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A Study of the Effect of Financial Leverage on Earnings Response Coefficient through out Income Approach: Iranian Evidence

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Abstract: Corporations raise their equity by different methods. Decision making on the choice of better methods is a challenge most financial managers of corporations face. In particular, accounting earnings come with informative content. In companies with outstanding debt the reaction of stock prices to unexpected earnings will be affected by the firm's bankruptcy risk. This is because it is the bankruptcy risk that determines the mechanism for allocation of wealth change due to unexpected earnings among stockholders and bondholders. Thus, it is expected that financial leverage is influences the earnings response coefficient. In this paper the relationship between financial leverage and the earnings response coefficient is studied through an income approach. The aim of the study is to provide further evidence about factors influencing the earnings response coefficient. The study includes corporations listed on the Tehran Stock Exchange. Research data has been collected from the seven years period from 2002 to 2008, and data analysis was done using multiple regressions. Results indicate that the earnings response coefficient for the low-leverage firms group is larger than the high-leverage ones, with differences in the means among groups statistically significant.

1. Introduction

Investment decisions in financial markets are influenced by information resources. From the viewpoint of stock exchange theorists, one useful source of data is financial statements, with one of the main goals behind financial