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THE IMPACT OF CAPITAL STRUCTURE CHOICE ON FIRM PERFORMANCE IN SRI LANKA: EMPIRICAL EVIDENCE FROM THE COLOMBO STOCK EXCHANGE

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The theory of capital structure and its relationship with a firm's performance has been a grey issue in corporate finance in Sri Lanka. The capital structure decision is crucial for any business organisation's performance and survival. The capital structure of an organization is a mix of debt and equity securities. An optimal capital structure leads to maximize the market value of the firms with the performance of an organization. The main purpose of the study was to investigate the relationship between capital structure and profitability of firms listed on the Colombo Stock Exchange (CSE). A sub objective was to observe the existence of pecking order theory in Sri Lanka. Moreover, the pecking order theory explains the negative relationship between profitability and debt ratios which in turn explains that firms prefer internal financing. The study used all non financial publicly traded firms during the period of 2011/2012. The sample represented 82 non-financial profit-oriented companies listed in the Colombo Stock Exchange during the sample period. This screening yielded a final sample of 82 firms. Firms with negative book equity were excluded and return on capital employed more than -5 percent were also excluded since that can lead to a downward bias in the mean estimates, and provide a high sample variance. Stepwise multiple regression analysis was used in the estimation of functions relating the return on Capital employed (ROCE) with measures of capital structure. Three of the accounting-based measures of financial performance were used as dependent variables such as debt ratio, net profit margin (NPM) and size of the firm is measured by log sales. The Stepwise Regression model was developed and results showed the degree of impact of capital structure choice and size of the firm on financial performance in Sri Lankan non-financial listed firms. The results revealed a significantly positive relation between the debt to total assets and return on capital employed. This proved that the practice of pecking order theory does not exist in Sri Lankan profitable firms. In addition to that a positive association between the ratio of debt to total assets and size of the firms was found. In the Sri Lankan case, most of the listed non financial organizations depend on a higher proportion of the debt.