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CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	CUSTOMER SATISFACTION AND SUSTAINABLE FIRM PERFORMANCE: THE ROLE OF UNCERTAINTY <i>DR. SANAL K. MAZVANCHERYL</i>	1
2.	MOVEMENT FROM EEE SYSTEM TO EET SYSTEM <i>DR. SAMBHAV GARG</i>	7
3.	THE IMPACT OF CAPITAL STRUCTURE-CHOICE ON FIRM PERFORMANCE: EMPIRICAL INVESTIGATION OF LISTED COMPANIES IN COLOMBO STOCK EXCHANGE, SRILANKA <i>B. PRAHALATHAN & DR. (MRS.) R.P.C.RANJANI</i>	12
4.	AN ANALYSIS OF ORGANISATIONAL CULTURE IN THE COMPANIES <i>DR. ARAVIND. S., DR. FISSEHA GIRMAY TESSEMA & DR. HAILAY GEBRETINSAE</i>	17
5.	RESOLVING EXPECTATIONS GAPS IN FINANCIAL REPORTING: ISSUES FOR INTERNATIONAL FINANCIAL REPORTING STANDARDS <i>DR. JOHN A. ENAHORO</i>	25
6.	E-BANKING SCENARIO AND ITS IMPACT ON CUSTOMERS' SATISFACTION IN INDIA <i>PROF. (DR.) SULTAN SINGH & SAHILA CHAUDHRY</i>	29
7.	A COMPREHENSIVE FINANCIAL ANALYSIS OF AQUA CULTURE FEED INDUSTRIES IN SOUTH INDIA <i>ASLAM CHINARONG, PROF. (DR.) K. MARAN & DR B. YAMUNA KRISHNA</i>	35
8.	A STUDY ON COUSTOMER SATISFACTION TOWARDS RELIANCE TELICOM IN TAMILNADU WITH SPECIAL REFERENCE TO SALEM CITY <i>MR. B. ADHINARAYANAN & DR. K. BALANAGA GURUNATHAN</i>	39
9.	VALUE FOR THE MONEY - SUCCESS MANTRA FOR MARKETERS IN RURAL MARKET <i>DR. N. RAJASEKAR & R.PRIYA</i>	44
10.	INDIGENOUS BRANDING – INDIA'S FUTURE BRAND STRATEGY (AN EMPIRICAL STUDY OF THREE DECADES OF BRAND WARFARE IN INDIA) <i>DR. S. P. RATH, PROF. BISWAJIT DAS & PROF. CHEF GERARD D' SOUZA</i>	49
11.	STOCK PRICE REACTION OF THE MERGED BANKS – AN EVENT STUDY APPROACH <i>DR. P. NATARAJAN & K. KALAICHELVAN</i>	54
12.	A STUDY ON ABSENTEEISM OF EMPLOYEES IN RETAILING INDUSTRY <i>DR. N. SANTHI, MRS. D. MARIA ANGELIN JAYANTHI & MS. HEMALATHA</i>	61
13.	MEASURING OF QUALITY OF WORK LIFE IN TEXTILE INDUSTRIES - AN INTEGRATION OF CONCEPTUAL RELATIONSHIP WITH PRODUCTIVITY <i>N. MOHAN & DR. J. ASHOK</i>	67
14.	RISK MANAGEMENT STRATEGIES AND PRACTICES IN THE BANKING SECTOR: CHALLENGES ARISING FROM GLOBAL RECESSION – KEY TO SURVIVAL & GROWTH <i>K. BHAVANA RAJ & DR. SINDHU</i>	71
15.	PREVENTIVE MEDICINE TO COMBAT OCCUPATIONAL STRESS OF EMPLOYEES IN BPO ORGANISATIONS – INDIA'S NEED OF THE HOUR <i>DR. R. SRINIVASAN & MRS. A. BHARATHY</i>	74
16.	AYURVEDIC WELLNESS TOURISM IN KERALA: A GATE WAY FOR ENTREPRENEURS TO EMERGE SUCCESSFUL <i>RAMESH U & KURIAN JOSEPH</i>	80
17.	THE BANNED SURROGATE MARKETING AS BRAND - NEW BRAND EXTENSION ADVERTISING <i>V V DEVI PRASAD KOTNI</i>	85
18.	COMPARATIVE STUDY ON RETAIL SHRINKAGE OF INDIA, ASIA-PACIFIC AND GLOBAL COUNTRIES <i>SANDEEP RAJENDRA SAHU</i>	90
19.	QUALITY OF WORK LIFE (QWL) FOR FINANCE PROFESSIONALS IN DUBAI <i>DR. SANGEETHA VINOD, FAYAZ AHAMED M.A. & N. MOHAMED RAFIQ</i>	96
20.	ART OF DELIGATION- A POWERFUL TOOL FOR LIBRARIAN <i>NARENDER KUMAR, ASHISH SIWACH & MRS. SUNITA BHARATWAL</i>	102
21.	A STUDY ON BENEFITS AND RISK ANALYSIS OF FUTURES AND OPTIONS IN MADURAI <i>MS. K. HEMA MALINI & ER. R. DEEPA</i>	105
22.	GREEN AND SUSTAINABLE MANAGEMENT – A DECIDING FACTOR FOR TOMORROW'S BUSINESS <i>HARDEEP SINGH & BIKRAM PAL SINGH</i>	110
23.	CHANGING CONDITIONS OF WORKERS AND PROCESSES OF WORK IN ADVERTISING AGENCIES IN INDIA <i>DR. YASHMIN SOFAT</i>	115
24.	INDIAN FINANCIAL SECTOR REFORM (1991-2001): MISSING A MANDATORY SOCIAL CONSENSUS <i>SANJAY BHATTACHARYA</i>	123
25.	A STUDY ON CONSUMER BEHAVIOUR IN SELECTING CREDIT CARDS <i>DR. A. VALARMATHI & MRS. PRIYA KALYANASUNDARAM</i>	127
	REQUEST FOR FEEDBACK	133

