IMPACT OF FINANCIAL SOUNDNESS ON FIRM PROFIT GROWTH IN THE FINANCIAL SECTOR IN SRI LANKA

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INTRODUCTION

Financial soundness refers to monitoring the health and soundness of financial institutions, businesses, and their corporate and public counterparts, an organization's ability to be regarded as a going concern. The management of the listed companies tries to maintain a sound financial position and hopes to maintain good trends in the future. Otherwise, they cannot attract the investors for the company. Their financial position should be enhanced to set aside the companies from bankruptcy. To reach this objective, there should be sound management control, supply of adequate working capital, and setting reasonable goals (Balasundaram, 2009). As a result, a financially stable business can successfully eliminate any problematic parts as soon as they are discovered, preventing further detrimental effects**.** Further, Kattel (2015) notes that the entire idea of soundness is typically predicated on guaranteeing an organization's long-term viability within its sector of operation.

Literature examining financial soundness either discusses a phenomenon's profit growth and potential or indicates the problem's impact. At the same time, reports of firm failure are continually increasing, as it is evident that the corporate sector is not satisfied with profit growth. Despite two inconclusive arguments (Fama & Jensen, 1983; Modigliani F. and Miller M., 1963; Modigliani & Miller, 1958), many observers reveal that financial soundness does not impact firm profit growth. The researchers investigate the impact of financial soundness on a firm's profit growth. Financial companies play a vital role in the economic development of countries because they have significant control over the money supply circulation, and companies need a sound financial position in the economy. Thus, this study focused on listed financial companies in Sri Lanka, which is essential to the wealth of the Sri Lankan economy. Most studies on financial soundness are conducted from the perspectives of accounting ratios such as liquidity ratios, profitability ratios, efficiency ratios (Saran, n.d. 2015) and z-core model (Anjum, 2012; Balasundaram, 2009) with few regards for LDR (Loan to Deposit Ratio), NPL (Non-Performing Loans), CAR (Capital Adequacy Ratio), ROA (Return On Asset), OER (Operational Efficiency Ratio) in Sri Lanka.

Some studies relate to financial soundness's impact on PG in the global context (Lesmana et al., 2020, Rusdianto & Pratama, 2017). In the Sri Lankan context, only a few research studies are based on financial soundness (Balasundaram, 2009). However, there needs to be research to identify the impact of financial soundness on PG, focusing on listed financial companies in Sri Lanka.

Much research has yet to be done on the impact of financial soundness on profit growth in the Sri Lankan context. In this concern, this study attempted to investigate the impact of financial soundness on the PG of listed financial companies in Sri Lanka.

The paper is organized as follows. First, it deals with the theoretical background, paying attention to financial soundness on company profit growth. The subsequent section deals with the empirical study. Next, it presents a methodology and summary of findings. The paper concludes with a discussion and future direction for research.

METHODOLOGY

This study uses annual audited financial statement data from the listed companies on the Colombo Stock Exchange (CSE) in Sri Lanka, covering 2016-2022. A multiple regression analysis to investigate the impact of financial soundness on firm profit growth. The profit growth variable is considered as a proxy for financial soundness. Financial companies are the population of this study. The method of sampling is judgmental sampling. Financial soundness is much more critical for the financial sector. Financial companies are different from the non-financial sector. This concept of financial soundness is most sensitive to the financial sector, and the preparation and audited financial statements and transactions of the companies differ from non-financial companies. Financial companies reported complete and clear data regarding related variables. Due to limitations, the researcher selected a sample of 36 financial companies according to data availability.

This study used quantitative data to analyze for seven years, from 2016/17 to 2021/22. All the essential data for this analysis were gathered from secondary sources for all 36 companies. Audited annual financial statements of the selected financial companies listed on CSE were used to extract the data. Statistical Package for Social Sciences (SPSS) and STATA, a program for computer-based statistical analysis, are used to examine the secondary data gathered. This research utilized Loan to Deposit Ratio (LDR), Non-Performing Loans (NPL), Capital Adequacy Ratio (CAR), Return on Assets (ROA), and Operational Efficiency Ratio (OER) as the independent variables. It investigated its impact with the dependent variable: Profit Growth. Two control variables were considered: Sales Growth (SG) and Asset Growth (AG).

