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How does Financial Leverage Affect Financial Risk? An Empirical Study in Sri Lanka

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Abstract

Having debt or preferred stock capital is an important decision made by firms because the return on equity, in general, is expected to be higher with debt. Nevertheless, the costs associated with leverage tend to outweigh the benefits when the leverage increases beyond an optimal level. Thus, excessive leverage may create an uncertainty about a firm's existence. However, straight forward guidelines on what constitutes the optimal level of leverage remain largely missing. Therefore, this study examines how financial leverage affects financial risk based on the data collected over ten years ranging from 2006 to 2015 regarding fifteen companies in hotels and travels, and chemicals and pharmaceuticals industries listed in the Colombo Stock Exchange. The findings revealed that financial leverage positively correlate with financial risk. However, firm size negatively affects the financial risk. Importantly, hotels and travels firms have a higher financial risk compared to chemicals and pharmaceuticals firms. Hence, financial leverage and firm size can be considered as determinants of financial risk. The findings imply that firms having a higher financial risk can avoid their risk by altering the capital structure when the market condition is favourable. Firms are, however, least able to do so during a decline in the industry.

Keywords: Debt Capital, Financial Leverage, Financial Risk, Firm Size

JEL Classification: G31, G32

Paper Classification: Research Paper

Introduction

Having debt or preferred stock capital is a vital decision made by firms because the return on equity is expected to be higher with debt capital (Bodie, Kane & Marcus, 2008; Modigliani & Miller, 1958). Considering the trade-off between a potentially higher shareholder's return and the potential decreases in financial strength and solvency is an important part of making financial decisions (Luoma & Spiller, 2002) because inappropriate financing decisions make firm's risk larger. However, Penman (2008) points that equity and capital investors expect to yield a return on the investment exceeding its cost of capital of equity or debt despite of risk of the investment.