RELATIONSHIP BETWEEN
CAPITAL STRUCTURE AND PROFITABILITY:
A TIME-SERIES CROSS-SECTIONAL
STUDY ON MALAYSIAN FIRMS

A thesis submitted to the Graduate School of Universiti Utara Malaysia
in partial fulfilment of the requirement for the degree of
Master of Science (Management)

BY
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April 1997

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ABSTRAK

ABSTRACT

Ever since the M&M Propositions were made in 1958, the issue of capital structure has gained much interest and controversy. The propositions which contended that the value of a firm is independent of its capital structure, have been put to test and researched into time and again. Most of the studies, however, were done in the U.S., hence doubts arise on whether the conclusions would apply in the Malaysian context. Based on this motivation, this study attempted to solve the dearth of research on capital structure, particularly its effect on profitability, of local firms. A total of 267 firms listed on the Kuala Lumpur Stock Exchange Main Board were put under study for a period of ten years (1985 - 1994). Two major sets of variables were used to indicate capital structure i.e. Debt/Equity Ratio, Debt Ratio, Financial Leverage Ratio, Funded Capital Ratio, Funded Debt Ratio, Current Debt Ratio, Funded Assets Ratio; and, profitability i.e. Return On Equity, Earnings Per Share, Return On Investment, Profit Before Tax, Net Income. The variables were analyzed using the time-series cross-sectional methodology. In order to generate empirical evidence, the Pearson Product-Moment Correlation, mean and bar chart analysis were employed. The results implied that profitability is significantly related to capital structure. Specifically, profitability was inversely related to the amount of liability in a company’s capital structure. Therefore, the more debt a firm incur, the worse its earnings is hurt. This study also found evidence of the existence an optimal capital structure among listed companies. Firms of different sectors were found to adjust their capital structure regularly in order to achieve an optimal combination of debt and equity.
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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>KLSE</td>
<td>Kuala Lumpur Stock Exchange</td>
</tr>
<tr>
<td>DER</td>
<td>Debt / <strong>Equity</strong> Ratio</td>
</tr>
<tr>
<td>DR</td>
<td>Debt Ratio</td>
</tr>
<tr>
<td>FLR</td>
<td>Financial Leverage Ratio</td>
</tr>
<tr>
<td>FCR</td>
<td>Funded Capital Ratio</td>
</tr>
<tr>
<td>FDR</td>
<td>Funded Debt Ratio</td>
</tr>
<tr>
<td>CDR</td>
<td>Current Debt Ratio</td>
</tr>
<tr>
<td>FAR</td>
<td>Funded Assets Ratio</td>
</tr>
<tr>
<td>ROE</td>
<td>Return On Equity</td>
</tr>
<tr>
<td>EPS</td>
<td>Earnings Per Share</td>
</tr>
<tr>
<td>ROI</td>
<td>Return On Investment</td>
</tr>
<tr>
<td>PBT</td>
<td>Profit Before Tax</td>
</tr>
<tr>
<td>NI</td>
<td>Net Income</td>
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CHAPTER I
INTRODUCTION

1.1 Context of the Study

The capital structure of a firm has long been a major subject for academic study in the corporate finance world. As early as 1945, Chudson carried out an extensive research into this area by asking the question (p.4):

“In what way does the structure of assets and liabilities of a given concern reflect the kind of industry in which a concern is engaged, the concern’s size and level of profitability?”

Chudson’s research question has implied that there might be a relationship between the capital structure practised by a firm with its profitability.

Furthermore, the importance of the capital structure issue was formally recognized internationally when the Nobel prize committee awarded its prizes for Economic Sciences to Franco Modigliani in 1985 and to Merton Miller in 1990, largely for their work on capital structure. In 1958, Merton Miller and Franco Modigliani published a paper containing the now famous Miller-Modigliani (M&M) propositions.

In essence, M&M were able to show that capital structure in a perfect market was irrelevant. The capital structure issue brought up by the M&M propositions had since then created tidal waves in the corporate finance academia. Researchers tested and retested the propositions e.g. Barges (1962), Lamothe (1982), and Canda (1991).
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