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DOES PROFITABILITY INFLUENCE DEBT RATIO? EVIDENCE FROM SRI LANKA'S LISTED COMPANIES

Tharsika, K.*
Department of Accounting, University of Jaffna, Sri Lanka
**tharsikrish@gmail.com*

This study investigates the influence of profitability and the total debt ratio (TDR) of Sri Lankan listed companies, contributing to the ongoing debate between the pecking order and trade-off theories. While the pecking order theory suggests that more profitable firms prefer internal financing, the trade-off theory argues that they may utilize debt to benefit from tax advantages. This research utilized the panel data from 50 companies listed on the Colombo Stock Exchange during the recent five-year period, 2020 to 2024. Return on assets and return on equity were considered independent variables, while TDR was the dependent variable. The Hausman test ($Chi^2 = 10.38$, $p < 0.01$), confirmed that the fixed-effects model was the appropriate specification. Correlation analysis and regression analysis results revealed a significant negative relationship between profitability and TDR, supporting the pecking order theory. Specifically, the Pearson correlation coefficients were -0.42 for ROA and -0.41 for ROE ($p < 0.01$), while the regression coefficients were -0.13 for ROA ($p = 0.09$) and -0.06 for ROE ($p = 0.07$). Regression results also indicated that the overall model was significant ($F = 8.68$, $p = 0.00$), and its low explanatory power ($R^2 = 0.19$) suggests that additional factors, such as firm size and macroeconomic conditions, influence firms' debt financing decisions. These findings suggest that more profitable firms in Sri Lanka rely less on debt, though variations across firms indicate that profitability alone does not fully explain debt ratio choices. Future research should explore industry-specific determinants and macroeconomic factors impacting corporate financing decisions.

Keywords: Profitability, Debt Ratio and Pecking Order Theory