

## FINANCIAL PERFORMANCE AND STOCK PRICE: EVIDENCE FROM LISTED MANUFACTURING COMPANIES IN SRI LANKA

Ekanayake, W.Y.M.M.N.<sup>1</sup> and Indrani, M.W.<sup>2</sup>

<sup>1</sup> Department of Finance, University of Ruhuna

<sup>2</sup> Department of Accountancy, University of Ruhuna

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### Abstract

*Despite several studies on the effect of financial performance in terms of profitability on stock price, existing literature provides contradictory conclusions regarding this association. Therefore, the main purpose of this study is to explore the effect of financial performance in terms of profitability on stock price, with special reference to the listed manufacturing companies in Sri Lanka from 2011 to 2021. Earnings per Share (EPS), Return on Equity (ROE), and Return on Assets (ROA) were used as proxies of profitability since the current study aims to investigate the aspect of profitability, while the average share price was used as a proxy of stock price. Moreover, the study used three firm-specific control variables, namely, Dividend per Share (DPS), Firm Size (FS), and Debt to Equity (DE). The data was collected from the published annual reports of 29 listed manufacturing companies out of 34 listed manufacturing companies. By employing fixed effect panel regression analysis, this study aims to examine whether there is an effect of financial performance in terms of profitability on stock price. Accordingly, the findings reveal a statistically significant positive effect on stock price in terms of ROA and EPS, despite ROE indicating a negative effect on stock price. Moreover, somewhat simultaneous and divergent results were indicated by the control variables. Accordingly, FS and DE demonstrated a positive association with stock prices. Contrary to this, DPS does not indicate any association with stock price. Moreover, the findings of the study provide insights to investors for encouraging investments and maximizing their investment income, to listed companies for making policy decisions connected with stock price and other investments, and to policymakers for formulating appropriate policies to promote stock investment while regulating credit policies and interest rates.*

**Keywords:** Manufacturing Companies, Stock Price, Financial Performance

**JEL Classification:**

### 1 Introduction

Financial performance is the accomplishments made by a particular company over a particular period of time (Asmirantho & Somantri, 2017), and a number of factors could have

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Corresponding email: [induwithana@badm.ruh.ac.lk](mailto:induwithana@badm.ruh.ac.lk)

an impact on a company's financial performance in terms of profitability. Therefore, profitability ratios have been employed to evaluate the financial performance, which encompasses Return on Equity (ROE) and Earnings per Share (EPS) (Asmirantho & Somantri, 2017), and the increased financial performance of the company seems to be extremely beneficial to investors (Elliott & Schaub, 2006). Further, financial ratios, including liquidity, efficiency, profitability, leverage, and other ratios, can be deployed to uncover financial performance. Ultimately, such ratios have an effect on stock pricing decisions, and the stock price of a company may be a reliable signal of its financial well-being. Previous studies have shown that one of the most critical aspects of a company's managerial effectiveness is its stock price. Investors, therefore, assume that management has been successful in overseeing the company if its stock price increases (Karamony & Tulung, 2020).

Prior researchers have conducted empirical studies to explore the effect of financial performance in terms of profitability on stock prices in different countries (Manoppo, 2015; Syamsujial et al., 2014). Accordingly, scholars have claimed conflicting evidence. For example, financial performance negatively affects stock prices in terms of ROE (Komala & Nugroho, 2013). In contrast, ROE does not imply a significant impact on stock prices (Saputra, 2022; Talamati & Pangemanan, 2015; Vora, 2018). More interestingly, financial performance seems to have a positive effect on stock price in terms of ROE and EPS (Agrawal & Prateek, 2020; Chang et al., 2008; Prateek & Prakash, 2020; Sebastianus, 2018; Velankar et al., 2017; Wati, 2015). Besides that, some empirical studies concluded that financial performance has a negligible effect on the stock price in terms of EPS (Artha et al., 2014). Even though extensive empirical studies have been performed on this association with respect to various countries in different periods, it remains an unsolved problem due to the absence of a clear conclusion (Lee & Lee, 2022). Hence, the main purpose of this study is to explore the exact relationship between financial performance in terms of profitability and stock price in the Sri Lankan context to fill the knowledge gap.

