

**SC**

***An Empirical Investigation on the Relationship  
between Financial Leverage and Value of the Firm***

***By***

***A.L.M. Jameel***

***(KEL/M.Com/96/06)***



***A dissertation submitted to the Faculty of Commerce and Management  
Studies, University of Kelaniya in partial fulfillment of the requirements  
for the Master's Degree in Commerce***

***M.Com. Degree Program  
Faculty of Commerce and Management Studies  
University of Kelaniya,  
Sri Lanka  
2004***

ප්‍රවේශ අංකය	539
වර්ෂ අංකය	

## Abstract

Whether the relationship between financial leverage (FLG) and value of the firm (VOF) is dependent or independent has been the subject of considerable controversy, both theoretically and empirically since the publication of irrelevancy theory of Miller and Modigliani (MM) (1958), which remarks that the VOF is independent with the FLG. This proposition contradicts with the relevancy theories especially traditional view, which says that the VOF is dependent with the FLG. MM (1963) made a correction on their proposition saying that the VOF is dependent with FLG but this dependence take place due to the tax deductibility of the interest charges and they say that the VOF after eliminating the tax effect on the interest charges is independent with the FLG.

The empirical researchers interested on the investigation of the relationship between FLG and value of the firm have been facing two main questions;

1. Whether or not the VOF is dependent with the FLG?
2. Whether or not the VOF is independent with the FLG due to the tax deductibility of interest charges?

Some of the empirical studies made on the first question support traditional view or relevancy hypothesis while some others support the MM's irrelevancy hypothesis. Some of the research studies which have been investigated on the second question support MM's corrected hypothesis that the VOF is dependent with the FLG due to the tax deductibility of the interest charges while some others reject this hypothesis and support the traditional view hypothesis.

This study attempted to investigate the relationship between the FLG and the VOF in the context of Sri Lanka with a view of achieving two main specific objectives which are based on the above two questions. The study used the data from 53 listed companies in the Colombo stock exchange (CSE) selected from the major five sectors influencing the market capitalization of CSE and these data were analyzed converting them into three types namely sector wise data, pooled data and all selected companies data.

The study developed three hypotheses and of which the hypothesis I involves with the testing whether the VOF is dependent or independent with the FLG and the hypothesis II involves

with the testing whether the VOF is dependent with the FLG due to the tax deductibility of interest charges. The hypothesis III involve with the testing of the significant differences between the sector wise results.

Two multiple regression models were constructed separately for hypothesis I and II respectively incorporating independent variables such as FLG, growth, size and dividend pay out ratio (D/P).

The study found, in relation to the hypothesis I, that the relationship between FLG and VOF is positive with the FLG and also found, in relation to the hypothesis II, that the VOF is dependent with the FLG due to the tax deductibility of interest charges. The study also found that the sector wise results differ from each other under the two hypotheses testing and also observed that the size variable has positive impact on the VOF while growth and D/P variables have negligible effect on the VOF.

## Chapter One

### Introduction