimal capital structure is to boost the firm value by the utilization of debt financing wisely and its leverage to empower the firm to reduce its weighted average costs of capital. In the real world, external debt financing is continuously less expensive than equity due to a lower risk level. Subsequently, a reasonable increment paying off debts will help to lessen equity, since equity financing is a costlier source of finance which is being supplanted by a less costly debt. Conversely, the increase in debt financing likewise raises the risk level of shareholders.

Brealey *et al.,* (2001) defined there is no theory of optimal capital structure to urge a massive number of firm capital structure decisions. Although there are few financial theories related to debt-to-equity, however, it is upon every specific firm assets, benefits, nature of business and market conditions. The capital structure decisions rely on the relative significance of the factors such as the main objective is to minimize the weighted average cost of capital. For instance, in the SME perspective, the tax-deductible advantage is less critical than preserve financial slack. When financing is accessible to endowments and expansion, it made business opportunities profitable and valuable. In general, as many firms reach the growth stage of the life cycle are attempting to utilize equity capital, while financial distress costs are relatively high. On the other hand, matured firms were regularly taking after the pecking order theory with asymmetric information to stop substantial equity issuance; therefore, firms could raise capital with its retained earnings and more debt issuance when necessary.

2.3 Determinants of Capital Structure Decisions

This study reviews the past empirical evidence to identify the most impactful determinant of capital structure decisions in developing countries, while generally examine its influences of firm performance from a financial perspective (De Silva et al., 2017; Kuruwitaarachchi et al., 2019; Pambreni et al., 2019; Fernando et al., 2019). In this study, five determinants of capital structure decisions were chosen to explore the performance measurement among SMEs in Malaysia depend on the unity in the majority of the past literature. This study investigates determinants of capital structure decisions include profitability, size of the firm, growth opportunity, age of firm and asset tangibility. These determinants were deliberated and studies given the past theoretical reviews, which clarifies the financial decision to achieve optimal capital structure by maximizing firm's value and shareholders' wealth and diminish the weighted average cost of capital.

2.4 Capital Structure Decisions and Firm Performance

In managing corporate finance in either developed or developing the country, it is imperative to understand how firms select financing choice in their capital structure has become a critical issue in managing the business, especially to achieve the optimum level of the capital structure is still known as a constant and complicated subject matter. Esparanca and Gama (2003) supported this view. Kjellman and Hansen (1995) highlighted that optimal capital structure is yet perplexed by debt, equity or hybrid securities issuance. Capital structure theories propose how a portion of the elements may be associated with leverage and many empirical reviews endeavouring to examine the debt-to-equity ratio in developed nations, especially in the United States. It has been acknowledged that the research on capital structure decisions is increasing to achieve the optimal capital structure on firm performance (Jayasuriya and Azam, 2017; Dewi et al., 2019; Nguyen et al., 2019; Kanapathipillai and Azam, 2019; Gunasinghe et al., 2019). Notably, the capital structure theory declared that a specific level of debt offers ascends to a particular risk of insolvency. The shareholder's risk with debt incites the market to request a higher return on equity until it counterbalanced the positive effect of debt financing (Maghfuriyah et al., 2019; Pushpakumara et al., 2019; Al Shehhi and Azam, 2019c). The firm has accomplished the optimal capital structure with its financial leverage by safeguarding the least weighted average cost of capital and in this manner, the most noteworthy firm value of the entire financial performance.

3. Materials and Methods

The primary objective of this study is to comprehend the determinants of capital structure decisions towards firm performance in the financial perspective. In this study, the structured questions created in the survey questionnaire are prescribed into self-administer format that allows participants to complete the survey at their own quickly in both offline and online platforms using their computer or digital devices. For this purpose of research, data will be gathered from each business owners, top management, shareholders or finance managers working in the Malaysian SME firms. They are probably involved in the financial decision of the firm and their responses as a single source of data in this study. Hence, the unit of analysis to be used is the individual. Therefore, the non-probability sampling design with judgmental sampling technique is employed in this study to focus on quality respondents who could communicate the virtue of financial knowledge and experience in a thoughtful manner with Malaysian SMEs perspective. The sampling frame for this study is business owner, top management, shareholder and finance manager in SME sectors. Business owner refers to an individual who starts and operates a small scale of business activities with limited resources and business risks. In this study, the research instrument requires respondents who have specific knowledge, a good understanding of the financial position, and treasury, budgeting, policies and capital structure by having direct access to the financial information about the firm. SME business owners, top management, shareholders and financial managers are recommended and additionally implicit that they have direct involvement in the financial decision making of the respective firm, specifically in selecting debt or equity financing options.

4. Results and Discussion

Together, this result of study outlines the evidence on the relationship between determinants of capital structure by identifying the determinants of capital structure decisions towards firm performance among SMEs in Malaysia. The primary objective of this study is achieved and significant influences between capital structure decisions and financial performance, as well as filling up the research gap of SME capital structure decisions appropriately. In general, majority of SMEs are more favourable with an internal source of finance, and external sources of finance like debt and equity are aims to accelerate their performance and business expansion, which in line with pecking order theory. In Examining the relationship between firm size and firm performance among SME in Malaysia. The statistical analysis showed firm size is constructively related to the firm performance (Ting & Lean, 2011; Muzir, 2011; Wellalage & Locke, 2015; Farhan *et al.*, 2016; Eddie *et al.*, 2016; Ying *et al.*, 2016; Shambor, 2017; Lisboa, 2017; Siddik *et al.*, 2017). It is incredibly essential for SMEs to understand the difference and drawbacks of each source of fund in the capital structure in accordance to their size and phase of the business life cycle before securing the most cost-effective source to finance their business plan and expansion.