Figure 1

Conceptual Framework
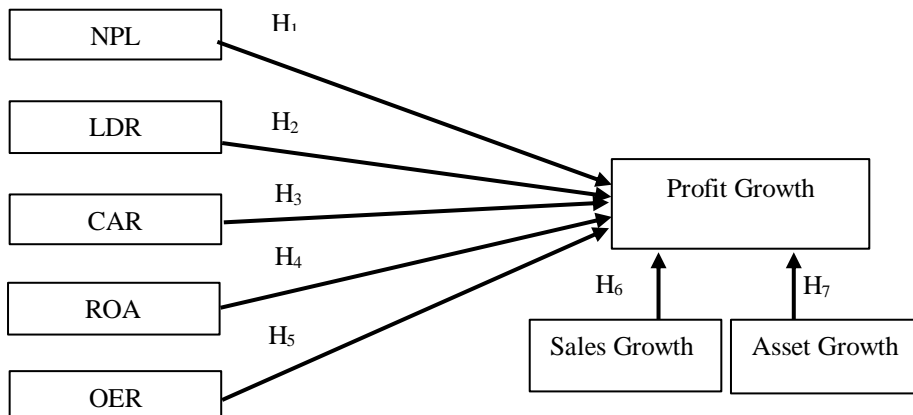
The following hypotheses were formulated considering the limited literature.

H_1: Non-performing loan has a negative impact on profit growth.
H_2: Loan to deposit ratio has a positive impact on profit growth.
H_3: Capital adequacy ratio has a positive impact on profit growth.
H_4: Return on assets has a positive impact on profit growth.
H_5: Operational efficiency ratio has a negative effect on profit growth.
H_6: Sales growth significantly impacts on profit growth.
H_7: Asset growth significantly impacts on profit growth.

RESULTS AND DISCUSSION

Descriptive statistics were carried out to obtain sample characteristics. The descriptive statistics table shows the minimum, maximum, mean, and standard deviation values, which were used as measurements of variability in this study. The descriptive analysis for PG revealed that the overall mean was -0.454, while the standard deviation was 1.019, indicating a higher variation in PG. NPL overall mean was 0.066, while the standard deviation was 0.604, indicating less variance in credit risk. Descriptive analysis for capital adequacy yielded an overall mean of 0.121, and the standard deviation was 0.221, indicating that there are fewer variations or high consistency for variations for capital adequacy. Descriptive analysis for ROA revealed that the overall arithmetic mean was 0.011, while the standard deviation was 0.029, indicating that there are fewer variations or high consistency for variations for ROA. OER overall arithmetic mean was 0.629, while the standard deviation was 0.433, indicating that there are fewer variations or high consistency for variations for operational efficiency. For the SG, the overall arithmetic mean was 0.158, while the standard deviation was 0.397, indicating fewer variations or consistency for variations for SG. The overall arithmetic mean for the AG was 0.175, while the standard deviation was 0.832, indicating fewer variations or consistency for variations for AG.

According to the correlation matrix, PG and LDR, NPL, CAR, ROA, and OER independent variables have no real systematic relationship. This implies that the linear associations between PG and these factors are relatively weak. A weak, significant positive relationship exists between CAR and LDR with a coefficient of 0.128. This implies that the CAR tends to increase slightly as the LDR increases. This might indicate that higher LDR could be associated with higher capital reserves. A weak negative significant relationship exists between ROA and LDR with a coefficient of -0.218. This implies that a higher LDR is associated with a lower ROA. It may suggest that excessive lending relative to deposits could negatively impact profitability. According to the correlation matrix, it is clear that there is no real systematic relationship between LDR and NPL, OER independent variables. There is a weak, significant positive relationship between CAR and NPL with a coefficient of 0.350. This suggests that a higher level of NPL is associated with a higher CAR. It might imply that banks with more NPLs are more conservative with their capital. According to the correlation matrix, it is clear that there is no real systematic relationship between NPL and ROA, OER independent variables. ROA and CAR have a strong negative significant relationship with a coefficient of -0.615. This indicates that the ROA tends to decrease significantly as the CAR increases. It implies that banks with higher capital adequacy may need to be more efficient in generating returns. There is a weak positive significant relationship between OER and CAR with a coefficient of 0.344. This suggests that banks with higher capital adequacy tend to have slightly higher operating expenses. It might imply that maintaining higher capital levels can result in increased costs. A moderate negative significant relationship exists between ROA and OER with a coefficient of -0.478. This implies that as operating expenses increase, the ROA tends to decrease. Banks with higher operating expenses might need help to maintain profitability. There is a weak positive significant relationship between ROA and SG with a coefficient of 0.167. This suggests that higher ROA is associated with slightly higher interest expenses. It could indicate that more profitable banks are willing to pay slightly more for borrowed funds.

