THE IMPACT OF CAPITAL GROWTH AND FINANCING SOURCES ON PROFITABILITY OF SMALL SCALE INDUSTRIES IN THE MANUFACTURING SECTOR IN SRI LANKA

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ABSTRACT

The study investigates the relationship between profitability and capital growth as well as profitability and growth of capital financing sources, i.e. equity and debt for small scale industries (SSIs) in the manufacturing sector in Sri Lanka. Financial capital is particularly important for firms in this sector because one of the major difficulties where SSIs' experience is the lack of financial capital for their growth (Bandaranayaka & Senevirathna, 2001; Lankatilaka, 1999; Binks and Ennew, 1996 and Wickramasooriya, 1995) and subsequently it brings a significant impact on profitability of firms. An understanding of the relationship between financing and profitability will lead to determine success and failure for SSIs. In addition to that, some other factors i.e. economic growth of the country, competitive strength of the firm, previous year financial leverage and size of the firm, also selected to test their significance in predicting profitability of firms.

A multi stage sample was purposely selected to obtain data for the study the stages being the industrial category basis. Since it was not possible to reach the entire industrial categories, furniture and carpentry, tea packetting and related products, chilies and other grinding mills, garments and handlooms, bakery products, and printing press were selected for the study. The sample contains 33 SSIs in the manufacturing sector and data collected over the period from 1996/1997 through 2001/2002. To qualify as a SSI in the manufacturing sector capital investment must be less than Sri Lankan rupees 20 million and that produced goods in a factory. The data utilized for the study is an accounting nature and obtained through financial records of the sample firms. The study developed hypotheses to predict the relationships of capital growth, financing sources and other factors on profitability. All the above variables are hypothesized on the basis of previous research studies and the study made use of multiple regression analysis.

The result indicates a significantly negative relationship between profitability and capital growth. When financial capital further divided in to equity and debt, the result indicates a significantly negative relationship between profitability and equity financing but there is no significant relationship between profitability and debt financing. Moreover the profitability of firms is positively related to both the external economic conditions and the firm's competitive strength. By contrast the relationship with profitability is negative for firm's previous year financial leverage. Further firm's size has no any relationship with its profitability.

Financial capital plays an important role in the profitability of firms in SSI sector (Fu, Ke and Huang, 2001). However, these results are inconsistent with the explanation that financial capital plays an important role in the profitability of firms in SSI sector in Sri Lanka. Thus firms with more adequate financial capital are more likely to experience lower profitability. That is firms invest more on projects, then they will receive lower rate of return from investment opportunities. Similarly firms with adequate equity sources are also associated with lower profitability. However, debt finance is not associated with high or lower profitability because it can be treated as negligible level of impact for SSIs in the manufacturing sector.

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