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THE IMPACT OF CAPITAL STRUCTURE-CHOICE ON FIRM PERFORMANCE: EMPIRICAL INVESTIGATION OF LISTED COMPANIES IN COLOMBO STOCK EXCHANGE, SRILANKA

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ABSTRACT

The purpose of this paper is to empirically examine the impact of capital structure choice on firms' performance in Sri Lanka. Sample of the study represents 65 Sri Lankan companies, listed at the Colombo Stock Exchange for the period 2003-2007. Multiple regression analysis is used in estimating the relationship between the capital structure and firm's performance. In this study, independent variables that is, capital structure of the companies, is measured by leverage ratios of short - term debt to total asset ratio (STD), long- term debt to total debt ratio (LTD) and total debt to total asset ratio (TTD) and also firm size(log S) are used as independent control variables. Three accounting-based measures of financial performance i.e. gross profit margin (GPM), return on asset (ROA) and return on equity (ROE) are used as the dependent variables for the present study. The findings reveal that STD, TTD have significant negative impact on GPM at the level of 0.01(confidence of 99%). In the case of LTD, which has a significant negative impact on GPM at the level of 0.05(confidence of 95%). Further, the results indicate that neither STD, LTD, nor TTD has a significant impact on firm's performance measured by ROE, and ROA respectively. These results contradict with findings of previous literature either in developed or transition economies which document a significant impact of capital structure on firm's performance either positively or negatively.

KEYWORDS

accounting-based performance measures, capital structure, leverage.

INTRODUCTION

Capital structure is a topic that continues to keep researchers pondering. Capital structure refers to the firm's financial frame work. Primarily, it consists of the debt and equity used to finance the firm. The theory of capital structure and its relationship with a firm's value and performance has been debatable issue in corporate finance since the seminal work of Modigliani and Miller (1958). The seminal work of Modigliani & Miller (1958) showed that the market value of the firm is determined by its earning power and the risk of its underlying assets, and is independent of the way it chooses to finance its investment or distribute dividends. Their arguments were based on very restrictive assumptions of perfect capital markets, investors' homogeneous expectations, tax-free economy, and no transactions cost. Although this theory is based on many unrealistic assumptions, it provides the basic theoretical background for further research and its underlying assumptions showing that capital structure affects firm's value and performance.

