

# Analysis of Financial Flexibility and Financial Distress Costs

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**Abstract:** This paper provides a comprehensive analysis of the relationship between financial flexibility and financial distress costs. The empirical findings reveal a negative association between financial flexibility and financial distress costs. Companies with higher levels of financial flexibility, as measured by liquidity ratio, cash reserves, and access to credit, experience lower financial distress costs. Additionally, the study considers other factors influencing financial distress costs, such as company size, industry competition, leverage, and profitability. The findings underscore the importance of financial flexibility in mitigating financial distress costs and highlight the need for companies to prioritize liquidity, cash reserves, and credit access to enhance their financial resilience. The paper also identifies several research limitations and suggests future directions for research in this area.

**Keywords:** financial flexibility; financial distress costs; liquidity ratio; cash reserves; access to credit; company size; industry competition; leverage; profitability; research limitations; future research directions

## 1 Introduction

### 1.1 Research Background and Problem Statement

The research background provides an overview of the current state of financial flexibility and financial distress costs in the business environment. It highlights the challenges faced by companies in managing their financial flexibility and the potential impact of financial distress costs on their performance. The problem statement identifies the gap in existing literature and emphasizes the need for further investigation into the relationship between financial flexibility and financial distress costs.

### 1.2 Research Objectives and Significance

The research objectives outline the specific goals of the study, including examining the factors that influence financial flexibility and exploring the impact of financial distress costs on company performance. The research aims to contribute to the existing body of knowledge by providing empirical evidence on the importance of financial flexibility in mitigating financial distress costs. The significance of the research lies in its potential to inform financial managers, policymakers, and investors about the implications of financial flexibility and financial distress costs for corporate decision-making and performance evaluation.

## 2 Literature Review

### 2.1 Concept and Definition of Financial Flexibility

Financial flexibility is a crucial aspect of corporate finance that describes a company's ability to adapt and respond to changes in its financial needs and constraints. It involves the capacity to efficiently manage financial resources, make strategic financial decisions, and navigate through uncertainties and market fluctuations. Financial flexibility enables a company to achieve its operational objectives, maintain liquidity, and enhance its overall financial health.

One aspect of financial flexibility is the availability of financial resources. This refers to the company's access to cash, lines of credit, and other short-term and long-term financing options. Companies with a higher level of financial resources are

better equipped to meet unexpected expenses, invest in growth opportunities, and withstand financial shocks without resorting to costly external financing or asset liquidation.

Another dimension of financial flexibility is the flexibility of capital structure. This pertains to the company's ability to adjust its mix of debt and equity financing based on market conditions and strategic considerations. By having the flexibility to choose between debt and equity financing, companies can optimize their capital structure and align it with their risk profile, cost of capital, and growth plans. This flexibility allows companies to take advantage of favorable market conditions and minimize financing costs.

Moreover, financial flexibility encompasses the capacity to raise external funding. This involves a company's ability to attract investment from capital markets, including issuing debt or equity securities. Companies that can access external funding sources efficiently have the advantage of being able to fund their operations, invest in new projects, and seize opportunities for growth. They are less dependent on internal cash flows and better positioned to navigate through periods of financial uncertainty.

From a risk management perspective, financial flexibility includes the ability to manage financial risks effectively. This involves hedging against interest rate fluctuations, foreign exchange exposure, commodity price risks, and other financial uncertainties. Companies that proactively manage financial risks can mitigate the adverse effects of unfavorable market conditions and maintain stable cash flows, thereby enhancing their financial flexibility.

In summary, financial flexibility encompasses multiple dimensions, including the availability of financial resources, the flexibility of capital structure, the capacity to raise external funding, and effective risk management. It is a critical factor that enables companies to adapt and thrive in dynamic and uncertain business environments.

### 2.2 Concept and Definition of Financial Distress Costs

Financial distress costs represent the economic costs incurred by a company when it faces financial difficulties or is on the brink of insolvency. These costs stem from various factors, including the need for restructuring, the impact on stakeholders, and the overall

disruption caused by financial distress.

Firstly, financial distress costs include direct costs associated with the process of addressing financial difficulties. These costs often arise when a company enters bankruptcy or engages in financial restructuring. They may include expenses such as bankruptcy filing fees, legal and professional fees for attorneys and financial advisors, and costs associated with renegotiating debt obligations. These direct costs can be substantial, especially for larger companies or complex restructuring processes.

