Impact of financial leverage on firm performance: with special reference to manufacturing sector in Sri Lanka

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Introduction

Capital structure plays a crucial role in enhancing performance of firms, by helping financial manager to select optimal mix of debt and equity to give required rate of return for shareholders. Generally, due to great cost of capital within the equity and tax advantage of debt, leverage consider as the optimal solution for a company, to gain financial resources. Therefore research is going to identify impact of financial leverage to the performance of firms within Sri Lankan context.

According to the Akhtar et.al (2012) leverage is consider as proportions of borrowing funds from outside sources. Through past decades, various theories set the foundation to optimize the debt financing usage in organizations. Warne and Rasoolpur (2013), mention that the greater use of debt will increases the net return to the equity shareholders. Moreover, Akthar et.al (2012) stated that leverage may enhance the profit after taxes; due to lower interest rates .Then eventually the higher earnings of firm will result to the higher earnings per share and then these higher dividend payout ratios which may increase the firm's performance. Duties of owners (shareholders) and managers are different in every organization. Due to that, management is more concern about personal gains. This may cause conflict situations within organizations. For that debt finance act as a control tool to restrict the opportunistic behavior of managers. On the other hand, Usage of debt is tradeoff between risk and return. Risk of the firm increase simultaneously with increasing leverage and leads towards liquidations and takeovers. Moreover, unbalanced debt will cause to financial distress cost and bankruptcy cost.

Therefore, this research aims to investigate this scenario within manufacturing industry in Sri Lanka. Accordingly, objectives of research were concluded, to examine the relationship of firm performance with short term debt (STDA), long term debt (LTDA) and total debt (TDA) respectively.

Methodology

Research was conducted regarding the Colombo Stock Exchange and population consists with manufacturing industry in Sri Lanka. 30 companies were used for the analysis. Data was collected through secondary data sources such as annual reports of companies through 5 years. Further, leverage was measured by using Long -Term Debt Ratio (LTDA), Short- Term Debt Ratio (STDA), Total Debt Ratio (TDA) which were used by Musiegaeth.al (2013) and Abort (2008). Firm performance proxy by Return on assets (ROA), Return on equity (ROE) and Gross pro fit margin (GPM) developed by Musiegaeth.al (2013) and Khan (2012). Data was analyzed by using Descriptive analysis, Correlation coefficient method and Regression analysis.

Results and Discussion

Pearson correlation analysis is shown below (Table 1) according to the rule of P-value < 0.05.

Table 01: correlation coefficient analysis results

		LTDA	STDA	TDA
ROA	Pearson Correlation	0.103	-0.267	-0.034
	Sig. (2-tailed)	0.587	0.154	0.86
ROE	Pearson Correlation	-0.094	-.498**	-.498**
	Sig. (2-tailed)	0.621	0.002	0.005
GPM	Pearson Correlation	-.549**	-0.176	-0.01
	Sig. (2-tailed)	0.002	0.353	0.957

Source: Modified from SPSS output of research data

ROA has statistically insignificant relationship with all three dimensions of leverage and LTDA has weak positive, STDA, TDA have weak negative relationships respectively. Then, ROE has significant relationships with STDA (0.002), TDA (0.005) and insignificant with LTDA. Furthermore, LTDA and TDA has weak negative (-0.094), (-.498**) relationships respectively and Strong negative relationship with STDA (-.498**). Moreover, LTDA have (-.549**) strong negative and significant relationship with GPM and STDA (-0.176), TDA (-0.01) has weak negative and insignificant relationship with GPM.

Regression analysis emphasis the relationship with leverage and firm performance

Y ROA =**.904 + .013TDA** (statistically not significant 0.093, R^2 .215)
Y GPM =**1.119+ .242LTDA** (statistically significant 0.006, R^2 .373)
Y ROE = .595 -1.004LTDA + .512STDA (statistically significant 0.010, R^2 .350)

According to the regression output, when TDA increase in 1 unit ROA will increase in 0.013.When LTDA increase in 1 unit GPM will increase in 0.242.Moreover, with considering ROE, when STDA increase in 1 unit ROE will increase in 0.512 and simultaneously ROE will decrease in 1.004 when LTDA increase in 1 unit. According to the information given above in the equation it conclude that leverage will impact differently to performance, when measuring with various indicators.

Conclusions

According to the research findings, it can conclude that leverage dimensions express various relationships with firm performance. Further, regression analysis identifies that ROE and GPM has significant relationship with leverage and ROA has insignificant relationship with it.

Therefore, this results emphasis that firms should more focus on their long term debt to handle their profitability, since increasing LTDA firm can earn higher gross profit margin. As per the results of ROE, firm can earn higher earnings by increasing short term debt financing and decreasing long term debt financing. Furthermore, according to the R square, Debt will not be the only indicator for influence the firm performance. As well, it emphasize that firm managers must try to balance the creditors and investors to manage the debt finance impact for the organization.

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