# HOW DOES FINANCING DECISION AFFECT SHAREHOLDER VALUE CREATION? SRI LANKAN EVIDENCE

**Herath, H.M.S.K.H.[1], Wanigasekara, W.A.D.K.J.[2], Deshika, N.P.T.[3]**

*[1,2,3]Department of Accountancy, Faculty of Business Studies & Finance, Wayamba University of Sri Lanka*
*[1]sanduniherath1996@gmail.com, [2]kaushalya@wyb.ac.lk, [3]deshika@wyb.ac.lk*

## ABSTRACT

This study is designed to examine the impact of financing decisions on shareholder value creation. Under the financing decision, researchers mainly consider the financial leverage. Maximizing shareholder wealth is one of the important issues for the management of listed companies. According to the study, market value added is one of the dependent variables and interest coverage time, debt-to-equity ratio and debt-to-assets ratio are the independent variables. The study is mainly based on the two listed sectors under the Colombo Stock Exchange in Sri Lanka, which are the food, beverage, and tobacco sectors and the consumer service sector. Data was collected from 195 annual reports which are related to 39 food, beverage and tobacco sector companies and 155 annual reports which are related to 31 consumer service sector companies listed in the Colombo Stock Exchange for five years from 2016/17 to 2020/21. The researchers used correlation analysis to measure the relationship between the variables and descriptive statistics, Regression was also used to analyse the data. According to the correlation analysis of the food, beverage and tobacco sector, there is a positive significant relationship between debt-to-equity ratio and market value added. In addition to that, there is a positive relationship between the interest coverage time and debt-to-assets ratio with market value added in the consumer service sector. Nevertheless, all the independent variables do have not any significant relationship with market value added in the consumer service sector. The findings of this study indicate a significant positive impact of debt-to-equity ratio on market value added in the food, beverage and tobacco sector companies. There is no significant impact of the debt-to-assets ratio and interest coverage time on market value added in the food, beverage and tobacco sector. Further, consider the consumer service sector company's debt to assets ratio and interest coverage time period have a significant positive impact on market value added. Conversely, there is an insignificant positive impact of the debt-to-equity ratio on the market value added of consumer service sector companies in Sri Lanka. The relationship between capital structure and firm value has been the subject of considerable debate. Indeed, the Pecking Order Theory found contradictory predictions in terms of the impact of the financial structure on shareholder value creation.

***Keywords: Debt to Assets ratio, Debt to Equity ratio, Interest coverage time and Market Value Added***

## 1. INTRODUCTION

A financing decision refers to the decision that firms are required to take regarding what amount of proportion of equity and debt capital to have in their capital structure. These decisions play a very crucial role in financing its assets, investment decisions, and shareholder value creation (Mehta, 2020). Nagalakshmi et al, (2015) point out that a financing decision entail selecting an appropriate financing mix by way of a combination of debt and equity in a company's capital structure. Companies can be financed entirely by equity or by debt or a combination of both. The debt and equity mix in a company is referred to as capital structure. Agbai, (2013) asserts that a firm's financing policy may be to choose from alternative sources, which may be internal or external. Carlos et al, (2015) discuss that sound financing decisions enable businesses to create economic value. Conversely, unsound financing decisions destroy value which threatens survival and the continuity of an enterprise

Furthermore, the financing decision can be divided into several parts. This study has examined how financial leverage is related to the financing decision. According to the financing decision, a company is expected to decide what proportion of equity and debt capital to have in its capital structure. El-Sayed Ebaid, (2009) suggested that generally efficiency of the foremost hotels in India is checked by the role of financing decisions showing that financial leverage works only for a few companies. Bhargav Pandya, (2016) examined a company that can be financed its investments by debt and equity, and a company may also use preference shares. The ratio of the fixed charge sources of a fund such as debt and preference shares to owners' equity in the capital structure is described as financial leverage. The study mainly focuses on identifying the impact of financial leverage on shareholder value creation. There were several studies on shareholder value creation and financing decisions have been carried out all over the world including in Sri Lanka. Pandya, (2016) study analysed the impact of financial leverage on market value and added 197 companies classified that are listed on the Bombay Stock Exchange. The researcher has considered debt equity ratio, debt ratio and interest coverage ratio as independent variables and Market Value Added as the dependent variable. The study has shown that the interest coverage ratio is the most significant variable to impact on market value added. Also, the equity ratio and the debt ratio are considered to be statistically significant and related to the market value added of sample companies in India. In addition to that, very few studies on financial leverage and shareholder value creation related to the Sri Lankan context consider the other researchers' studies that have investigated the listed companies.