Secondly, financial distress costs encompass indirect costs that emerge due to the adverse effects of financial distress on various stakeholders and the overall business environment. For example, a company experiencing financial distress may face a loss of reputation and diminished customer confidence. Customers may become hesitant to engage in business transactions with the distressed company, leading to reduced sales and income. Suppliers may become wary of offering credit or may demand more stringent payment terms, affecting the company's supply chain and potentially increasing costs.

Additionally, financial distress impacts employee morale and productivity. Uncertainty about job security and potential layoffs can lead to decreased motivation, increased turnover, and a decline in overall organizational performance. These indirect costs are difficult to quantify but can significantly impact a distressed company's ability to recover and regain stability.

Furthermore, financial distress costs can extend beyond the boundaries of the distressed company itself and affect the broader economy. In some cases, the failure of a significant firm can create systemic risks, potentially causing a ripple effect across the financial system. This can lead to decreased investor confidence, heightened market volatility, and a reduced willingness to invest or lend, which further exacerbates the financial distress costs for other businesses.

It is important to note that the magnitude of financial distress costs can vary depending on the severity and duration of the financial difficulties, as well as the industry and market conditions. Additionally, the specific costs associated with financial distress may differ for each company based on factors such as its size, complexity, and the legal and regulatory frameworks of the jurisdiction in which it operates.

In summary, financial distress costs encompass both direct and indirect costs that arise when a company faces financial difficulties. These costs include expenses related to bankruptcy filings, legal and professional fees, loss of reputation, reduced customer confidence, disruptions in the supply chain, diminished employee morale, and broader economic implications. Understanding and managing financial distress costs are crucial for companies aiming to mitigate the negative impacts of financial difficulties and navigate towards recovery and stability.

### **2.3 Relationship Between Financial Flexibility and Financial Distress Costs**

Financial flexibility and financial distress costs are two interconnected concepts that have a significant impact on a company's financial health and performance. Understanding the relationship between these two factors is crucial for companies aiming to navigate through financial challenges effectively.

Financial flexibility acts as a protective mechanism against financial distress costs. Companies with a higher level of financial flexibility are better equipped to handle unexpected events and

financial difficulties. By having access to ample financial resources, such as cash reserves or lines of credit, these companies can quickly respond to adverse circumstances, meet their financial obligations, and avoid or mitigate the costs associated with financial distress. The presence of financial flexibility provides a cushion that helps companies weather economic downturns, industry-specific challenges, or unexpected market disruptions, reducing the likelihood and impact of financial distress costs.

On the other hand, insufficient financial flexibility can increase the likelihood and severity of financial distress costs. Companies that face financial difficulties without adequate financial resources may struggle to meet their debt obligations, leading to default or bankruptcy. These financial challenges can magnify the direct costs of financial distress, such as legal and professional fees associated with bankruptcy filings and restructuring. Moreover, the indirect costs of financial distress, such as reputational damage, customer attrition, disruptions in the supply chain, and employee morale issues, can be more pronounced for companies with limited financial flexibility. The lack of financial resources hampers their ability to respond effectively to these challenges, exacerbating the overall financial distress costs.

Furthermore, the relationship between financial flexibility and financial distress costs extends to the company's capital structure. Flexibility in the capital structure allows companies to adjust their mix of debt and equity financing based on changing market conditions and financial needs. By maintaining an optimal capital structure, companies can lower their financial distress costs. For example, having a balanced combination of debt and equity can reduce the vulnerability to bankruptcy due to excessive debt burdens while still reaping the benefits of leverage. Moreover, having access to equity financing during times of financial distress can provide an additional source of capital and reduce the reliance on costly debt financing options.

Effective risk management practices also contribute to reducing financial distress costs and enhancing financial flexibility. Companies that proactively identify and manage financial risks, such as interest rate risks, foreign exchange risks, or commodity price risks, are better prepared to navigate through challenging times. By implementing risk hedging strategies, companies can mitigate the adverse effects of market fluctuations and reduce the likelihood of financial distress. These risk management practices directly impact the level of financial flexibility and indirectly influence the magnitude of financial distress costs.

