Impact of Capital Structure and Dividend Policy on Firm Value: Evidence from Largest Market Capitalization Companies Listed in Colombo Stock Exchange

Farveen, M. N. N.*[1] and Azeem, A.M.[2]

[1]*Department of Business Finance, University of Peradeniya, Sri Lanka*
[2]*Department of Commerce, University of Jaffna, Sri Lanka*

Abstract

This study examines whether capital structure and dividend policy influence firm value among selected listed companies in Sri Lanka. The study specifically seeks to determine whether how firms finance operations and distribute earnings is reflected in their market valuation. Firm value is represented by Tobin's Q, with firm size and growth incorporated as control variables. A quantitative research design was adopted using 250 firm-year observations drawn from selected large-capitalisation companies listed on the Colombo Stock Exchange. The study uses data from published annual reports and applies panel-data econometric techniques to account for firm-level and temporal variation. The empirical evidence demonstrates that capital structure exerts a positive and statistically significant influence on firm value, highlighting the relevance of financing choices in corporate value creation. Conversely, dividend policy exhibits a negative but statistically insignificant relationship with firm value, indicating that variations in dividend distributions do not provide sufficient evidence of changes in market valuation within the study setting. The findings further reveal that growth is positively associated with firm value, whereas firm size demonstrates a significant negative relationship. Collectively, the results suggest that the market valuation of the selected firms is more responsive to financing structure and growth prospects than to dividend distribution decisions. The study enriches the empirical understanding of corporate financial decision-making in an emerging-market context and provides meaningful insights for corporate managers, investors, and other capital-market participants in developing strategies aimed at sustainable firm value enhancement.

***Keywords*:** Capital structure, dividend policy, firm value, Tobin's Q, market capitalization

1. Introduction

Maximising firm value is one of the fundamental objectives of modern corporate financial management, as it reflects the overall financial health, market performance, and long-term sustainability of a company. Firm value represents investors' perceptions of a company's future earning potential and growth prospects and is commonly reflected through its market price. A higher firm value not only increases shareholders' wealth but also enhances investor confidence, strengthens the company's reputation, and improves its ability to obtain external

* Corresponding author: nashathfarwin911@gmail.com

© 2026 Sri Lanka Finance Association
ISSN 2792-1220, eISSN 2806-514X

financing. Consequently, identifying the factors that influence firm value has become a central focus of corporate finance research.

Among the various financial decisions undertaken by management, capital structure and dividend policy play a significant role in determining firm value. Capital structure refers to the proportion of debt and equity used to finance a firm's assets and business operations, whereas dividend policy concerns the decision regarding the distribution of earnings between dividend payments to shareholders and retained earnings for future investment. These financial decisions directly influence investment opportunities, financing costs, risk exposure, and shareholders' expectations, ultimately affecting the market value of a company. Several financial theories provide different perspectives on the relationship between capital structure, dividend policy, and firm value. The Modigliani and Miller (1958) Irrelevance Theory argues that capital structure does not affect firm value under perfect capital market conditions. However, Modigliani and Miller (1963) later introduced corporate taxes into their model and suggested that the use of debt creates tax advantages, thereby increasing firm value. The Trade-off Theory further explains that firms seek an optimal capital structure by balancing the tax benefits of debt against the potential costs of financial distress (Kraus & Litzenberger, 1973). Similarly, the Pecking Order Theory proposed by Myers and Majluf (1984) suggests that firms prefer internal financing first, followed by debt, and issue equity only as a last resort because of information asymmetry between managers and investors.

Dividend policy has also been explained through several theoretical perspectives. The Dividend Relevance Theory developed by Gordon (1962, 1963) and Walter (1963) argues that dividend payments positively influence firm value because investors generally prefer certain dividend income over uncertain future capital gains. In contrast, the Dividend Irrelevance Theory proposed by Modigliani and Miller (1961) suggests that dividend policy does not influence firm value in a perfect market because investors are indifferent between receiving dividends and capital gains. Furthermore, the Signaling Theory proposed by Bhattacharya (1979) and further supported by John and Williams (1985) explains that dividend announcements and financing decisions convey important information about a firm's prospects and financial strength, thereby influencing investors' perceptions and market valuation. Although these theories provide valuable explanations, empirical evidence remains inconclusive. Previous studies conducted in both developed and developing countries have reported mixed findings regarding the impact of capital structure and dividend policy on firm value. While some researchers have found that debt financing and higher dividend payments enhance firm value, others have reported negative or insignificant relationships. These inconsistencies suggest that the influence of financial decisions may vary across countries, industries, and economic conditions.

Sri Lankan corporate sector provides an important setting for examining these relationships. Companies listed on the Colombo Stock Exchange (CSE) have experienced significant economic challenges in recent years, including the effects of the COVID-19 pandemic, economic instability, inflation, rising interest rates, and foreign exchange shortages. These conditions have influenced corporate financing decisions, dividend distributions, and market valuations. Therefore, understanding how capital structure and dividend policy affect firm value within the Sri Lankan context is essential for improving

corporate financial decision-making and enhancing shareholder wealth. Although several international studies have examined the determinants of firm value, limited empirical evidence exists for Sri Lanka, particularly regarding the combined influence of capital structure and dividend policy. Most local studies have investigated these variables separately or focused on specific industries, leaving a gap in the literature. Therefore, this study seeks to examine the impact of capital structure and dividend policy on the firm value of the largest market capitalisation companies listed on the Colombo Stock Exchange during the period 2021 to 2025. Capital structure is measured using the Debt-to-Equity Ratio (DER), dividend policy is measured using the Dividend Payout Ratio (DPR), and firm value is measured using Tobin's Q ratio, while firm size and firm growth are incorporated as control variables. The findings of this study are expected to contribute to the existing corporate finance literature by providing recent empirical evidence from an emerging market. The study will also offer practical implications for corporate managers in designing appropriate financing and dividend strategies, assist investors in evaluating investment opportunities, and support policymakers in formulating policies that promote sustainable corporate growth and maximise firm value.