The paper purposely analyses the financial leverage impact on market value added. The research findings accommodated managers in assessing how different financing decisions impact the value of the firm in general and specifically on the creation of shareholder value. It will help to act as a guide in planning for the ideal combination of a financial decision as well as identifying and selecting strategies that create the highest value for the shareholder. The study findings provide insight to fund providers such as the consumer service sector and food, beverage, and tobacco sector in understanding the financial behaviour of the listed companies in Sri Lanka. J. & M., (2014) investigated the 6 quoted private Sri Lankan banks for the period 2011-2013.

They examined the association between Economic value added, Market value added and leverage. This research has helped to identify how the food, beverage and tobacco sector and the consumer service sector are activated to impact financial leverage on shareholder value creation.

## 2. LITERATURE REVIEW

There have been several studies conducted to study the linkage of financial leverage and shareholder value creation over the last three and a half decades. These prior studies have concluded differing outcomes. In this section, the independent variables and dependent variables are clearly explained. Some studies have shown a significant relationship between financial leverage and shareholder value creation, whereas some have shown no linkage between financial leverage and shareholder value creation. Selected studies reviewed for conducting this study are as under.

Bei & Wijewardana, (2012)examined financial leverage, firm growth and financial strength in listed companies in Sri Lanka. The study mentioned financial leverage is one of the most influencing factors in determining financial growth. In addition to that research mentioned that capital structure studies have been done to examine the relationship between observed Financial Leverage and the value of the firm and share prices. The researcher investigated 62 firms trading in the Colombo exchange out of the 13 sectors. The required data were collected from published annual reports, the Handbook of listed companies in the Colombo Stock Exchange and the annual report of the Central Bank of Sri Lanka. The study has been used to analyse the data by the regression model. The final output of this study found financial leverage in the Sri Lanka context to be positively related to the growth.

Sharma et al., (2015) investigated shareholder value creation and measuring in Indian companies. The study was considered a sample of 30 Sensex companies. The study was based on secondary data. Those companies represented ten industrial sectors for a period of five years 2009-2013. The study has taken the capital structure and dividend as an independent variable. The capital structure is determined by the debt-equity ratio. And shareholder value creation dependent variable. Also, this study has used regression analysis techniques. The result of this study identified, that there is a positive impact on the companies under the economic value-added method. As per the research, the debt-equity ratio (financial leverage) also positively impacts shareholder value creation. Finally, this research found that capital structure decisions have a 40 per cent impact on shareholder value creation. The industry has given the first priority to shareholders.

Vijayalakshmi and Manoharan, (2015) examined the corporate level and its impact on the economic value added and marketing value added. This study was carried out as an empirical study which impacts leverage on shareholder value creation. This study was mainly studied to reveal that leverage has a significant impact on the shareholder value creation process. And researcher has decided to get the long-term and short-term debt ratio, interest coverage ratio and financial leverage as independent variables. The study found that there is a relationship between leverage and shareholder value creation. There is an effective impact between leverage and shareholder value creation. This study provides detailed information on how the leverage impacts the economic value added and market value added. According to De Wet & Hall (2004), South African researchers investigated industry specified determinants of shareholder value creation. This study has considered about the relationship between Economic value added, Market value added and leverage. The researchers adopted a spreadsheet model to study the relationship between leverage and shareholder value creation. In this study, researchers have tried to obtain more refined and industry specified variables to determine the value creation for the shareholder. Regarding about this study has suggested that the unique characteristics of each and every industry determine the optimal level of choices for shareholder value creation measurement. So different types of industries are based on the specialization value creation method.

Pandya, (2016) examined the impact of financial leverage on market value added. This study has considered 197 companies classified as a group listed on the Bombay Stock Exchange. The study covered financial data from the period 2010 to 2014. The study has shown that the interest coverage ratio is the most significant in depend variable to impact on market value added. Also, debt equity ratio and the debt ratio are considered to be statistically significant and related to the market value added of sample companies in India.