Moreover, due to the disparities in financial performance among numerous companies, investors can evaluate the financial performance of such companies. As a consequence, they can choose the best company to employ their limited funds in order to optimize return while minimizing risk. Further, financial statements can provide information about stock prices since the stock is a substantial investment instrument (Shim et al., 2007). Moreover, assessing the financial statements published by various companies makes it easier for investors to make

investment decisions since the comparability of financial statements strengthens the interpretation of stock price information (Piotroski & Roulstone, 2004), and financial efficiency increases the net worth of stocks and influences their prospective price as well.

Few studies (Kasthury & Anandasayanan, 2020; Wijerathna et al., 2018) have been conducted on manufacturing companies in Sri Lanka, and the majority of studies (Agrawal & Bansal, 2021; Reboredo & Ugolini, 2022) focused on this correlation with respect to developed countries (Elangkumaran & Nimalathan, 2013). Thus, the findings of those studies (Berggrun et al., 2020; Chue & Xu, 2022) cannot be applied to the Sri Lankan context due to the contextual differences. Moreover, the financial performance of companies changes substantially in a timely manner. Hence, existing studies (Kasthury & Anandasayanan, 2020; Wijerathna et al., 2018) investigated this association constantly over the period, deploying numerous profitability ratios in terms of EPS, Return on Assets (ROA), and ROE and various empirical tools. For example, survey data, interviews, and fieldwork were used to collect data. Therefore, this association needs to be more thoroughly explored by employing the most recent data from 2011-2021.

## **2 Literature Review**

The association between financial performance in terms of profitability and stock price stems from two major theories, namely, agency theory and signalling theory. The agency theory suggests that agents need to boost their financial performance while acting on behalf of shareholders. A company's stock price will therefore increase if its financial performance is improved (Scott, 2009). Thus, the market responds favourably when financial performance improves by appreciating the improvement in stock prices (Cruz & Haugan, 2019). However, the poor performance of agents leads to the lower financial performance of companies and ultimately influences the reduction of investments (Hindasah & Harsono, 2021). Hence, the company's management (agents) must occasionally review the oversight of the company as it is depicted in the company's profitability (Jensen & Meckling, 2019).

According to signalling theory, companies disclose financial information across financial statements. In this context, investors are able to analyse accurate information as an analytical tool when making investment decisions (Hindasah & Harsono, 2021). Thus, investors respond favourably to market information published by a company since the financial information of a company provides them with a signal about its financial status, and investors are extremely motivated while concentrating on the disclosed financial information (Christina

& Robiyanto, 2018). Thus, stock prices of companies increased when such firms demonstrated substantially improved financial performance to encourage investments in stocks via a proper signal (Wang et al., 2020). Accordingly, the underlying idea indicated that a company's financial performance has an impact on the value of its stocks (Puspitaningtyas & Kurniawan, 2012).

The success of a company's financial performance is reflected in its stock price, and rising stock prices signify improved financial performance (Ragab & Omran, 2006). Financial performance is measured via profitability, and controversial findings have been uncovered in many studies (Alaagam, 2019; Murniati, 2016). Accordingly, EPS and ROE have a positive effect on stock prices simultaneously, and higher stock prices persuade interested parties to invest in stocks (Hendra, 2017). However, a single measurement indicator of financial performance cannot influence the stock price, and the researchers discovered that key financial performance indicators are collaborating together to influence the stock price (Macharia & Gatuhi, 2013). Hence, investors can assess the measurement indicators of financial performance collaboratively when making investment decisions (Peter & Simon, 2013). Moreover, ROE and other profitability ratios were examined to figure out how the company could assess its performance over an extended period (Bunea et al., 2019), and ROE has a positive effect on the stock price since ROE is used to assess the shareholder return on investment (Utomo, 2019). Nevertheless, the association between ROE and the stock price is not clear (Siregar & Siregar, 2012).

