The Impact of Capital Structure on Firm Performance EmpiricalEvidence from Companies Listed in Colombo Stock Exchange

R.M.C. Wathsala[1,*] and P.D.N.K. Palihena[2]

[1,2]*Department of Accountancy and Finance, Faculty of Management Studies, Rajarata University of Sri Lanka, Mihintale, Sri Lanka*

[*]Corresponding author: chamariwathsala14@gmail.com

Abstract

Capital structure refers to the firm's financial framework which consists of equity and debt. An optimal capital structure leads to minimizing the firm's cost while maximizing the value of the firm. Exactly how firms choose the amount of debt and equity in their capital structure a question. The answer to this question is very important as it influences the way investors perceive the firm. Most of the companies in Sri Lanka use debt more than equity for financing their firms. It will impact the overall performance of the firm. Accordingly, the main objective of this study is to investigate the impact of capital structure on the firm performance of companies listed in the Colombo Stock Exchange. However, only a limited number of studies have been used several sectors of the Colombo Stock Exchange for their analyses. Accordingly, in the present study, the researchers studied and tested a sample of 50 companies that represent 15 sectors in the Colombo Stock Exchange. In this study, return on assets and return on equity used to measure the firm performance of companies. Debt equity ratio and long-term debt to total assets ratio used to measure the capital structure while keeping firm size, tangibility, age, and growthas control variables. Statistical methods such as descriptive analysis, correlation analysis,and regression analysis have been used to analyse the gathered data by using IBM SPSS-26 software. The required data were extracted from the financial statements of respective companies over the five years from 2016 to 2020. Results of the present study suggest that there is a negative and significant impact of debt equity ratio and long-term debt to total assets ratio on return on assets and return on equity. However, control variables of firm size, tangibility, age, and growth indicated an insignificant impact on the firm performance. The present research results affirm that by reducing the debt ratio, management can increase the performance of a firm while increasing the shareholders' wealth which supports the various theoretical stances developed by scholars over the last five decades.

Keywords: Capital structure, firm performance, return on assets, return on equity