Recent evidence indicates that the relationship between capital structure, dividend policy and firm value remains inconclusive across emerging and frontier markets. In Sri Lanka, for example, Hettiarachchi et al. (2025) examined 222 companies listed on the Colombo Stock Exchange (CSE) over 2013–2024 and found that the debt-to-equity ratio positively influenced firm value, particularly in transitions between lower and higher valuation categories. However, Gajanayaka and Swarnapali (2024) reported that the relationship between capital structure and firm value among Sri Lankan non-financial listed companies remained inconclusive, demonstrating that findings can vary according to the sample, measurement and research setting. The evidence concerning dividend policy is similarly mixed. In Sri Lanka, Gowthaman and Kengatharan (2025) investigated 90 non-financial CSE-listed companies over 2017–2021, demonstrating continued academic interest in the relationship between dividend policy and market valuation. International evidence also reports contrasting outcomes: Arumona et al. (2024), using 70 listed non-financial Nigerian firms, found that the debt-to-equity ratio had a negative and insignificant effect on firm value, whereas dividend per share significantly affected firm value. Conversely, Fahad et al. (2024) reported a positive relationship between dividend payout and Tobin’s Q in an emerging-market sample. These contrasting findings suggest that the effects of financing and payout decisions cannot be generalised across different institutional and market environments.

The key research gap is therefore not the absence of studies on these variables, but the limited and fragmented evidence on their combined influence on firm value within a clearly defined segment of the Sri Lankan capital market. Existing Sri Lankan studies have largely examined broader samples, specific sectors, individual financial decisions, or alternative measures of firm value. Consequently, there remains insufficient evidence on whether capital structure and dividend policy simultaneously explain firm value among the largest market-capitalisation companies listed on the CSE. This is particularly relevant because recent international research shows that the valuation effect of dividends can depend on firm-level and country-level characteristics, while recent Sri Lankan evidence continues to identify capital structure as an important but context-sensitive determinant of firm value (Baroon et al., 2025; Mertzanis et al., 2024). According to that, the research problem addressed by this study is the lack of sufficiently focused and recent empirical evidence on whether capital

structure and dividend policy significantly influence the firm value of the largest market-capitalisation companies listed on the Colombo Stock Exchange. By examining the Debt-to-Equity Ratio and Dividend Payout Ratio jointly in relation to Tobin's Q, this study seeks to provide more specific evidence for the Sri Lankan capital market and extend the existing literature beyond broader or sector-specific samples.

2. Literature Review

2.1 Theoretical Review

The relationship between capital structure and firm value is explained through several established theories. The Modigliani and Miller (MM) theory (1958) proposes that capital structure does not affect firm value under perfect market conditions; however, when taxes are considered, debt financing can increase firm value through the interest tax shield. Agency Theory explains that debt can reduce managerial opportunism by restricting excess free cash flow, potentially improving firm value (Jensen & Meckling, 1976; Jensen, 1986). In contrast, Pecking Order Theory suggests that firms prioritise retained earnings, followed by debt and equity, due to information asymmetry (Myers & Majluf, 1984). Therefore, differences in firms' reliance on debt may lead to differences in firm value. These theories collectively provide the theoretical foundation for examining capital structure as a determinant of firm value in the present study.

Trade-Off Theory further suggests that firms can enhance firm value by maintaining an appropriate level of debt that balances the tax benefits of borrowing against the costs of financial distress (Scott, 1977; Gaud et al., 2005). Thus, moderate leverage may contribute positively to firm value, whereas excessive debt may reduce value due to increased financial risk. Market Timing Theory argues that firms make financing decisions according to prevailing market conditions, such as issuing equity when market valuations are favourable and relying on debt when conditions are less attractive (Baker & Wurgler, 2002). Accordingly, these theories indicate that the effect of capital structure on firm value may vary depending on the benefits, costs, and circumstances associated with debt financing. This provides a theoretical basis for testing the impact of capital structure on firm value within the selected firms.

The relationship between dividend policy and firm value is explained through competing dividend theories. Signalling Theory suggests that dividend payments communicate information about a firm's profitability and prospects to investors, thereby potentially increasing firm value (John & Williams, 1985; Fauziah, 2017). Dividend Relevance Theory, proposed by Gordon (1962, 1963) and Walter (1963), similarly argues that dividend payments can influence investor perceptions and market valuation. Conversely, Dividend Irrelevance Theory argues that dividend policy does not affect firm value under perfect market conditions because value is determined by earnings and investment decisions rather than the distribution of profits (Sitanala, 2010; Rosmika, 2020). These contrasting theoretical perspectives establish the basis for empirically examining whether dividend policy influences firm value. Hence, the combined capital structure and dividend policy theories provide the theoretical foundation for the present study's investigation of the impact of capital structure and dividend policy on firm value.

2.2 Empirical Review

Capital structure is a fundamental corporate financial decision because it determines how a firm's assets and investment activities are financed through debt and equity. The financing mix selected by management can influence the cost of capital, financial risk, investment capacity, and ultimately the market valuation of the firm. Consequently, the relationship between capital structure and firm value has received sustained attention in corporate finance research. The theoretical foundation of this relationship originates from Modigliani and Miller (1958), who proposed that financing decisions are irrelevant to firm value under a set of highly restrictive assumptions, including perfect capital markets, the absence of taxes and transaction costs, and no costs of financial distress. However, the introduction of corporate taxation into the model changed this conclusion. Modigliani and Miller (1963) demonstrated that debt financing can generate tax advantages because interest expenses are generally deductible from taxable income. Thus, moderate use of debt may enhance firm value through the interest tax shield.