Alloy & Alfred (2014) investigated the 6 quoted private Sri Lankan banks for the period 2011-2013. They examined the association between economic value added, market value added and leverage. In this study has been used correlation and regression methods for the data analysis. In this research leverage and economic value added have been used as the independent variables and market value added has been used as the measure of shareholder wealth creation and it has been considered as the dependent variable. The final output of this study, there is no significant relationship between the economic value added, market value added and leverage. In the banking sector there is no significant impact on leverage and shareholder value creation and different types of industries, sectors depend on the specialized independent variables for shareholder value creation.

Atiyet (2012) carried out a study on the effect of financial leverage on shareholder value creation on French firms using secondary data from 1999 to 2005. This study used the factors that drive shareholders' wealth to determine the most factor that have an effect on shareholders' wealth. The secondary data were analysed with a regression analysis model. The study used shareholder's wealth creation as the dependent variable measured by economic value added and market value added. The independent variable of the study was debt finance which was measured by self-finance, equity finance and leverage. The study measured self-finance by cash flow from financing activities. The findings pointed out that self-financing positively and significantly favours shareholder value creation. While the leverage had a positive and significant effect on the economic value added and was negatively related to the market value added.

## 3. METHODOLOGY

The researchers have selected only two sectors from the listed companies in the Colombo Stock Exchange. The reason behind the selection of the two sectors because that sectors with very high debt ratios. Food beverage and tobacco sector and the Consumer service sector have been selected when looking at the high debt ratio compared with the other sectors. The population comprises 45 listed companies in the Food Beverage and tobacco sector and 35 listed companies in the Consumer service sector of CSE as of 21 May 2021 and the researcher selected 38 (based on the debt-to-equity ratio) companies from Food Beverage and Tobacco sector and 31 (based on the debt to ratio) companies from Consumer Service Sector as a sample, using a simple random sampling technique. Data was collected for the recent 5 years from 2016/17 to 2020/21. The study focuses on secondary data collected through the published annual reports of the sample.

With the help of reviewing existing studies and theories, the following model was developed to carry out the research. This study employed descriptive statistics, correlation analysis, and regression to analyse the data.

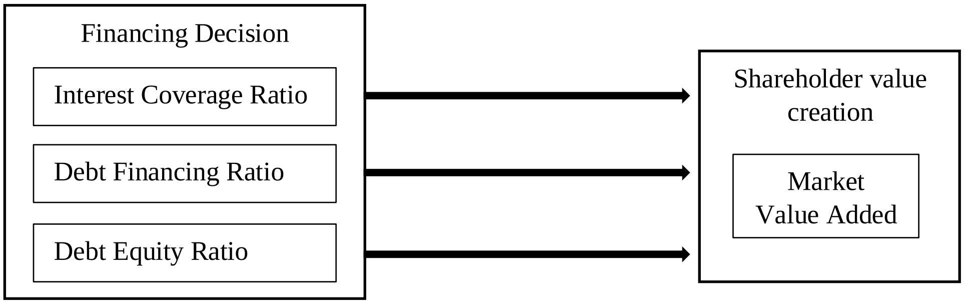


**Figure 1. Conceptual Framework**

The following hypotheses were formulated for the study.

H1: There is a positive impact of financing decisions on Shareholder Value Creation

H2: There is a positive relationship between financing decisions and shareholder value creation.

H1a: There is a significant impact of Debt Equity Ratio on Shareholder Value Creation

H1b: There is a significant impact of Interest Coverage Ratio on Shareholder Value Creation

H1c: There is a significant impact of the Debt Financing Ratio on Shareholder Value Creation

To test the hypotheses the following Panel regression model is developed.

$$MVA = \beta 0 + \beta 1\ IC + \beta 2\ DE + \beta 3\ DA + \varepsilon$$

## 4. FINDINGS AND DISCUSSION

The main objective of the study was to identify the impact of financing decisions on shareholder value creation. Under the financing decision study consider the financial leverage. As per the independent variables study selected interest coverage time, debt to equity and debt to assets ratio. The study used to analyse the panel data and the regression model to reveal the impact of financing decisions on shareholder value creation. As per the result, there is a positive impact of financing decisions on shareholder value creation in both sectors.

