# A Study on Financial Leverage and Financial Distress in the Listed Banks on Colombo Stock Exchange in Sri Lanka

**Mohamed Ansar Mohamed Abdullah**
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**Department of Accountancy and Finance**
**Faculty of Management and Commerce**
**South Eastern University of Sri Lanka**
**Oluvil**
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# ABSTRACT

Use of debt in the capital structure in different proportion is called as financial leverage or financial gearing. Several scholars have studied about the relation between financial leverage and financial distress in developed as well as in emerging markets. Most of their findings suggested that different proportion of financial leverage causes variability in the returns of shareholders, as a result it adds financial distress of a firm. In order to unfold the gap in Sri Lanka, this study attempts to examine the relationship between financial leverage and financial distress in the Sri Lankan Context. The main objectives of this study are to find out the relationship between the financial leverage and financial distress for the listed banks on Colombo Stock Exchange in Sri Lanka and to investigate the financial soundness of the listed banking firms over the study period. Eight listed banks on Colombo Stock Exchange were taken as sample for a five year period. For this purpose, the data were extracted from the annual reports of the selected banks and website of CSE during the period of 2007 – 2011. Simple regression models were used to find the relationship between financial leverage and financial distress. Total debt ratio, financial leverage index and capital structure leverage ratio are used as measures of financial leverage while, Altman Z-score is used to measure the financial distress in this study.

The overall results of the study revealed that financial leverage found to have significant positive impact on financial distress in the banking firms in the Sri Lankan context. The results further suggested that there is probability of financial distress when an organization achieves favorable or advantageous effect of financial leverage on firm's return. So, firms should ensure the optimal capital structure in order to avoid the future financial distress. Furthermore, the test of financial soundness as revealed by Z-score (Altman model) showed that the selected banking firms were on the severe of failure. In order to save the banks from total bankruptcy, their financial position should be improved without any further delay.



**Keywords:** Financial leverage, Z-score, Financial distress, Financial soundness, Optimal capital structure