In determining the relationship between growth opportunity and firm performance among SME in Malaysia. The study found the relationship between growth opportunity and firm performance is positively related to the firm performance, which aligned with previous studies (Qayyum, 2013; Kariuki & Kamau, 2014; Acaravci, 2015; Alipour *et al.*, 2015; Ying *et al.*, 2016; Shambor, 2017; Lisboa, 2017; Siddik *et al.*, 2017). It explains most of the SMEs whom with better growth opportunities will have greater access to finance and more sources in selecting financing options compared to low growth firms in Malaysia. According to the findings of this study, firm age of the capital structure determinant is positively associated with the firm performance of SMEs in Malaysia (Saarani & Shahadan, 2013; Zabri, 2013; Wellalage & Locke, 2015; Mota & Moreira, 2017; Shambor, 2017; Lisboa, 2017). It justifies that the older of the firm age, the higher creditworthiness and better historical records that provide a more significant reputation and trust to financial institutions. In investigating the relationship between asset tangibility and firm performance among SME in Malaysia, this study proves a positive relationship between the asset tangibility and firm performance (Ibrahim & Masron, 2011; Ghazouani, 2013; Siti & NurAinna, 2014; Alani & Alamri, 2015; Alipour *et al.*, 2015; Berkman *et al.*, 2016; Mota & Moreira, 2017; Shambor, 2017). Asset tangibility serves as an essential determinant of capital structure decision because it influences the firm's opportunity in obtaining funding of capital. It also uses as collateral to secure debt and lenders are more willing to supply finance.

This study examines the financial behaviour among SMEs in Malaysia in respects to their financial practices and preference in deciding on capital structure. The knowledge of SME capital structure decision has mostly concentrated on the patterns of fundraising among SMEs business owners, top management, shareholders and finance managers during the business life cycle and the availability of financing facilities. Referring to the past literature on the topic relevant to capital structure in Malaysia is majority focused on those large firms, commercial banks, multinational companies or leading board listed companies in Bursa Malaysia. Subsequently, these leave a critical knowledge gap in the research of financing practices and capital structure of SMEs, even Shariah compliant SMEs in Malaysia. This study derives plentiful literature in the field of corporate finance, Islamic finance, entrepreneurship, performance management to build up a conceptual framework to explain the significant determinants of capital structure decisions in the SME context by embracing financial growth life cycle theory, agency theory and pecking order theory. The deliberation of these philosophies fosters the outcomes of the study involving the impact of a business network, environment, knowledge and the influences of capital structure on firm performance. Ultimately, this study brings the capital structure theories from western developed countries together with the real financing practices of SMEs. Hence, it bridges the gap between theory and practice by making several contributions to the existing body of knowledge in corporate finance management.

5. Conclusion and Recommendation

This study assumed the actuality of a significant association between capital structure decisions and firm performance in the SMEs context. The outcomes evidence the existence of a statistical correlation between the two, as well as extends the current literature by revealing the determinants of capital structure decisions towards financial performance among SMEs. The results are presented that in developing the research instrument for evaluating the capital structure decisions, the item constitution might differ subject to the business sector context, instead of stipulating a single instrument to all sectors among SMEs in Malaysia. Hence, the adoption of using the contingent instrument in different sectors will produce better and more relevant results in the SME context and likewise, require fundamental restructuring. Those managerial implications will support entrepreneurs to select the appropriate sources of capital for their firms. The literature and findings of capital structure theories in explicating firm financing behaviour and practices imply that trade-off theory, agency theory and pecking order theory are applicable and practical theory for entrepreneurs and finance managers. Current findings indicate that business owners focus on private finance, which believes it brings higher gains. In contrast, it may cause them to fail to spot the opportunities for expansion if they do not undertake external finance sources. Alternatively, the growth of Islamic finance should be considered and known as a prospective external finance instrument in fundraising and investment. The understanding of the circumstances of successful financial management will direct the business owners, particularly new startup entrepreneurs to furnish themselves with substantial information in managing the firm performance with maximum the returns and minimum cost of capital adequately. Moreover, it further prepares SME business owners to predict the market challenges and changing the economic climate by embracing necessary changes for a brighter future.

The number of literature on SMEs capital structure in Malaysia is relatively limited. Therefore, the recommendation for future research to study on other determinants of capital structure decisions which did not utilize in this study, for example, liquidity, non- debt tax shield and financial flexibility to examine the impact of capital structure decisions of SMEs. The research area of capital structure can be further developed by directing a comparative study between Malaysia and other developing countries to explore the dissimilarities in terms of firm capital structure decisions among SMEs in very culture, financial framework and policies.

The future study of capital structure, corporate governance and economic factors will expand the literature with a better understanding of the influences of economics in making financing decisions. Another possible area of future research would be to investigate the liability and personal risks of SME business owners because of owner equity and level of management control.

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