Seminal paper of Jensen et al (1976), demonstrates that the amount of leverage in a firm's capital structure affects the agency conflicts between managers and shareholders by constraining or encouraging managers to act more in the interest of shareholders, which means that the amount of leverage in capital structure affects firm performance. In practice, firm managers who are able to identify the optimal capital structure are rewarded by minimising a firm's cost of finance thereby maximising the firm's revenue. If a firm's capital structure influences a firm's performance, then it is reasonable to expect that the firm's capital structure would affect the firm's health. The value of the business is the present value of all the expected future cash flows to be generated by the company's weighted average cost of capital (Ehrhard et al, 2003). Weighted Average Cost of Capital (WACC) has a direct impact on the value of a business (Johannes et al, 2007). Harris et al (1991) argue that capital structure is relates to the trade-off between cost of liquidation and the gain from liquidation to both shareholders and managers. So, the amount of leverage in capital affects firm performance (Harris et al, 1991; Graham et al, 2001).

Since seminal paper of the Jensen et al (1976), several researchers have followed this extension and conducted numerous studies that aim to examine the relationship between financial leverage and firm performance over the last decades. However, empirical evidence regarding this relationship is contradictory and mixed. Positive relationship between leverage and firm performance has been identified in some studies (Taub, 1975; Roden et al, 1995; Champion, 1999; Ghosh et al, 2000). Other studies document a negative relationship between leverage and firm performance (Fama et al, 1998; Gleason et al, 2000; Simerly et al, 2000).

While most of the research studies on capital structure has used data from developed markets (e.g.USA and Europe), little is empirically known about such implications in emerging or transition economies like Sri Lanka. In such a country as Eldomiaty(2007) argued capital market is less efficient and incomplete and suffers from higher level of information asymmetry than capital markets in developed countries. This environment of the market may cause financing decisions to be incomplete and subject to a considerable degree of irregularity. It is, therefore, necessary to examine the validity of corporate leverage levels impact on a firm's performance in Sri Lanka as an example of emerging economies. The main aim of this paper is to empirically examine the relationship between debt level

and financial performance of companies listed in SriLankan stock exchange during the period 2003-2007 using three accounting-based measures of firm performance: Gross Profit Margin (GPM), Return on Asset (ROA) and Return on Equity (ROE) as used by Ibrahim (2009).

OBJECTIVE OF THE STUDY

The main objective of this study is to empirically examine the relationship between capital structures and firm's performance of the listed companies in Sri Lanka during the period 2003 - 2007. Apart from the main objective, the researchers are going to empirically examine

1. the significant leverage element which determining the firm performance
2. the trend of the performance and leverage level of listed companies in Colombo Stock Exchange.

REVIEW OF LITERATURE

The pioneer modern theory of capital structure began with the paper of Modigliani and Miller (1958). Since, then, various studies have been directed to explore the optimal capital structure in the absence of Modigliani-Miller's assumption.

One of the main factors that could influence the firm's performance is capital structure. Firms are willing to maximize their performance and minimize their financing cost, by maintaining the appropriate capital structure or the optimal capital structure. Kinsman et al (1999) argue that investigating the relationship between capital structure choice and performance of the firms is very important. Since, objective of share holder wealth maximization depends on the association between debt level and firm's performance.