**Table 1: Correlation Analysis for the Food Beverage and Tobacco Sector**

| Variable | MVA | IC | DE | DA |
|---|---|---|---|---|
| MVA | 1.000 | | | |
| IC | -0.022 | 1.000 | | |
| | `0.767 | | | |
| DE | 0.315** | -0.089 | 1.000 | |
| | 0.000 | 0.111 | | |
| DA | 0.130 | -0.061 | 0.262** | 1.000 |
| | 0.073 | 0.166 | 0.000 | |

** Correlation significant at the 0.05 level

As per Table 1, the results of the correlation analysis showed that both debts to equity and debt to assets presented a positive, weak relationship with market value added, and debt to equity is significantly correlated with market value added at a 5% significant level. The interest coverage ratio showed no relationship with the market value added while interest coverage and debt to assets have a weak positive relationship and are significant at 0.01 level.

**Table 2: Correlation Analysis for Consumer Service Sector**

| Variable | MVA | IC | DE | DA |
|---|---|---|---|---|
| MVA | 1.000 | | | |
| IC | 0.025 | 1.000 | | |
| | 0.752 | | | |
| DE | -0.081 | -0.037 | 1.000 | |
| | 0.319 | 0.649 | | |
| DA | 0.050 | -0.032 | 0.919** | 1.000 |
| | 0.536 | 0.696 | 0.000 | |

** Correlation significant at the 0.05 level

As per the table, 2 results showed that interest coverage and debt to assets ratio have not presented relationship with market value added, and the one variable is weak and positively related to the market value added. The study met all four assumptions of regression and the results show in the following table.

**Table 3: Regression Results for Food Beverage and Tobacco Sector**

| MVA | Coefficient | Standard error | t | p>t |
|---|---|---|---|---|
| IC | 1.5808 | 7.6008 | 0.207365 | 0.8360 |
| DE | 1.4810 | 3.5409 | 4.189085 | 0.0000 |
| DA | 2.8909 | 4.0609 | 0.712930 | 0.4768 |
| Cons | 2.4909 | 2.5209 | 0.9867 | 0.3250 |

The results presented in Table 3 indicate that debt to equity has a significant positive impact while other variables are insignificant at a 95% confidence level. However, the R Squared 0.1020 indicates that financial performance and condition explained 10.20% variations of the market value added. Further adjusted R-squared indicates that there is an 8.7% impact of interest coverage, debt to equity and debt to assets on market value added.

**Table 4: Regression Results for Consumer Service Sector**

| **MVA** | **Coefficient** | **Standard error** | **t** | **p>t** |
|---|---|---|---|---|
| IC | 6888.314 | 4.3408 | 3.282286 | 0.0001 |
| DE | -3.8409 | 25461.81 | 0.270535 | 0.7871 |
| DA | 4.5009 | 9.2308 | -4.161139 | 0.0001 |
| Cons | 1.4209 | 1.1009 | 4.084167 | 0.0001 |

The results in the table 4 indicates that interest coverage and debt to assets have a significant positive impact while the variable is insignificant at the 95% confidence level. But the R squared 0.1057 indicates that financial performance and condition explained a 10.57% variation of the market value added. Further adjusted R-squared indicates that there is an 8.8% impact of interest coverage, debt to equity and debt to assets on market value added.

**Table 5: Regression model summary**

| | Consumer Service | Food beverage |
|---|---|---|
| Number of observations | 155 | 190 |
| F- statistics | 5.953984 | 7.043541 |
| Problem> f | 0.000 | 0.000 |
| R- squared | 0.105778 | 0.102016 |
| Adjusted R-squared | 0.088012 | 0.087396 |

**Hypotheses testing**

H1 - There is a positive impact of financing decisions on shareholder value creation. (As per the regression model summary Table 5)

Food Beverage Tobacco sector Accepted

Consumer Service sector Accepted

H2 - There is a positive relationship between financing decisions and shareholder value creation.