The potential benefits of debt, however, must be considered alongside the costs associated with increasing financial leverage. As a firm's reliance on external borrowing increases, its exposure to financial distress, default risk, agency conflicts, and refinancing costs may also increase. This perspective is consistent with the trade-off theory, which proposes that firms seek an appropriate balance between the tax benefits of debt and the expected costs of financial distress. Conversely, the pecking-order theory suggests that firms generally prefer internally generated funds, followed by debt financing and, only as a last resort, external equity. These theoretical differences provide an important explanation for the absence of a universally consistent relationship between leverage and firm value. Empirical research provides support for both value-enhancing and value-reducing effects of leverage. Recent evidence from Indian firms demonstrates that capital structure can interact with other corporate mechanisms in determining firm value. Tripathi et al. (2024), for instance, examined 306 non-financial Indian firms over the period 2013–2022 and demonstrated that capital structure can influence the effectiveness of corporate governance mechanisms in relation to firm value. Similarly, Evelyne et al. (2024), examining Indonesian industrial companies, reported that capital structure was relevant to firm value and considered profitability as a potential mechanism through which financing decisions affect valuation. Other recent evidence also suggests that the effect of capital structure may not always be statistically significant. Yuliyanti et al. (2024), using 340 observations from Indonesian consumer non-cyclical companies, found that capital structure had a positive but statistically insignificant effect on firm.

Likewise, Liong and Uluputty (2024), in their examination of infrastructure companies, considered capital structure together with financial performance and investment decisions as potential determinants of firm value. These findings reinforce the argument that the consequences of leverage may vary according to industry characteristics, firm-specific conditions, investment opportunities, and the structure of the capital market. Evidence from emerging markets also demonstrates considerable variation. A recent study of Vietnamese listed firms found that debt financing could contribute positively to market-based measures of

firm value, suggesting that leverage may create benefits when firms are able to employ borrowed funds productively. Conversely, other studies indicate that excessive debt can expose firms to financial constraints and increase the likelihood that financing costs outweigh the benefits of debt. The overall evidence therefore supports a contingent rather than universal interpretation of the capital structure–firm value relationship. The Sri Lankan context is particularly relevant because firms operate within an emerging capital market characterised by distinctive financing conditions and institutional features. Recent Sri Lankan research continues to report inconclusive evidence. Gajanayaka and Swarnapali (2024), examining 244 listed non-financial companies in Sri Lanka, investigated the influence of debt-to-assets, total debt, and equity-related measures on firm value using Tobin's Q and price-to-earnings ratio as valuation measures. Their study specifically highlights the continuing uncertainty surrounding the capital structure–firm value relationship in Sri Lanka.

Similarly, Baroon et al. (2023), using a data-triangulation approach involving 90 listed non-financial companies over eight years, demonstrated that firm-specific and governance characteristics influence capital structure decisions and that capital structure can form part of the mechanism linking these characteristics to firm value. These findings indicate that the effect of capital structure on firm value cannot be adequately explained by assuming that either greater or lower leverage is inherently beneficial. Rather, the effect is likely to depend on the firm's ability to generate returns from borrowed funds, its financial risk, profitability, asset structure, growth opportunities, and the broader economic environment. Therefore, examining capital structure within the specific institutional setting of Sri Lanka remains important, particularly when the analysis focuses on companies with substantial market capitalisation.

Dividend policy represents the managerial decision concerning the distribution of corporate earnings between current payments to shareholders and retained earnings for future investment. Because dividend decisions influence both investors' current income and the resources available for corporate expansion, they constitute an important component of corporate financial policy. In addition to their direct financial consequences, dividend announcements may provide information about management's expectations regarding future earnings and cash flows. Consequently, dividend policy has long been debated as a potential determinant of firm value. The theoretical debate surrounding dividends can largely be explained through the dividend irrelevance and dividend relevance perspectives. Miller and Modigliani (1961) argued that dividend policy should not affect firm value under perfect capital-market assumptions because investors can theoretically construct their preferred cash-flow pattern independently of the firm's payout decision. In contrast, the signalling perspective suggests that dividend decisions may convey information to investors because managers may possess superior information about the firm's prospects. A stable or increasing dividend may therefore be interpreted as an indication of financial strength, while a reduction in dividends may generate concerns regarding future profitability. The bird-in-the-hand argument similarly suggests that some investors may place greater value on relatively certain current dividends than uncertain future capital gains.

Recent empirical research continues to produce contrasting findings. In the Turkish financial sector, for example, a study of 111 firms listed on Borsa Istanbul found a positive and statistically significant relationship between dividend policy and firm value. The authors further reported that this relationship became stronger following IFRS adoption, suggesting that the informational value of dividend-related measures may depend partly on the quality of financial reporting (2024). Similarly, Nur Aisyah et al. (2024), examining 103 Indonesian manufacturing companies, reported a positive effect of dividend policy on firm value.

These findings are consistent with the argument that dividend payments can strengthen investor confidence and provide a favourable signal concerning a firm's future financial condition. Nevertheless, the empirical evidence is not uniformly supportive of dividend relevance. Erinaldi and Hasibuan (2024), for example, found that dividend policy did not significantly alter the relationships between selected financial performance variables and firm value. Similarly, Ijma et al. (2024) found that dividend policy did not significantly affect firm value among Indonesian processed-food companies. Their findings suggest that investors may place greater emphasis on profitability and future growth opportunities than on immediate dividend distributions. This perspective is particularly relevant to firms operating in industries where retained earnings are essential for investment and expansion. A systematic review by Prasojoharto et al. (2024) further illustrates the continuing diversity of findings in the dividend literature. Based on the existing literature, the authors emphasised that the relationship between dividend policy and firm value has been examined from multiple theoretical and empirical perspectives, with results varying across research settings. Therefore, dividend policy should not automatically be assumed to increase firm value simply because dividends provide an immediate return to shareholders.

The Sri Lankan evidence also reflects this lack of consensus. Gunarathne et al. (2016), examining Sri Lankan manufacturing companies, found that dividend-related variables had differing effects on market value and stock-price volatility, indicating that dividend policy may influence different dimensions of market performance in different ways. More recent Sri Lankan research has continued to examine dividend decisions from different perspectives. Baker et al. (2019), using data from 190 Sri Lankan firms and 1,330 firm-year observations together with survey evidence, identified several firm-specific and institutional factors associated with dividend policy, highlighting the distinctive nature of dividend decisions within the Sri Lankan market. More recent Sri Lankan evidence also indicates that financing and dividend decisions are interconnected. Athukorala and Weerakkody (2025), examining firms in the Food, Beverages and Tobacco and Capital Goods sectors, found that firms with higher debt ratios tended to distribute lower dividends, while firms with stronger equity positions were more likely to maintain dividend payments.