The concept of performance is a controversial issue in finance largely due to its multidimensional meanings. Performance measures are either financial or organizational. Financial performance such as profit maximization, maximizing profit on assets and maximizing shareholders' benefit are based on firm's effectiveness (Chakravarthy, 1986). Ehrhard et al (2003) argue that the value of a business is the present value of all the expected future cash flows generated by the assets, discounted at the company's Weighted Average Cost of capital (WAAC). Johannes et al (2007) reveal that WAAC has a direct impact on the value of a business. The choice between debt and equity aims to find the right capital structure that will maximize shareholders' wealth. In this way, Messbacher (2004) pointed out that minimizing WACC of any firm will maximize value of the firm and shareholders' wealth as well.

The usefulness of measure of performance may be affected by the objective of a firm. That would affect its choice of performance measure and the development of the stock and capital market. The most commonly used performance measure proxies are return on asset (ROA) and Return on equity (ROE). These measures have been used by many researches (eg. Demsetz et al, 1985, Gorton et al, 1995, Mehran, 1995).

There are various measures of leverage which can be classified as accounting based measures, market value measures and quasi market measures. When choosing a measure of leverage, attention should be given on the framework for the relationship between leverage and performance, which is based on market values of leverage. Since market values of leverage may be difficult to obtain, accounting based measures are often applied as proxies. Rajan et al (1995) discuss various accounting based measures of leverage and their information content.

DIFFERENT THEORIES OF CAPITAL STRUCTURE

Prior to MM theory (1958), conventional perspective believed that using financial leverage increases company's value. Therefore, there is an optimal capital structure that minimises capital costs. Modigliani et al (1958) argued that in an efficient market the debt equity choice is irrelevant to the value of the firm. In a subsequent paper, Modigliani et al (1963) showed that under capital market imperfection where interest expenses are tax deductible, firm value will increase with higher financial leverage. However, increasingly debt results in an increased probability of bankruptcy. Thus the optimal capital structure represents a level of leverage that balances bankruptcy costs and benefits of debt firms.

STATIC TRADE-OFF THEORY

According to trade-off theory, the firm's optimal capital structure could be determined by the trade-off among the effects of corporate and personal taxes, bankruptcy costs and agency costs. That is debt benefits include tax shields (savings) induced by the deductibility of interest expenses from pre-tax income of the firm, reduction of agency cost through the threat of liquidation which causes personal losses to managers of salaries, reputation, perquisites (Grossman et al 1982; William, 1987). Therefore more profitable firms have higher income to shield and should borrow more to take tax advantages. Thus, according to trade-off theory a positive relationship could be expected between debt level and firm's performance. A number of studies provide empirical evidence supporting this relationship. (Taub, 1975; Roden et al, 1995; Ghosh et al, 2000).

PECKING ORDER THEORY

The capital structure theory is developed by Myers (1984) and Myers and Majluf (1984). Asymmetric information is the base of choice the pecking order theory of financing. The main conclusion drawn from the pecking order theory is that there is a hierarchy of firm's preference with respect to the financing of their investment. That is, issuing new shares may harm existing shareholders through value transfer from old to new shareholders. So, managers will prefer financing new investments by internal sources (i.e. retained earnings) first, if this source is not enough then managers seek for external sources from debt as second and equity as last. Thus, according to the pecking order theory firms that are profitable and, therefore, generate high earnings to be retained are expected to use less debt in their capital structure than those do not generate high earnings, since they are able to finance their investment opportunities with retained earnings. Consequently, negative relationship could be expected between debt level and firm's performance (i.e. profitability). A number of studies provide empirical evidence supporting this negative relationship between debt level and firm's performance or profitability (Kester, 1986; Friend et al, 1988; Titman et al, 1988; Rajan et al, 1995; Fama et al, 2002).

According to the above analysis, we may argue that firm's financing decision is influenced by many factors, and explaining that decision by one theory (trade-off or pecking order) may be short of providing a complete diagnosis of that decision. In fact, each capital structure theory works under its own assumptions and so does not offer a complete explanation of financial decisions. This means that searching for impact of capital structure choice on optimal capital structure is not one-way to go (Myers, 2001; Eldomiaty, 2007).

