

## **Testing the Static Trade-off Theory and the Pecking Order Theory of Capital Structure: Evidence from Sri Lankan Listed Manufacturing Firms**

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The purpose of this study is to find whether the Static trade-off theory or the Pecking order theory provides a better explanation of the capital structure patterns of listed manufacturing firms in Sri Lanka. Data were collected from randomly selected 20 firms for 6 consecutive years from 2011 to 2016. In order to test the tradeoff theory, tangibility, profitability, non-debt tax shields, volatility and firm size were considered as response variables, and debt ratio was used to measure the capital structure. The simple pecking order model originally developed by Shyam - Sunder and Myers (1999) and modified by Frank and Goyal (2003) was applied to test the pecking order theory in this study. To assess the application of pecking order theory, financial deficit was considered as an explanatory variable and change in long term debt was considered as dependent variable. Hypotheses derived from the static trade-off and pecking order were tested using an OLS regression model. Results revealed that there is a significant positive relationship of tangibility and non-debt tax shields with the capital structure. Further, the results revealed that there is no significant relationship of profitability, volatility and firm size with the capital structure. Therefore, it can be concluded that trade-off theory is supported by tangibility and non-debt tax shields. The study finds that the beta coefficient value of pecking order model is not close to 1. Therefore, validation of pecking order theory is weak in selected Sri Lankan companies. This indicates the pecking order theory is not applicable to capital structure of manufacturing firms in Sri Lanka and static trade-off is more applicable for deciding capital structure in this respect. The results of this study are helpful to policy makers in defining policies and procedures to ensure reliable and easy accessibility to different sources of finance for Sri Lankan listed manufacturing companies. It suggested to extend this study to other sectors of Colombo Stock Exchange based on a large sample

**Key words:** *Static trade-off theory, Pecking order theory, Capital structure*