This finding is particularly relevant because it indicates that dividend policy may be influenced by capital structure rather than operating as an entirely independent financial decision. Accordingly, the literature suggests that dividend policy can influence firm value through several possible channels, including investor signaling, shareholder preferences, agency considerations, and the availability of profitable investment opportunities. However, the strength and direction of this relationship may vary according to firm characteristics and

market conditions. This inconsistency creates a need for further investigation within the Sri Lankan capital market, particularly among firms with relatively high market capitalization.

3. Methods

The study adopts a hypothetico-deductive approach, where hypotheses are developed based on relevant financial theories and tested using empirical evidence (Creswell, 2014). A quantitative explanatory research design is employed to examine the impact of capital structure and dividend policy on firm value. The study uses panel data covering the period from 2021 to 2025, allowing variations across firms and over time to be examined.

The population comprises companies listed on the Colombo Stock Exchange (CSE) during the study period. From this population, 50 companies with the largest market capitalisation are selected as the study sample. The selection of the largest firms is intended to focus on companies with substantial market presence and greater economic significance within the CSE, while also improving the availability and consistency of financial and market-related information. The sample excludes banks, insurance companies, and other financial-sector entities, as their capital structures and regulatory requirements differ considerably from those of non-financial companies. Companies with inadequate or incomplete data for the study period are also excluded.

The study uses secondary data collected primarily from the published annual reports of the selected companies for 2021–2025. Information relating to capital structure, dividend policy, firm value, and relevant control variables is extracted from the financial statements and other disclosures contained in the annual reports. Market-related information, including share prices and market capitalisation, is obtained from reliable CSE sources where required. The collected information is organised into a panel dataset for subsequent statistical analysis. This is also methodologically defensible because market-cap rankings are commonly used to identify the largest CSE-listed companies, and current CSE-related market data are explicitly reported on a market-capitalisation basis.

Company value reflects investor perceptions, often tied to stock prices and influenced by factors like dividend policy and capital structure (Margaretha, 2014; Husain & Sunardi, 2020). Achieving maximum market value aligns with financial decisions that drive growth and higher stock prices, enhancing firm value (Harmono, 2017; Wahyudi & Pawestri, 2006). This study uses Tobin's Q ratio to measure firm value, comparing a company's market value to the replacement cost of its assets. Regarded as more precise than market-to-book value, Tobin's Q highlights whether a firm is overvalued or undervalued, despite challenges in estimating replacement costs (Brealey et al., 2018).

Capital structure represents the mix of a company's financing through debt and equity, balancing short-term debt, long-term debt, preferred shares, and common shares (Halim, 2007). An optimal capital structure maximises company value or share price (Husnan & Pudjiastuti, 2006). The Debt to Equity Ratio (DER), expressed as a percentage, measures capital structure by comparing total debt to equity. A higher DER indicates greater reliance on debt, increasing obligations to creditors (Robert, 1997). Effective capital structuring supports business growth, profitability, and investor value.

Table 1: Operationalization of Variables

Variables	Measurement	Source
Capital Structure	Debt to Equity = Total Debt / Total Equity	(Umer M. et al., 2012)
Dividend Policy	Dividend Payout Ratio = Dividend Per Share / Earnings Per Share	(C. Anup and P.C Suman., 2010) (Umer M. et al., 2012)
Firm Value	Tobin's Q Ratio = Market Value of Equity + Book Value of Debt / Market Value of Assets	(Jaelani et al., 2013)
Firm Size	Natural Logarithm of Total Assets	Shumi Akhtar (2005), Yu-Shu Cheng, Yi-Pei Liu and Chu-Yang Chien (2010)
Firm Growth	Current Year Sales - Previous Year Sales / Previous Year Sales	Yi-Pei Liu and Chu-Yang Chien (2010) Feng-Li Lin (2010) (Shah and Khan., 2007)

Dividend policy determines whether profits are distributed to shareholders or retained for investment (Sartono, 2011). Higher dividends typically raise stock prices and company value, while lower dividends can reduce them. Dividend Payout Ratio (DPR) measures the proportion of earnings distributed to shareholders in cash. Profitable companies with higher earnings have a greater capacity to pay dividends, reflecting their financial health and enhancing investor confidence (Sugiono, 2009).

This study uses firm size and firm growth as control variables. Firm size, measured as the natural logarithm of total assets, can positively or negatively influence firm value, as larger firms may demonstrate greater profitability (Abor, 2005) or face value declines (Lin, 2010). Firm growth, defined by the growth rate of operating sales, typically correlates positively with firm value, reflecting profitability and expansion opportunities, though some studies suggest no significant relationship (Lin, 2010).

To examine the extent to which capital structure and dividend policy affect firm value, we use regression analysis (pooled OLS). However, a pooled OLS (Ordinary Least Squares) does not take into account the potential endogeneity of capital structure and dividend policy arising from unobserved firm heterogeneity. We use the Hausman specification test to decide whether the fixed effects method (FEM) or random effects method (REM) is econometrically a more appropriate approach to our data because, if there is a significant correlation, the FE model is preferable. After all, it accounts for any individual-specific effects that may be related to the independent variables, providing more reliable results in such cases. Hausman test (x= 15.320815, P-value= 0.0038) reveals systematic differences in coefficients between the two models, which indicates highly significant firm-specific effects and their correlation with the dependent variable, thus showing that FEM provides a better specification of our model relative to REM.

4. Results and Findings

Table 2 presents the descriptive statistics for the 250 firm-year observations of the selected listed companies with the largest market capitalisation in Sri Lanka. The analysis includes the dependent variable, firm value (FV), the two main independent variables, capital structure

(CS) and dividend policy (DP), and the control variables, firm size (FS) and growth (GR). The mean and median describe the central tendency of the variables, while the standard deviation, minimum and maximum values indicate the extent of variation across the sampled firms. Such descriptive analysis provides an initial understanding of the characteristics of the data before examining the relationships between capital structure, dividend policy, and firm value through further econometric analysis (Field, 2018).