The researcher used the Hausman test to choose between fixed and random effect panel data models. This study used fixed effect panel regression for all 4 Models.

Table 3

Regression Analysis

Models	Model 1 (Without Control Variables)	Model 2 (With Control Variable - SG)	Model 3 (With Control Variable - AG)	Model 4 (With All Variables)
PG	Coef.	Coef.	Coef.	Coef.
NPL	1.379	1.377	1.413	1.404
	0.364	0.366	0.347	0.351
LDR	0.208	0.209	0.288	0.291
	0.094	0.097	*0.025	*0.025
CAR	2.502	2.501	2.614	2.609
	**0.000	**0.000	**0.000	**0.000
ROA	0.041	0.006	0.844	0.699
	0.991	0.999	0.185	0.852
OER	0.219	0.219	0.234	0.236
	0.243	0.244	0.207	0.206
SG		0.006		0.027
		0.972		0.889
AG			- 0.187	- 0.189
			*0.021	*0.021

** $p<0.01$ *$p<0.05$

According to models 1 and 2, CAR significantly impacts PG, with a coefficient of 2.502, 2.501, and a P-value of 0.000. Supporting that CAR positively impacts PG of Listed Financial Companies in Sri Lanka. According to models 3 and 4, CAR significantly impacts PG, with a coefficient of 2.614, 2.609, and a P-value of 0.000. Supporting that CAR positively impacts PG of Listed Financial Companies in Sri Lanka.

AG has a significant impact on AG and PG, with a P-value of 0.021. It depicted that AG has a significant impact on PG of Listed Financial Companies in Sri Lanka.

Hypothesis Acceptance summary according to regression analysis results.

Table 4

Hypothesis Testing

Hypothesis	Model 1	Model 2	Model 3	Model 4
H_1	Not Accepted	Not Accepted	Not Accepted	Not Accepted
H_2	Not Accepted	Not Accepted	Accepted	Accepted
H_3	Accepted	Accepted	Accepted	Accepted
H_4	Not Accepted	Not Accepted	Not Accepted	Not Accepted
H_5	Not Accepted	Not Accepted	Not Accepted	Not Accepted
H_6	Not Accepted	Not Accepted	Not Accepted	Not Accepted
H_7	Not Accepted	Not Accepted	Accepted	Accepted

CONCLUSION AND IMPLICATIONS

The impact of financial soundness on firm profit growth has been widely examined for financial companies listed in CSE, with differing results based on the methodology adopted. Many empirical studies on the financial soundness and firm profit growth nexus, including those that examine the issues for the Sri Lankan context, have tested for most of the annual audited data. The aim of this study is to examine the impact of financial soundness on firm

profit growth in the Sri Lankan context with a focus on establishing the short-run impact of financial soundness on firm profit growth. Using a multiple regression model approach, the empirical analysis highlights the importance of CAR and AG for financial soundness proxy variables for firm profit growth in the Sri Lankan context.

The analyzed results accepted a positive significant impact between CAR and PG and a negative significant impact between AG and PG of Listed Financial Companies in Sri Lanka. This research will be useful to people who want to continue studying this subject. The significance of the theories employed in this study will benefit students and upcoming scholars. Correspondingly, this research will be useful in real-world applications. Because businesses, investors, regulators, and policymakers can get an understanding of the relationship between Financial Soundness and Profit Growth.

Keywords: Asset growth, capital adequacy ratio, financial soundness, loan to deposit ratio, non-performing loan, operational efficiency ratio, profit growth, return on asset, sales growth.

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