Relationship between Financial Leverage and Firm Growth: Referenceto the Listed Material Companies in Sri Lanka

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Abstract

Capital is one of the fundamental requirements of a firm. Firms can use internal or external sources to finance firm's assets. Retained earnings are an internal source of financing and debt, issuing equity are external sources of financing. A firm's capital consists of either equity capital or debt capital. Debt capital and equity capital are related to a firm's capital structure. The basic objective of decisions related to the capital structure is decreased total cost of capital, increase return and earning per share thereby maximizing the value of the firm. Usage of debt capital and equity capital vary between countries, industries, and firms. The capital structure shows how debt and equity capital employed for financing firm operations. There is a large number of researches that have been conducted to investigate the relationship between financial leverage and firm growth. Contradictory results can be found when referring to the literature regarding this relationship, maybe it is due to the variety of contexts. Therefore, the objective of this study is to investigate the relationship between financial leverage and the firm growth while considering debt to total asset ratio and debt to equity ratio as independent variables. Asset growth, sales growth, and profit growth were considered as dependent variables while the firm size was considered as the control variable. There are twenty-one material firms listed in the Colombo Stock Exchange and all material companies are used as the sample of the study. The data was collected from the annual reports of selected companies from 2014 to 2020 years. Descriptive statistics and inferential statistics were used to analyse the data. Correlation results showed a positive relationship between financial leverage and sales growth. The same relationship was found between financial leverage and profit growth. However, financial leverage and asset growth showed a negative relationship. Firms use a large amount of debt in situations where there is not enough equity capital therefore identifying the relationship between financial leverage and firm growth is vital for the internal stakeholders like managers to take effective and efficient future financing decisions.

Keywords: Assets growth, firm growth, leverage, profit growth, sales growth