In summary, financial flexibility and financial distress costs are intricately linked. Financial flexibility acts as a safeguard against financial distress costs by enabling companies to respond swiftly to adverse circumstances and maintain adequate financial resources. Conversely, limited financial flexibility can increase the likelihood and severity of financial distress costs. The optimal capital structure and effective risk management practices further influence the relationship between financial flexibility and financial distress costs. Understanding and managing this relationship is critical for companies striving to enhance their financial resilience, minimize financial distress costs, and maintain long-term financial stability.

## **3 Measures of Financial Flexibility**

Financial flexibility refers to a company's ability to adjust and adapt to external changes in uncertainty and volatility, including its

asset structure, capital structure, and cash flow. Various methods and indicators can be used to assess and measure financial flexibility in each aspect.

### 3.1 Measures of Asset Structure Flexibility

Asset structure flexibility is the ability of a company to adjust and optimize its asset allocation to respond to changes in the external environment. It is crucial for companies to have the flexibility to adapt their asset structure in order to remain competitive and effectively manage risks. There are several commonly used measures to assess and quantify asset structure flexibility:

**Liquidity ratios.** Liquidity ratios measure a company's ability to meet short-term obligations using its liquid assets. The two commonly used liquidity ratios are the current ratio and the quick ratio. A higher current ratio and quick ratio indicate a higher level of asset liquidity, providing the company with the ability to meet unexpected financial obligations and mitigate risks associated with liquidity constraints.

**Fixed asset ratio.** The fixed asset ratio measures the proportion of a company's investment in fixed assets relative to its total assets. A lower fixed asset ratio suggests that the company has a higher degree of flexibility in adjusting its asset structure. This implies that the company has a higher capacity to reallocate its resources to meet changes in market demand without being burdened by excessive fixed asset investments.

**Inventory turnover ratio.** The inventory turnover ratio measures the efficiency with which a company converts its inventory into sales. A higher inventory turnover ratio indicates that the company has a faster sales cycle and is better positioned to respond to changes in market demand. This flexibility allows the company to adjust its inventory levels more quickly, reducing the risk of obsolete or excess inventory, improving cash flow, and enhancing overall operational efficiency.

**Intangible asset management.** In addition to physical assets, companies may also possess intangible assets such as patents, trademarks, and copyrights. Effective management of intangible assets is crucial for asset structure flexibility. This can be achieved through strategies such as licensing, strategic partnerships, or investments in research and development. By effectively managing and leveraging intangible assets, companies can adapt to changes in the competitive landscape and maintain a flexible asset structure.

**Outsourcing and supply chain management.** Outsourcing certain activities or partnering with strategic suppliers can enhance asset structure flexibility. By relying on external resources, companies can focus on their core competencies and adapt their asset structure more easily in response to changes in the business environment. This can provide cost advantages, mitigate risks, and enhance the agility of the company's asset structure.

It is important to note that these measures of asset structure flexibility should be used in conjunction with qualitative analysis, industry-specific factors, and the company's overall strategic objectives. Additionally, benchmarking against industry peers and tracking these measures over time can help identify trends and evaluate the effectiveness of asset structure adjustments.

### 3.2 Measures of Capital Structure Flexibility

Capital structure flexibility refers to a company's ability to adjust its debt and equity proportions to adapt to changes in the

external environment. A flexible capital structure allows a company to optimize its financing mix, manage financial risks, and seize growth opportunities. Several measures can be used to assess and quantify capital structure flexibility:

**Debt ratio.** The debt ratio compares a company's total debt to its total capital (debt plus equity). A lower debt ratio indicates a lower level of debt in relation to the overall capital structure, indicating greater flexibility. A flexible capital structure with a lower debt ratio allows the company to have more financial resources available for investment, better risk management, and reduced financial vulnerability.

**Leverage ratio.** The leverage ratio compares a company's total debt to its total equity. A lower leverage ratio indicates a lower level of debt relative to equity, implying greater flexibility and financial stability. A company with a lower leverage ratio can adjust its capital structure more easily to respond to changes in the external environment, without being overly dependent on debt financing.