The Tobin's Q, suggests that on average, the market value of the firms is marginally higher than the replacement-cost benchmark represented by a Tobin's Q of one (Chung & Pruitt, 1994). In comparison, capital structure shows a substantial variation in the financing structures of the firms. Such variation is important for this study because capital structure theories suggest that the use of debt can affect firm value through tax benefits, agency considerations, financial risk, and information asymmetry (Jensen & Meckling, 1976; Modigliani & Miller, 1958; Myers, 1984). Therefore, the observed differences in capital structure provide an appropriate basis for investigating its influence on firm value.

Similarly, dividend policy also shows a considerable variation among the sampled firms. This variation is relevant to the research because dividend policy theories provide different expectations regarding its effect on firm value. While dividend relevance and signaling perspectives suggest that dividend payments may influence investor perceptions and firm valuation, the dividend irrelevance perspective argues that dividend decisions do not affect firm value under perfect market conditions (Gordon, 1962; Miller & Modigliani, 1961; Miller & Rock, 1985; Walter, 1963).

Table 2: Descriptive statistics

	FV	CS	DP	FS	GR
Mean	1.0424	.6901	.3929	21.9548	.2622
Median	1.0000	.4051	.2487	23.2059	.1126
Maximum	2.7711	18.7155	20.0000	26.8693	8.1379
Minimum	.5737	.0003	-9.0909	12.2281	-.7565
Std. Dev.	.2343	1.3121	1.4523	3.0916	.7058
Skewness	5.0577	10.7134	8.8676	-.8193	6.4973
Kurtosis	32.6058	144.2768	141.4718	2.9478	66.0764
Observations	250	250	250	250	250

Table 3 presents the Pearson correlation matrix showing the relationships among firm value (FV), capital structure (CS), dividend policy (DP), firm size (FS), and growth (GR). Pearson's correlation coefficient measures the direction and strength of the linear relationship between two variables, with values ranging from −1 to +1. A positive coefficient indicates that the variables move in the same direction, whereas a negative coefficient indicates an inverse relationship. The magnitude of the coefficient represents the strength of the association between the variables (Field, 2018).

The results indicate that capital structure has a strong positive and statistically significant relationship with firm value (r = .6793, p = .0114). This suggests that firms with higher levels of capital structure tend to have higher firm value. The positive association is consistent with the argument that debt financing can enhance firm value through tax benefits and the disciplinary role of debt in reducing managerial agency problems (Modigliani & Miller,

1958; Jensen & Meckling, 1976). In contrast, dividend policy has a moderate negative relationship with firm value ($r = -.4156$, $p = .057$). This indicates that higher dividend policy is associated with lower firm value in the sample. However, since the p-value is greater than 0.05, the relationship is not statistically significant at the 5% level, although it is marginally significant at the 10% level. Therefore, the correlation results do not provide strong evidence of a significant relationship between dividend policy and firm value at the 5% significance level.

Regarding the control variables, firm size demonstrates a strong positive relationship with firm value ($r = .6508$, $p = .0502$), indicating that larger firms tend to be associated with higher firm value. The p-value is approximately equal to the 5% significance threshold, suggesting a marginal statistical relationship. Growth has a weak positive and statistically significant relationship with firm value ($r = .1464$, $p = .0206$), indicating that firms with greater growth tend to have relatively higher firm value. The results further show positive associations between capital structure and dividend policy ($r = .6320$), capital structure and firm size ($r = .5166$), capital structure and growth ($r = .4865$), dividend policy and growth (r = .4644), and firm size and growth ($r = .6885$). These findings provide preliminary evidence regarding the relationships among the variables and, particularly, indicate that capital structure is positively associated with firm value, while dividend policy demonstrates a negative but statistically insignificant association with firm value. The direction and statistical significance of these relationships can subsequently be evaluated through the regression analysis in accordance with the objectives of the study.

Table 3: Results of Pearson's Correlation Analysis

Variable	FV	CS	DP	FS	GR
FV	1.0000				
CS	.6793	1.0000			
	(.0114)				
DP	-.4156	.6320	1.0000		
	(.0570)	(.6137)			
FS	.6508	.5166	-.6599	1.0000	
	(.0502)	(.7931)	(.8762)		
GR	.14642	.4865	.4644	.6885	1.0000
	(.0206)	(.1725)	(.3099)	(.1627)	

Note: p-values are inside parentheses

Table 4 presents the results of the multicollinearity test conducted for the explanatory and control variables included in the model. The Variance Inflation Factor (VIF) is used to assess whether a high degree of linear association exists among the independent variables, which could affect the reliability of the estimated regression coefficients. In this analysis, the Centered VIF values are considered because they account for the presence of the constant term in the regression model. Generally, a VIF value below 10 is considered acceptable, while values substantially exceeding this threshold may indicate a serious multicollinearity concern (Gujarati & Porter, 2009).

The results indicate that the Centered VIF values for all explanatory and control variables are below 10. Capital structure (CS) records the highest VIF value of 4.2502, followed by

firm size (FS) with 3.1759, growth (GR) with 2.4037, and dividend policy (DP) with 1.5761. These values remain within the commonly accepted range, indicating that the variables do not exhibit a level of linear association that would pose a serious multicollinearity problem in the regression model. Therefore, the coefficient estimates for capital structure, dividend policy, firm size, and growth can be considered sufficiently reliable for examining their relationships with firm value.

Table 4: Multicollinearity test

Variable	Coefficient variance	Uncentered VIF	Centered VIF
Constant	.013971	4813.908	NA
CS	.004128	8.060178	4.250156
DP	.000328	51.29494	1.576101
FS	1.048605	2437.085	3.175887
GR	.004532	1242.249	2.403739

Table 5 presents the panel regression results on the impact of capital structure and dividend policy on firm value, while controlling for firm size and growth. Since the study uses firm-year observations, Pooled Ordinary Least Squares (Pooled OLS), Random Effects Model (REM), and Fixed Effects Model (FEM) were estimated to identify the most appropriate model. Panel data methods are particularly useful in corporate finance research because they allow differences across firms and changes over time to be considered within the same analytical framework (Mavruk, 2025). The use of alternative panel estimators also helps account for unobserved firm-specific characteristics that may influence firm value, thereby providing more reliable estimates of the relationships among the study variables.