According to the previous studies, Abor (2005) investigates the relationship between capital structure and profitability of listed firms in Ghana showing that STD and TTD are positively related with firm's profitability (i.e. ROE), where as LTD is negatively related with firm's profitability (i.e. ROE). Kyereboah-Coleman (2007) examines the relationship between capital structure and performance of microfinance institutions in sub-Saharan Africa showing that high leverage is positively related with performance (i.e. ROA and ROE). Zeitun et al (2007) examine the relationship between capital structure and performance of Jordan firms showing that debt level is negatively related with performance (both the accounting and market measures). Finally, Abor (2007) examines the relationship between debt policy (capital structure) and performance of small and medium-sized enterprises in Ghana and South Africa showing that capital structure, especially long-term and total debt level, is negatively related with performance (both the accounting and market measures).

RESEARCH METHOD

SAMPLE AND DATA

The study on the impact of capital structure choice on firm's performance of SriLankan companies selected from the Colombo Stock Exchange Market. There are 236 companies listed in Colombo Stock Exchange belonging to 20 different industries. As for companies' selection, the sample companies were selected on the basis of the industries' fraction of the total market capitalization. According to that, first six industries were selected for the study. Since these six industries capture average of 79.5% market capitalization of out of twenty industries (129 companies; see table: 1). However, as for companies selected, only non-financial companies were selected. This is due to the reasons that financial firms such as banks and insurance companies' leverage are strongly influenced by investor insurance schemes. Furthermore, their debt-like liabilities are not strictly comparable to the debt issued by non-financial firms and regulations such as minimum capital requirements may directly affect capital structure of these financial firms. Therefore the selected sample includes, in total, 96 companies belonging to 5

industries. Representative companies were: diversified holdings (11),telecommunication (03),beverage & food (18),manufacturing (33) and hotels & travel (33).The companies then tested for availability of financial data during the last five year investigating period (2003 – 2007).This screening yielded a final sample of 65 companies.

TABLE 1: SAMPLE SPLIT ACCORDING TO FRACTION TOTAL MARKET CAPITALIZATION

Industry	Number of Companies	Fraction of Total Market Capitalization
Diversified Holdings	11	20.0
Bank & Finance	33	18.29
Telecommunication	03	17.31
Beverage & Food	18	9.8
Manufacturing	31	7.2
Hotels & Travels	33	6.9
Oil Palms	05	3.82
Health Care	06	3.72
Land & Property	22	2.49
Plantation	18	1.92
Trading	11	1.4
Power & Energy	04	1.448
Motor	07	1.181
Stores & Supplies	06	0.92
Chemicals & Pharmaceuticals	09	0.88
Investment Trust	05	0.86
Construction & Engineering	03	0.76
Foot Wear & Textile	04	0.642
Services	06	0.421
IT	01	0.038
Total	236	100

Source: Research Data

VARIABLES MEASUREMENT

DEPENDENT VARIABLE: PERFORMANCE

This study uses three of common accounting-based performance measures, as used by Ibrahim (2009), to evaluate the firm's performance. These measures are: Return on Equity (ROE) which computed as the ratio of net profit to total equity, Return on Asset (ROA) which computed as the ratio of net profit to total assets and Gross Profit Margin (GPM) which computed as the ratio of gross profit to sales.

INDEPENDENT VARIABLES

1. FINANCIAL LEVERAGE

Similar to Ibrahim (2009), financial leverage is measured in the study by three ratios:

STD: Short term debt to total assets;

LTD: Long term debt to total assets; and

TTD: Total debt to total assets.

2. CONTROL VARIABLE

Firm's size may influence its performance, larger firms have a greater variety of capabilities and can enjoy economies of scale, which may influence the results (Ramaswamy, 2001; Frank and Goyal, 2003; Jermias, 2008). Therefore, this study controls the differences in firm's operating environment by including the size variable in the model. Size is measured by the log of total assets of the firm and included in the model to control for effects of firm size on dependent variable (i.e. performance).