Both sectors have a negative and positive relationship between the financing decision and shareholder value creation

H1a - There is a significant impact of Debt Equity Ratio on Shareholder Value Creation

Food Beverage Tobacco sector Accepted

H1b- There is a significant impact of Interest Coverage Ratio on Shareholder Value Creation

Consumer Service sector Accepted

H1c- There is a significant impact of Debt Assets Ratio on Shareholder Value Creation

Consumer Service sector Accepted

## 5. CONCLUSION

The study examined the relationship between shareholders' wealth and financing decisions of the food, beverage and tobacco sector and Consumer service sector in Sri Lanka. According to the findings of the analysis the result of the study was revealed that there is a positive impact of financing decision on shareholder value creation when consider about the food, beverage tobacco and consumer service sectors, therefore hypothesis H1 is accepted both of sectors. It was found that analysed, all three measures of financial leverage namely; debt equity ratio, interest cover and debt to assets ratio were differently related to market value added. When considering the food, beverage and tobacco sector there is a significant impact of Debt to equity on market value added. In the consumer service sector has been represented the insignificant impact of Debt to equity on Market value added. The empirical findings indicated both positive and negative relationships between independent and dependent variables. Most of the empirical findings of the correlation analysis were consistent with the results of the study while a few variables were not. Associated limitations were, that researchers only consider the influence of financial leverage over the market value added. The results of this study draw significant policy implications at micro and macroeconomic levels. Decisions related to the choice of appropriate sources of funds are crucial since they have an impact on continuous value creation and maintenance. To enhance and maintain value creation, management should aim at minimizing the weighted average cost of capital, analyse inherent risks associated with various capital and investment projects and aim at maintaining the firm's credibility. This will ensure the continuous supply of both short-term and long-term finances and boost investors' confidence in a firm's going concern. The research only examined data for five years.

## REFERENCES

Atiyet, B. A. (2012). The impact of financing decision on the shareholder value creation. *Journal of Business Studies Quarterly, 4*(1), 44.

Acevedo Peña, C. G. (2015). Developing Inclusive Innovation Processes and Co-Evolutionary Approaches in Bolivia (Doctoral dissertation, Blekinge Tekniska Högskola).

Bei, Z., & Wijewardana, W. P. (2012). Financial leverage, firm growth and financial strength in the listed companies in Sri Lanka. *Procedia-social and behavioral sciences, 40,* 709-715.

de Wet, J. H., & Hall, J. H. (2004). The relationship between EVA, MVA and leverage. *Meditari Accountancy Research*, *12*(1), 39–59. https://doi.org/10.1108/10222529200400003

El-Sayed Ebaid, I. (2009). The impact of capital-structure choice on firm performance: empirical evidence from Egypt. *The Journal of Risk Finance*, *10*(5), 477–487. https://doi.org/10.1108/15265940911001385

J., A. N., & M., A. (2014). The Association between Economic Value Added, Market Value Added and Leverage. *International Journal of Business and Management*, *9*(10), 126–133. https://doi.org/10.5539/ijbm.v9n10p126

Mehta, A. M. (2020). Myth vs . Fact ; Influence of Financial Leverage on Shareholder's Return: An Empirical Study of Sugar Sector of Pakistan, 104–114.

Sreelakshmi, K. R., Manjusha, L., Nagalakshmi, K., Chouksey, M. K., & Venkateshwarlu, G. (2015). Ready-to-serve crab sandwich spread in retort pouch: Product development and process optimization. J*ournal of Aquatic Food Product Technology, 24*(4), 315-329.

Pandya, B. (2016). Impact of Financial Leverage on Market Value Added: Empirical Evidence From India. *Journal of Entrepreneurship, Business and Economics*, *4*(2), 40–58.

Pandya, Bhargav. (2017). Association of Financial Leverage with Cost of Capital and Shareholder Value : An empirical study of BSE Sensex Companies. *II*(1), 17–28.

Sharma, P., & Grover, A. (2015). Creating and measuring shareholders' value in Indian companies. *International Journal of Applied Business and Economic Research*, *13*(1), 53–66.

Vijayalakshmi, D., & Manoharan, P. (2015). Corporate leverage and its impact on profitability : A panel data approach. *International Journal of Multidisciplinary Research and Development*, *2*(2), 22–25.