The Pooled OLS estimation produced an R-squared of .4512 and an adjusted R-squared of .4415, indicating that approximately 45.12% of the variation in firm value was explained by capital structure, dividend policy, firm size, and growth under the pooled specification. The model was statistically significant overall, with an F-statistic of 6.2541 (p = .0004). Capital structure had a positive and statistically significant coefficient (β = .0122, p = .0275), suggesting that higher capital structure was associated with higher firm value. Dividend policy had a negative but statistically insignificant coefficient (β = −.0076, p = .9482). Firm size was also statistically insignificant (β = .0053, p = .2685), while growth had a positive and statistically significant coefficient (β = .0444, p = .0359). Although these results provided preliminary evidence, the pooled specification did not explicitly account for unobserved firm-specific effects.

The Random Effects Model produced an R-squared of .5195 and an adjusted R-squared of .4886, indicating that approximately 51.95% of the variation in firm value was explained by the variables included in the model. The overall model was statistically significant (F = 12.6541, p < .001). Capital structure remained positive and statistically significant (β = .0116, p = .0221), providing consistent evidence of a positive relationship between capital structure and firm value. Dividend policy remained negative and statistically insignificant (β = −.0015, p = .8620). Firm size was insignificant (β = .0022, p = .7498), whereas growth had a positive and statistically significant coefficient (β = .0527, p = .0051). The persistence of the positive

capital structure coefficient across the pooled and random effects estimations provided preliminary support for the relevance of financing structure to firm valuation.

Under the selected Fixed Effects Model, capital structure had a positive and statistically significant coefficient of .0364 (p = .0110). This indicated that, holding dividend policy, firm size, growth, and time-invariant firm-specific characteristics constant, an increase in capital structure was associated with an increase in firm value. The finding suggested that financing decisions played an important role in determining how the market valued firms. The result was consistent with capital structure theories suggesting that debt financing can influence firm value through tax advantages, agency considerations, and the disciplinary effects of debt, although excessive leverage can also expose firms to financial distress costs (Jensen & Meckling, 1976; Modigliani & Miller, 1958). Recent empirical evidence also indicated that the relationship between capital structure and firm value could differ according to firm characteristics and the economic environment, highlighting the importance of examining this relationship within specific markets and samples.

Table 5: Multiple Regression Results

Variable	Pooled OLS		REM		FEM	
	Coefficient	**Prob.**	**Coefficient**	**Prob.**	**Coefficient**	**Prob.**
C	.9229	.0000	.9866	.0000	.9656	.0000
CS	.0122	.0275	.0116	.0221	.0364	.0110
DP	-.0076	.9482	-.0015	.8620	-.4530	.7509
FS	.0053	.2685	.0022	.7498	-.1329	.0011
GR	.0444	.0359	.0527	.0051	.0783	.0001
No of observations		250		250		250
R-squared		.4512		.5195		.6582
Adjusted R-quared		.4415		.4886		.6345
F-statistic		6.2541		12.6541		15.1485
Prob(*F*-statistic)		.0004		.0000		.0000
F Test				14.0154		
(Pooled VS Fixed)				.0000		
Breusch & Pegan Lagrange Multiplier Test						98.1456
p-value						.0000
Hausman test- Chi square				21.1452		
p-value				.0451		

In contrast, dividend policy had a negative coefficient of −.0030 but was statistically insignificant (p = .7509) under the Fixed Effects Model. Therefore, the study did not provide sufficient statistical evidence to conclude that dividend policy had a significant impact on firm value among the sampled companies. Although the estimated coefficient was negative, the relatively high p-value indicated that this effect was not statistically distinguishable from zero at conventional significance levels. This finding was consistent with the fundamental dividend irrelevance proposition of Miller and Modigliani (1961), under which dividend decisions do not independently determine firm value under idealized market conditions. Nevertheless, contemporary evidence demonstrates that the dividend–firm-value relationship can vary across markets and institutional settings. For example, recent international research reports that investors may place a valuation premium on dividends in firms with particular organizational and agency characteristics (Chasiotis et al., 2024). Similarly, recent evidence

from emerging-market firms has reported both significant and insignificant dividend–firm-value relationships, demonstrating that the effect of dividend policy is context-dependent.

The results for the control variables provided additional insights into firm valuation. Firm size had a negative and statistically significant coefficient under the Fixed Effects Model ($\beta = -.1329$, $p < .0011$). This implied that, after controlling for capital structure, dividend policy, growth, and unobserved time-invariant firm characteristics, increases in firm size were associated with lower firm value within the sample. The negative coefficient should not be interpreted as meaning that larger firms are inherently less valuable; rather, it indicated a negative within-firm association after the other explanatory factors and firm-specific effects were controlled for. In contrast, growth had a positive and highly statistically significant coefficient ($\beta = .0783$, $p < .0001$). This indicated that firms experiencing stronger growth tended to have higher firm value, holding the other variables constant. The result was consistent with the valuation perspective that firms with stronger growth opportunities may attract higher market valuations because investors anticipate greater future economic benefits.

In addition to that, the selection tests provided evidence that the Fixed Effects Model was the most appropriate model for the study. First, the F-test comparing Pooled OLS with Fixed Effects reported a statistic of 14.0154 with a *p*-value of .0000. Since the *p*-value was below the 5% significance level, the null hypothesis that the pooled model was appropriate was rejected. This indicated that significant firm-specific effects existed and that Pooled OLS was not the preferred specification. The Breusch–Pagan Lagrange Multiplier test comparing Pooled OLS and Random Effects reported a statistic of 98.1456 with a *p*-value of .0000. The null hypothesis of no random effects was therefore rejected, indicating that a model incorporating individual firm effects was preferable to the pooled specification. These tests collectively demonstrated that the panel structure of the data should be explicitly incorporated into the regression analysis. Finally, the Hausman test was used to determine whether Fixed Effects or Random Effects was more appropriate. The test produced a chi-square statistic of 21.1452 with a *p*-value of .0451. Since the *p*-value was below .05, the null hypothesis underlying the Random Effects specification was rejected. Consequently, the Fixed Effects Model was selected as the final model. The Hausman framework is widely used to assess whether the firm-specific effects are systematically related to the explanatory variables, which is an important consideration when choosing between fixed- and random-effects estimators (Hausman, 1978; Hill et al., 2024).