MODEL

The relationship between leverage and a firm's performance was tested by the following regression models; Ibrahim (2009).

$$\text{Performance}_{i,t} = \beta_0 + \beta_1 \text{STD}_{i,t} + \beta_2 \log S_{i,t} + e_{i,t} \quad \text{Model-I}$$

$$\text{Performance}_{i,t} = \beta_0 + \beta_1 \text{LTD}_{i,t} + \beta_2 \log S_{i,t} + e_{i,t} \quad \text{Model-II}$$

$$\text{Performance}_{i,t} = \beta_0 + \beta_1 \text{TTD}_{i,t} + \beta_2 \log S_{i,t} + e_{i,t} \quad \text{Model-III}$$

where

$\text{STD}_{i,t}$ = Short-term Debt to Total Asset for firm i in year t .

$\text{LTD}_{i,t}$ = Long-term Debt to Total Asset for firm i in year t .

$\text{TTD}_{i,t}$ = Total Debt to Total Asset for firm i in year t .

$\log S_{i,t}$ = logarithm of total assets for firm i in year t .

$e_{i,t}$ = the error term

ANALYSIS AND RESULTS

DESCRIPTIVE STATISTICS

TABLE 2. PREDICTORS OF FIRMS' PERFORMANCE

Variable	Mean	Std.Devi	Minimum	Median	Maximum
GPM	43.5940	26.8385	7.82	34.3400	100
ROA	8.8411	5.8634	-3.42	8.0000	26.29
ROE	10.6622	9.1471	-7.51	9.6400	42.94
STD	24.7385	15.3763	1.91	20.4200	68.40
LTD	16.4349	13.5335	0.50	13.5400	72.47
TTD	42.4151	24.6648	2.65	39.5800	122.73
Log S	9.1454	0.6226	7.96	9.0500	10.61

Source: Research Data

Table 2 shows the summary of descriptive statistics of the dependent and independent variables used in the study. The mean (median) of GPM, ROA, ROE are 43.5940(34.34), 8.8411(8), 10.6622(9.64). These results suggest that SriLankan listed companies have relatively poor performance during the period of 2003-2007 except gross profit margin.

Further, the mean (median) value of ratio of TTD to total assets is 42.4151(39.58); this figure indicates that about 42.41% of total assets of SriLankan companies are financed by debt. The mean (median) of ratio of STD to total assets and ratio of LTD to total assets are 24.7385(20.4200) and 16.4349(13.5400), respectively; this figures indicates that the SriLankan companies depend on STD for financing their operation more largely on LTD.

REGRESSION ANALYSIS

Table.3

		Section-1			Section-2			Section-3		
		Performance - GPM			Performance - ROA			Performance - ROE		
		Model I	Model II	Model III	Model I	Model II	Model III	Model I	Model II	Model III
STD	β	-0.488			0.210			0.170		
	t	-4.489			1.702			1.401		
	Sig	0.000			0.094			0.166		
LTD	β		-0.298			-0.145			0.168	
	t		-2.281			-1.066			1.273	
	Sig		0.026			0.291			0.208	
TTD	β			-0.480			0.060			0.167
	t			-4.204			0.457			1.332
	Sig			0.000			0.649			0.188
Log S	β	-0.259	-0.084	-0.072	0.166	0.202	0.126	0.288	0.201	0.222
	t	-2.386	-0.646	-0.630	1.344	1.483	0.967	2.374	1.517	1.771
	Sig	0.020	0.520	0.531	0.184	0.143	0.337	0.021	0.134	0.082
F- Value		11.890	4.085	10.595	2.126	1.228	0.754	3.474	3.0290	3.373
Sig.F		0.000	0.022	0.000	0.128	0.300	0.475	0.037	0.044	0.041
Observations		65	65	65	65	65	65	65	65	65