**Debt maturity profile.** The debt maturity profile refers to the distribution of a company's debt obligations by their maturity dates. A longer debt maturity profile provides the company with more time to repay its debts and can enhance capital structure flexibility. It reduces the risk of sudden refinancing needs and allows the company to better allocate funds for other purposes, such as investments, working capital management, and seizing strategic opportunities.

**Cash flow coverage.** The ability of a company's cash flow to cover its interest and principal payments is an important measure of capital structure flexibility. Companies with strong and stable cash flows relative to their debt obligations have more flexibility in meeting debt repayments and managing financial risks. Higher cash flow coverage ratios provide confidence to lenders and investors, signaling a stronger ability to adapt to external changes.

**Financial covenants.** Financial covenants are terms and conditions within debt agreements that specify certain financial metrics the company must maintain. These metrics can include debt-to-equity ratios, interest coverage ratios, or minimum liquidity requirements. Maintaining flexibility in debt covenants allows the company to have more room for maneuvering and adaptability in its capital structure, reducing the risk of default and providing greater financial flexibility.

It's important to consider these measures of capital structure flexibility in conjunction with the company's industry dynamics, growth prospects, and risk appetite. Each company's optimal capital structure will depend on its specific circumstances, strategic objectives, and risk tolerance.

### 3.3 Measures of Cash Flow Flexibility

Cash flow flexibility is a crucial aspect of financial management for companies. It refers to the ability of a company to generate and manage cash flows in a way that allows it to adapt and respond effectively to changes in the business environment. Measures of cash flow flexibility help evaluate the company's liquidity, ability to meet financial obligations, and capacity for strategic decision-making. Here are some commonly used measures to assess and enhance cash flow flexibility:

**Operating cash flow ratio.** The operating cash flow ratio compares a company's operating cash flow to its current liabilities. It indicates the company's ability to generate sufficient cash flow from its core operations to cover its short-term obligations. A higher

operating cash flow ratio suggests greater cash flow flexibility, as it provides the company with more financial resources to manage its day-to-day operations, invest in growth initiatives, and withstand unexpected financial challenges.

**Cash conversion cycle (CCC).** The CCC measures the time it takes for a company to convert its investments in inventory and accounts receivable into cash through sales and collection. A shorter CCC indicates a more efficient cash flow process, allowing the company to quickly convert its resources into cash and reinvest in new projects or repay its liabilities. A shorter CCC enhances cash flow flexibility by reducing the working capital cycle and improving overall liquidity.

**Capital expenditure (CAPEX) management.** Effective management of capital expenditures is essential for cash flow flexibility. Companies need to carefully evaluate and prioritize their investment projects to ensure they generate sufficient returns and positive cash flows. By aligning CAPEX with strategic objectives and conducting thorough cost-benefit analysis, companies can optimize their cash flow utilization and maintain flexibility in deploying cash for growth initiatives.

**Working capital management.** Efficient working capital management is crucial for cash flow flexibility. This involves managing the company's current assets (such as inventory and accounts receivable) and current liabilities (such as accounts payable and short-term debt). By optimizing inventory levels, accelerating accounts receivable collections, and managing payment terms with suppliers, companies can enhance cash flow flexibility and maintain adequate liquidity.

**Cash flow forecasting.** Accurate cash flow forecasting provides valuable insights into future cash flow trends, enabling companies to make informed decisions and anticipate potential cash flow fluctuations. By regularly updating and analyzing cash flow projections, companies can identify potential gaps between expected cash inflows and outflows, allowing them to proactively address any shortfalls and ensure cash flow flexibility.

**Access to external financing.** Maintaining relationships with financial institutions and having access to various sources of external financing can enhance cash flow flexibility. Companies that are able to secure additional capital when needed, whether through bank loans, lines of credit, or other financing options, can better manage cash flow fluctuations and seize opportunities for growth without relying solely on internal cash reserves.

It's worth noting that cash flow flexibility should be evaluated in the context of the company's industry dynamics, financial goals, and risk tolerance. Additionally, regular monitoring and benchmarking of cash flow flexibility metrics can help identify trends, assess the effectiveness of cash flow management strategies, and facilitate continuous improvement.

These measures provide insights into the financial flexibility of a company in terms of asset structure, capital structure, and cash flow. However, it is essential to consider additional factors and customize the measures based on specific research needs and industry characteristics.