Overall, the Fixed Effects Model provides the principal empirical evidence for this study. The results demonstrate that capital structure has a positive and statistically significant impact on firm value, supporting the view that financing decisions are relevant to corporate valuation. Conversely, dividend policy has a negative but statistically insignificant effect on firm value, indicating that the study does not find sufficient evidence to establish dividend policy as a significant determinant of firm value within the selected sample. Among the control variables, firm size has a significant negative effect, while growth has a significant positive effect on firm value. The overall significance of the model ($p < .001$) and its explanatory power ($R^2 = .6582$) indicate that the selected variables collectively explain a substantial proportion of the variation in firm value.

The findings also demonstrate that the relationship between capital structure, dividend policy, and firm value should be interpreted within the institutional and market context of the sampled listed companies. Recent empirical research continues to report differing results regarding these relationships. For instance, recent studies have found significant positive, insignificant, and even negative effects of capital structure and dividend policy depending on the country, industry, measurement approach, and model specification. Therefore, the present findings contribute to the existing literature by providing firm-level panel evidence on how capital structure and dividend policy jointly relate to firm value in the selected Sri Lankan listed companies.

The hypotheses of the study were evaluated using the probability values obtained from the selected Fixed Effects Model. A 5% significance level was adopted for determining whether the proposed relationships are statistically supported. The hypothesis decision is based primarily on whether the probability value is below the predetermined significance level, while the sign of the estimated coefficient is considered to determine the direction of the relationship.

H_1: Capital structure has a significant impact on firm value.

The positive coefficient of *CS* indicates that the proposed relationship is positive, meaning that variations in capital structure are associated with corresponding increases in firm value, ceteris paribus. Thus, the empirical evidence provides statistical support for the proposition that capital structure is an important determinant of firm value in the context of the selected listed companies. This finding is compatible with the argument that financing choices can affect corporate valuation through the benefits and costs associated with debt financing (Modigliani & Miller, 1958; Jensen & Meckling, 1976).

H_2: Dividend policy has a significant impact on firm value.

Although the *DP* coefficient carries a negative sign, the statistical evidence is insufficient to establish that changes in dividend policy systematically affect firm value in the sampled firms. The finding is compatible with the proposition that dividend decisions may not independently determine firm valuation when other relevant factors are taken into consideration (Miller & Modigliani, 1961).

5. Conclusions and Implications

This study examined the impact of capital structure and dividend policy on firm value among selected listed companies in Sri Lanka, using Tobin's Q as the measure of firm value and firm size and growth as control variables. Based on the panel-data analysis, the Fixed Effects Model was identified as the most appropriate estimation technique. The findings reveal that capital structure has a positive and statistically significant effect on firm value, indicating that financing decisions play an important role in determining market valuation. In contrast, dividend policy has a negative but statistically insignificant effect, suggesting that dividend payments alone may not significantly influence firm value among the selected companies.

These findings highlight the greater importance of capital structure in explaining firm value within the sample and study period.

The findings have important implications for corporate managers and investors. Managers should carefully determine their financing structure by considering investment requirements, debt repayment capacity, and financial risk, as appropriate financing decisions may contribute to firm value creation. However, increasing debt does not necessarily guarantee higher firm value. Similarly, dividend decisions should be made by considering the firm's profitability, investment opportunities, and long-term financial requirements rather than relying solely on dividend payments to improve market valuation. For investors, the findings highlight the importance of evaluating a company's financing structure and growth prospects alongside its dividend policy when making investment decisions.

The study is subject to certain limitations, as it focuses on selected listed companies with large market capitalisation in Sri Lanka and relies mainly on secondary financial and market data. Therefore, the findings may not be generalisable to smaller firms, unlisted companies, or other markets. Future studies could extend the sample to different firm sizes and industries, incorporate additional variables such as profitability, liquidity, corporate governance, ownership structure, and business risk, and examine the moderating effects of corporate governance and other firm characteristics. Further research using alternative measures of firm value and data from other emerging markets could provide a broader understanding of the relationship between corporate financial decisions and firm valuation.

References

Abor, J. (2005). The effect of capital structure on firm performance: An empirical analysis of listed firms in Ghana. *The Journal of Risk Finance*, 6(5), 438–445. https://doi.org/10.1108/15265940510633505

Akhtar, S. (2005). The determinants of capital structure for Australian multinational and domestic corporations. *Australian Journal of Management*, *30*(2), 321–341. https://doi.org/10.1177/031289620503000208

Arumona, O. J., Orbunde, B. B., & Be lo, M. (2024). Capital structure, dividend policy and firm value of listed non-financial companies in Nigeria. *International Journal of Research and Innovation in Social Science*, 8(4), 1279–1296. https://doi.org/10.47772/IJRISS.2024.804096

Baker, H. K., Dewasiri, N. J., Weerakoon Banda, Y. K., & Azeez, A. A. (2019). Dividend policy determinants of Sri Lankan firms: A triangulation approach. *Managerial Finance, 45*(1), 2–20. https://doi.org/10.1108/MF-03-2018-0096

Baker, M., & Wurgler, J. (2002). Market timing and capital structure. *The Journal of Finance*, 57(1), 1–32. https://doi.org/10.1111/1540-6261.00414

Baroon, A., Dayaratne, D. A. I., & Menike, L. M. C. S. (2025). Mediating role of capital structure between determinants of capital structure and firm value: A path analysis using econometrics model. *International Journal of Research and Innovation in Social Science, 9*(6), 5604–5616. https://doi.org/10.47772/IJRISS.2025.906000428

Bhattacharya, S. (1979). Imperfect information, dividend policy, and "the bird in the hand" fallacy. *The Bell Journal of Economics*, 10(1), 259–270.