Source: Research Data

Table3 shows the results of ordinary least squares regression used in testing the relationship between capital structure choice and firm's performance. Section-1 of the above table shows the results of testing the relationship between capital structure measured by ratio of STD to total assets. (Model 1), ratio of LTD to total assets (Model 2), ratio of TTD to total assets (Model 3), and firm's performance measured by GPM. As shown in this table, the results indicate a significant negative relationship between STD and GPM; the coefficient of STD in Model 1 is negative and statistically significant at level of 0.01(confidence of 99%), which indicates that an increase in STD associated with decrease in GPM. The results of model-II indicates a significant negative relationship between LTD and GPM; the coefficient of LTD in Model 2 is negative and statistically significant at level of 0.05(confidence of 95%), which suggests that an increase in LTD associated with decrease in GPM. On the other hand, as shown in model- III, TTD has significant negative relationship with GPM; the coefficient of TTD in Model-III is statistically significant at level of 0.01(confidence of 99%). At the same time, the results show that firm performance-GPM has only significant negative relationship at level of 0.05(confidence of 95%) with control variable (firm size) in model-I.

Section-2 of the above table shows the results of testing the relationship between capital structure measured by ratio of STD to total assets. (Model 1), ratio of LTD to total assets (Model 2), ratio of TTD to total assets (Model 3), and firm's performance measured by ROA. As shown in this table, the results indicate to neither STD, LTD, nor TTD has a significant relationship with firm's performance measured by ROA; the coefficient of STD in Model 1, the coefficient of LTD in Model 2, and the coefficient of TTD in Model 3 are not statistically significant at level of confidence of 95%. The results also indicate that the control variable (firm size) has no significant effect on firm's performance-ROA.

Further, Section-3 of the above table shows the results of testing the relationship between capital structure measured by ratio of STD to total assets. (Model 1), ratio of LTD to total assets (Model 2), ratio of TTD to total assets (Model 3), and firm's performance measured by ROE. As shown in this table, the results indicate to neither STD, LTD, nor TTD has a significant relationship with firm's performance measured by ROE; the coefficient of STD in Model 1, the coefficient of LTD in Model 2, and the coefficient of TTD in Model 3 are not statistically significant at level of confidence of 95%. But the results indicate that the control variable (firm size) has significant positive effect on firm's performance-ROE at level of confidence of 95% with STD.

MULTICOLLINEARITY ANALYSIS OF THE VARIABLES

It is possible that the selected explanatory variables may be correlated, so the chosen variables may actually measure the effects of several different variables. To address this problem the study tests for the multicollinearity. The presence of multicollinearity makes the estimation and hypothesis testing about individual coefficients in regression not possible (Gujarati, 2003).

The variance Inflation Factor (VIF) is a commonly used for assessing multicollinearity problems. It shows the degree to which each independent variable is explained by other independent variable. As a rule of thumb, a VIF greater than 10 indicates the presence of harmful collinearity (Gujarati, 2003).

TABLE.4 MULTICOLLINEARITY ANALYSIS OF THE VARIABLES

Model	Dependent Variable	Independent Variables	Tolerance	VIF
Model - I	GPM,ROA,ROE	STD	0.988	1.012
		Log Sale	0.988	1.012
Model - II	GPM,ROA,ROE	LTD	0.835	1.198
		Log Sale	0.835	1.198
Model - III	GPM,ROA,ROE	TDR	0.922	1.084
		Log Sale	0.922	1.084

Source: Research Data

The results of VIF show that VIF for all the variables in all the models are less than 10. So, it indicates that the presence of non harmful collinearity among the variables.

CONCLUSION

The objective of this paper is to empirically investigate the impact of capital structure choice on firm's performance in SriLanka. Most of these studies examines these implication in the develop countries. There are very few studies have been carried out in emerging economies, like SriLanka.

For the total sample, the study found that STD, TTD, and LTD have significant negative impact on GPM. But, the results, further indicates that neither STD, LTD nor TTD has a significant impact on firm's performance measured by ROE and ROA respectively. Results of this study contradict with findings of previous literature.

Further, on the method side, it would be desirable to investigate the determinants of capital structure over longer period of time and over number of economic cycle. Finally, the analysis under this title further could be improved by differentiating the firm's performance level and could examine the different determinants of capital structure of SriLankan firms.

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