

6.24 Degree of operating leverage and stock returns: an empirical study of Colombo Stock Exchange

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ABSTRACT

The impact of accounting information on stock market has been one of the most studied topics in the Accounting and Finance research literature. Most of the studies are aimed at identifying in what ways and dimensions of the accounting information is effectively relevant for the investors' decision making. When making decisions with the purpose of maximizing wealth, investors take into account the impact of macro economic and firm specific variables. But, most of the studies have focused on accounting information such as Profitability, Earning per Share (EPS), Return on Capital Employed (ROCE) etc. The present study draws an attention to another important accounting variable, Degree of Operating Leverage (DOL) which is the relationship between Earning Before Interest and Tax (EBIT) and Sales. Hence, this study was undertaken with the purpose of determining the impact of the Degree of Operating Leverage on Stock Return in the Colombo Stock Exchange. This research was based on data from manufacturing firms listed on the Colombo Stock Exchange for the period of 2003 to 2007. The final sample contained 27 companies out of 31 companies in the manufacturing sector. Empirical tests were performed to test the hypothesis that the Degree of Operating Leverage has a positive impact on Stock Returns. We find that there is not a positive and significant relationship between those two variables as expected.

Key words: Degree of Operating Leverage, Stock Returns, Accounting information, Profitability, Earning per Share (EPS), Return on Capital Employed (ROCE)