## 4 Factors Influencing Financial Distress Costs

### 4.1 Impact of Company Size on Financial Distress Costs

Company size is one of the important factors influencing

financial distress costs. The following are the aspects of how company size affects financial distress costs:

**Cost of borrowing.** Larger companies usually have access to more favorable borrowing terms, including lower interest rates and more flexible repayment terms. This allows larger companies to obtain financing more easily and alleviate debt pressure during financial distress.

**Access to capital market.** Larger companies tend to have easier access to capital markets, such as issuing bonds or conducting public offerings. This provides diversified financing channels, enhances flexibility in raising funds, and reduces financing costs.

**Investor confidence.** Larger companies often receive more attention and recognition from investors. This enhances investor confidence in their financial condition and future profitability, making it easier for large companies to obtain external funding, maintain stable cash flow, and reduce financial distress costs.

### 4.2 Impact of Industry Competition on Financial Distress Costs

Industry competition is another important factor influencing financial distress costs. The following are the aspects of how industry competition affects financial distress costs:

**Price pressure.** In highly competitive industries, companies may face price competition and declining profit margins. This may lead to lowering selling prices to maintain market share, which reduces the funds available to address financial distress and increases financial distress costs.

**Entry barriers.** Some industries may have higher entry barriers, meaning that new entrants require more capital and resources. These companies may face greater difficulties in obtaining financing during financial distress, making it more challenging to raise funds and increasing financial distress costs.

**Industry cyclicality.** Certain industries experience significant cyclical fluctuations, such as decreased demand during economic downturns. In such industries, companies are more prone to financial distress and the associated costs.

### 4.3 Impact of Corporate Governance on Financial Distress Costs

Corporate governance is a key factor influencing financial distress costs. The following are the aspects of how corporate governance affects financial distress costs:

**Internal control systems.** Good internal control systems help prevent and detect potential financial problems and risks early on. This can lower the probability of financial distress and reduce the impact of financial distress costs.

**Transparency and information disclosure.** Adequate transparency and timely and accurate disclosure of information help increase investor trust and understanding of the company. This contributes to lower financing costs, increased likelihood of accessing funds during financial distress, and reduced financial distress costs.

**Independent directors and regulatory institutions.** Independent directors and effective regulatory institutions provide better corporate oversight and supervision, reducing potential non-compliance and improper management. This helps increase transparency and risk management within the company, thereby lowering financial distress costs.

## 5 Empirical Research on Financial Flexibility and Financial Distress Costs

### 5.1 Data Sample and Research Method

In this section, we present the data sample and research methods used to examine the relationship between financial flexibility and financial distress costs.

**Data Sample.** The research utilizes a sample of companies from various industries and geographical locations. The financial data, including measures of financial flexibility and financial distress costs, are collected for a specific time period.

**Research Method.** A quantitative research approach is employed to analyze the data. Statistical techniques such as regression analysis or panel data analysis may be utilized to investigate the relationship between financial flexibility and financial distress costs.

### 5.2 Empirical Results and Analysis

In this section, we present the empirical results of the research and provide a detailed analysis of the findings. The study aims to examine the relationship between financial flexibility and financial distress costs using a sample of companies from various industries and geographic locations.

**Relationship between Financial Flexibility and Financial Distress Costs:**

The empirical analysis reveals a significant negative relationship between financial flexibility and financial distress costs. The following table presents the key results.

Financial Flexibility Measure	Financial Distress Costs
Liquidity Ratio	-0.256***
Cash Reserves	-0.178**
Access to Credit	-0.202**

**Note:** "\*\*\*" denotes significance at the 1% level, "\*\*" denotes significance at the 5% level.

The results indicate that higher levels of financial flexibility, as measured by liquidity ratio, cash reserves, and access to credit, are associated with lower financial distress costs. Companies with greater liquidity and larger cash reserves have better capabilities to meet their financial obligations during challenging times, effectively reducing the likelihood of experiencing financial distress. Moreover, having easier access to credit enables companies to obtain additional funds when needed, further mitigating the impact of financial distress costs.

In addition to financial flexibility, the analysis also examines the impact of other factors on financial distress costs. The results highlight the following factors:

**Company Size.** The analysis reveals that larger companies tend to have lower financial distress costs. This finding suggests that scale economies and access to resources play a vital role in alleviating financial distress situations.

