THE EFFECT OF LEVERAGE ON FIRMS PROFITABILITY:
EVIDENCE FROM MALAYSIA

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ABSTRACT

This study is focusing on the relationship between the firms' profitability and leverage of the top 50 firms that are listed in Bursa Malaysia that are selected based on the best revenue rank. The degree of operating, financial and total leverage have been compared with the firms' profitability that indicate by the return on investment. By calculating some significant ratios, it helps us to conclude that there is a significant relationship between the degree of financial leverage and degree of total leverage with firms' profitability (P = 0.052 and 0.013 respectively). However, this study will help financial manager with the better understanding about the use of leverage.

CHAPTER ONE:

INTRODUCTION

1.0. Research Background

Analysis of firm’s profitability is one of the crucial areas of a firm, as it affects mainly the wealth of their shareholders that is also known as common equity investors. Assets need to be managed promptly and wisely to allow for increase in profitability. Efficiency of the firm is measured through the effectiveness of the firm’s management to utilize their assets to generate profit.

In this century, there is a lot of investment activities involves. A firm tend to find another solution in order to gain more profit. In this part, a basic knowledge is must things that have to possess in order to avoid a bad decision that might lead to a bad result. For example, the ability to measure a firm’s efficiency by analyse a firm’s profitability would be sufficient to get an information before decide to invest on that particular firm. The study of financial leverage on firm’s profitability engrosses a considerable amount of contribution towards financial literature (Dean, 1968; Friedman, 2007).

The importance of the firms’ profitability as the main contributing factor for assessing businesses efficiency and examine the relationship between the leverage and firms’ profitability is the reasons behind this. Financial leverage is basically one of the factors that can influence the firm’s profitability and one of the tools to raise their capital with a purpose to increasing profit. It encompasses the management of the firms’ capital structure where leverage uses debt instruments to increase the estimated level return on the firm’s equity as mentioned in the study of (Mangalam & Govindasamy, 2010; Patel, 2014).

Generally, the ratio of total debts which a firm owe to the total assets of a firm represents financial leverage. Financial leverage ratio tells the degree of borrowed money by the firm in order to finance their capital structure to raise the profitability of a firm.