Brealey, R. A., Myers, S. C., & Allen, F. (2018). Principles of corporate finance (12th ed.). McGraw-Hill Education.

Cheng, Y.-S., Liu, Y.-P., & Chien, C.-Y. (2010). Capital structure and firm value in China: A panel threshold regression analysis. *African Journal of Business Management, 4*(12), 2500–2507. https://doi.org/10.5897/AJBM.9000127

Chung, K. H., & Pruitt, S. W. (1994). A simple approximation of Tobin's q. *Financial Management, 23*(3), 70–74. https://doi.org/10.2307/3665623

Creswell, J. W. (2014). Research design: Qualitative, quantitative, and mixed methods approaches (4th ed.). SAGE Publications.

Erinaldi, D. R. W., & Hasibuan, H. T. (2024). The effect of financial performance on firm value: Dividend policy's moderating role. *E-Jurnal Akuntansi, 34*(5), 1343–1356. https://doi.org/10.24843/EJA.2024.v34.i05.p20

Evelyne, T., Imelda, E., & Hidajat, N. C. (2024). The effect of capital structure on firm value with profitability as variable mediator in industrial companies listed on the IDX. *International Journal of Application on Economics and Business, 2*(3), 227–235. https://doi.org/10.24912/ijaeb.v2i3.227-235

Field, A. (2018). Discovering statistics using IBM SPSS statistics (5th ed.). SAGE Publications.

Gowthaman, M., & Kengatharan, L. (2025). The role of dividend policy in shaping market value of shares: Evidence from Colombo Stock Exchange. *South Asian Journal of Finance, 5*(1), 84–99. https://doi.org/10.4038/sajf.v5i1.105

Gujarati, D. N., & Porter, D. C. (2009). Basic econometrics (5th ed.). McGraw-Hill Irwin.

Hausman, J. A. (1978). Specification tests in econometrics. *Econometrica*, 46(6), 1251–1271. https://doi.org/10.2307/1913827

Hettiarachchi, S., Kasthuriarachchi, U., Kokilakumar, S., Himaanthri, S., Jayathilaka, R., & Peiris, S. (2025). Determinants of firm value in frontier markets: Evidence from a panel oprobit analysis in Sri Lanka. *Asia-Pacific Financial Markets*. https://doi.org/10.1007/s10690-025-09568-w

Ijma, Syahputra, R. A., & Wahdania. (2024). The effect of activity on firm value with dividend policy as an intervening variable. *Journal of Business and Behavioural Entrepreneurship, 8*(1), 109–120. https://doi.org/10.21009/JOBBE.008.1.12

Inrawan, A. (2024). Dividend policy as moderator of firm value determinants. Ultima Management: *Journal Ilmu Manajemen, 17*(1), 104–129. https://doi.org/10.31937/manajemen.v17i1.4205

Jensen, M. C. (1986). Agency costs of free cash flow, corporate finance, and takeovers. *The American Economic Review, 76*(2), 323–329. https://doi.org/10.1016/0304-405X(76)90026-X

John, K., & Williams, J. (1985). Dividends, dilution, and taxes: A signalling equilibrium. The *Journal of Finance, 40*(4), 1053–1070. https://doi.org/10.1111/j.1540-6261.1985.tb02363.x

Kraus, A., & Litzenberger, R. H. (1973). A state-preference model of optimal financial leverage. *The Journal of Finance, 28*(4), 911–922. https://doi.org/10.1111/j.1540-6261.1973.tb01415.x

Liong, H., & Uluputty, N. F. (2024). Capital structure, financial performance, investment decision and firm value. *Economic and Accounting Journal, 7*(1), 23–31. https://doi.org/10.32493/eaj.v7i1.y2024.

Mavruk, T. (2025). Panel-data analysis. In Quantitative research methods in corporate finance, 185–213. Cambridge University Press. https://doi.org/10.1017/9781009307383

Miller, M. H., & Modigliani, F. (1961). Dividend policy, growth, and the valuation of shares. *The Journal of Business, 34*(4), 411–433. https://doi.org/10.1086/294442

Miller, M. H., & Rock, K. (1985). Dividend policy under asymmetric information. *The Journal of Finance, 40*(4), 1031–1051. https://doi.org/10.1111/j.1540-6261.1985.tb02362.x

Modigliani, F., & Miller, M. H. (1958). The cost of capital, corporation finance and the theory of investment. *The American Economic Review, 48*(3), 261–297.

Modigliani, F., & Miller, M. H. (1963). Corporate income taxes and the cost of capital: A correction. *The American Economic Review, 53*(3), 433–443.

Myers, S. C., & Majluf, N. S. (1984). Corporate financing and investment decisions when firms have information that investors do not have. *Journal of Financial Economics, 13*(2), 187–221. https://doi.org/10.1016/0304-405X(84)90023-0

Prasojoharto, P., Chariri, A., & Purwanto, A. (2024). Dividend policy and firm value: A systematic literature review of the past decade. *Journal of Marketing and Emerging Economics, 4*(5), 217–225.

Shah, A., & Khan, S. (2007). Determinants of capital structure: Evidence from Pakistani panel data. *International Review of Business Research Papers, 3*(4), 265–282

Tripathi, V., Goode l, J. W., Madhavan, V., & Kumar, S. (2024). Moderating effect of capital structure on the relationship between corporate governance mechanisms and firm value: Evidence from India. *International Review of Economics & Finance*, 92, 1336–1350. https://doi.org/10.1016/j.iref.2024.02.082

Walter, J. E. (1963). Dividend policy: Its influence on the value of the enterprise. *The Journal of Finance, 18*(2), 280–291. https://doi.org/10.1111/j.1540-6261.1963.tb00724.x

Yuliyanti, L., Nugraha, N., Disman, D., Solikin, I., & Mulyana, D. (2024). Determinants of firm value with dividend policy as the moderating variable. *Jurnal Pendidikan Akuntansi & Keuangan, 12*(2)