THE IMPACT OF FINANCIAL LEVERAGE ON COMPANY GROWTH OF THE LISTED COMPANIES IN COLOMBO STOCK EXCHANGE

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Abstract

This study investigates the impact of financial leverage (FL) on company growth of the listed companies traded in Colombo Stocks Exchange (CSE). Many scholars (Gupta, 1968; Jensen and Meckling, 1976; Ross, 1977; Scott, 1977; Warner, 1977; Bredly, Jarrell and et al 1984; Senbent and Traggart 1984; Myers and Majluf, 1984; Titman, 1984; Titman, and Wessels, 1988; Rajan and Zingales, 1995) have argued that the FL is one of the most influencing factors in determining the growth of a company. The common approach in empirical capital structure studies has been to examine the relationship between observed FL and the set of explanatory variables. This approach has a number of shortcomings. The problem of this study is to investigate whether the FL influences negatively or positively on signaling the firms' growth. This problem furnishes useful information to two groups of users of accounting information; accounting policy makers and financial managers. The objectives of this problem are mainly divided into a primary objective and secondary objectives. The primary objective is to identify the relationship between FL position and the growth rate of the listed companies traded on the Colombo Stock Exchange (CSE). The observation of the level of FL and the growth rate, industrial differences and the degree of relationship of FL and the growth rate and the relationship between financial strength (FS), growth and FL are secondary objectives of this study. Sample size of this study is 30% of thirteen sectors which represent sixty-three quoted companies randomly selected from the CSE, and a period of ten years from 1990 to 2000. The required data and information for the study were gathered from published annual reports, Handbook of listed companies in CSE from 1994, 1997 and 2001 and Central Bank annual report of 2000 AD. The financial ratios are used to evaluate the companies' financial performance and conditions. The growth of the companies is represented by total assets, profit, and sales, which were calculated using the growth index. Altman (1968) multiple discriminant function was constructed to ascertain financial strength of the sample companies. Under the descriptive analysis, average, median and Standard deviation (SD) of the sample companies and sectors were calculated. The relationship between independent variable FL of the sample companies and sectors and dependent variables growth and FS of the sample companies and sectors were tested by regression analysis. F- Statistics was performed to test the significance of the β parameter in the regression model at 5% level of significance. In addition to the above, correlation coefficient (R) and goodness to fit the model (Coefficient of Determination- R^2) were calculated. The results of the study are presented with the use of table and line chart. The overall results of the study indicate that the FL had a strong positive relationship between growth and FS. Conversely, this situation supports this view that there is a positive rather than a negative relationship between FL and other growth variables as implied by the negative signals about the future growth of the company.

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