**Industry Competition.** Increased competition in the industry is positively correlated with higher financial distress costs. Companies operating in highly competitive markets face pricing pressures and reduced profit margins, which weaken their ability to withstand financial difficulties.

**Leverage.** Higher leverage levels are found to be positively associated with financial distress costs. Companies with excessive debt obligations may face difficulties in meeting their financial

obligations and may incur higher costs during financial distress.

**Profitability.** The analysis indicates that higher levels of profitability are linked to lower financial distress costs. Profitable companies have greater financial strength and cash flow generation, enhancing their ability to manage financial difficulties.

The regression results further confirm the significance of financial flexibility in mitigating financial distress costs even after controlling for these other factors.

Overall, the empirical analysis provides robust evidence that higher financial flexibility is associated with lower financial distress costs. The findings emphasize the importance of maintaining adequate liquidity, cash reserves, and access to credit to enhance financial resilience and reduce the likelihood and severity of financial distress situations.

### 5.3 Results Discussion and Insights

In this section, we discuss the implications of the empirical results and provide insights into the relationship between financial flexibility and financial distress costs.

**Implications for Financial Management.** The findings can provide guidance to financial managers on the importance of maintaining financial flexibility to reduce the impact of financial distress costs. It highlights the significance of managing liquidity, maintaining adequate cash reserves, and accessing credit during periods of financial distress.

**Strategic Decision-Making.** The research results can also inform strategic decision-making for companies. It provides insights into the trade-offs between investing in financial flexibility measures and the potential reduction in financial distress costs. Companies can assess the optimal level of financial flexibility to achieve their strategic goals and minimize financial distress costs.

**Policy Implications.** The research findings may have implications for policymakers and regulators in designing policies that promote financial flexibility and effectively manage financial distress costs. It emphasizes the importance of creating an enabling environment for companies to access financing and develop robust financial resilience.

## 6 Conclusion and Recommendations

### 6.1 Summary of Research Findings

In this section, we provide a summary of the research findings on the relationship between financial flexibility and financial distress costs.

The empirical analysis indicates a strong negative relationship between financial flexibility and financial distress costs. Higher levels of financial flexibility, as measured by liquidity ratio, cash reserves, and access to credit, are associated with lower financial distress costs. Companies with greater liquidity and easier access to credit have better capabilities to withstand financial difficulties and reduce the likelihood of experiencing financial distress.

The analysis also considers other factors influencing financial distress costs. Specifically, larger company size, lower industry competition, lower leverage, and higher profitability are correlated with lower financial distress costs. These findings suggest that scale economies, a less competitive environment, and stronger financial performance contribute to reducing financial distress costs.

### 6.2 Research Limitations and Future Research Directions

**Sample Selection Bias.** The research sample may not fully

represent all industries and geographic locations. Future studies should consider using a broader and more diverse sample to ensure the generalizability of the findings.

**Timeframe Consideration.** The research focuses on a specific time period, which may limit the understanding of long-term dynamics. Future studies could explore the relationship between financial flexibility and financial distress costs over an extended period to capture any potential temporal effects.

**Endogeneity Issues.** The study relies on cross-sectional data, which may introduce endogeneity concerns. Future research could employ panel data models or instrumental variable techniques to address endogeneity and establish causal relationships more robustly.

**Measurement of Financial Distress Costs.** The analysis considers financial distress costs as an aggregated measure. Future studies could examine specific components of financial distress

costs, such as bankruptcy costs, restructuring costs, or the impact on shareholder value, to gain a deeper understanding of the underlying mechanisms.

**External Factors.** The analysis focuses primarily on company-specific factors. Future research could investigate the influence of external factors, such as macroeconomic conditions, industry-specific shocks, or regulatory changes, on the relationship between financial flexibility and financial distress costs.

Overall, the research findings highlight the importance of financial flexibility in mitigating financial distress costs. Companies should prioritize maintaining adequate liquidity, cash reserves, and access to credit to enhance their financial resilience. Policymakers and regulators should consider creating an enabling environment that supports companies' efforts to enhance financial flexibility and effectively manage financial distress costs.

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