The correlation between profitability and stock price in terms of ROE is the subject of numerous studies. Manoppo (2015) and Albulescu et al. (2018) claim that ROE seems to have a significant effect on the stock price, thus, investors use firm-level information when making investment decisions. On the contrary, Vora (2018) claimed that investors should not focus on this association when making their decisions since it is weak and unfavourable (Badruzam, 2020), whereas the stock price has been greatly and partially impacted by ROE with respect to Indonesia's cement industry (Agrawal & Bansal, 2020). Furthermore, the effect of ROE on the stock price can be either positive or negative, depending on management's effectiveness and profitability (Raballe & Hedensted, 2008). Thus, there is no exact conclusion regarding the effect of ROE on stock prices (Eugene, 1965).

Since the EPS is one of the most crucial indicators of financial performance, it is extremely useful for predicting stock prices (Menike & Prabath, 2014). Further, various researchers (Kusnandar & Sari, 2020; Nadyayani & Suarjaya, 2021) found divergent findings on this

association in terms of EPS. Accordingly, Zhu (2003) and Sun et al. (2016) declared that EPS has a significantly positive effect on the stock price. Thus, higher stock prices result from higher EPS, which enables the company to boost dividend payments to shareholders. Consequently, the higher shareholder's return may impact investors' perceptions of stock investing (Brigham & Joel, 2010). On the contrary, EPS does not have a significant impact on stock prices since a single indicator cannot influence stock prices (Natasha, 2017). Further, domestic investors are unable to precisely measure stock prices since the EPS does not reliably forecast the stock price and has not been updated to reflect the new stock price in the market (Dongwei, 2003). However, companies can also use EPS as accounting information to forecast stock prices since EPS has a significant effect on stock prices (Arsal, 2021; Habeeb & Athambawa, 2015; Sari, 2021).

Further, a higher ROA ratio is beneficial for investors as it demonstrates that the company successfully manages its assets to produce a profit (Vora, 2018). Moreover, numerous researchers have uncovered contradictory findings on this association in terms of ROA. Accordingly, ROA has a positive effect on the stock price (Rieke & Sugiyanto, 2022; Saputra, 2022; Sholichah et al., 2021) due mainly to the moderating factors of EPS that enhance the impact of ROA on the stock price (Haryanti & Murtiasih, 2019). In light of this, a rise in ROA also results in an increase in stock price (Hayati et al., 2020). Therefore, a greater ROA stimulates investors' interest in purchasing stocks since it reveals the company's capacity for generating profit (Arifin, 2002). Even though ROA has no effect on stock price as a standalone indicator, ROA and EPS together have an impact on stock price since greater ROA denotes higher profit, which in turn implies higher EPS (Idawati & Wahyudi, 2015; Sudarman & Diana, 2022). In comparison, according to Menaje (2012), ROA only has a marginally negative correlation with the stock price, whereas ROE and ROA have a negative effect on stock price, particularly in Sri Lanka (Madhushani & Perera, 2022). Overall, the profitability of the company does not significantly affect the stock price in the non-bank financial industry (Karamony & Tulung, 2020).

This literature review reveals the inconsistency of the findings on the effect of financial performance in terms of profitability on stock prices. Furthermore, the discussion highlights that this association depends on the contextual settings and the financial performance dimension. Despite being a significant factor that has been employed in various ways to investigate the association between financial performance in terms of profitability and stock price, this association is still unresolved since there is no clear conclusion regarding this

relationship (Suhadak. et al., 2017), even though the majority of studies (Alaagam, 2019; Murniati, 2016) have been conducted (Prasetyo et al., 2021). Notwithstanding the availability of many studies (Kusnandar & Sari, 2020; Nadyayani & Suarjaya, 2021) on financial performance on stock price, very few studies (Menike & Prabath, 2014; Rajapaksha & Yapa, 2016) have been conducted in the Sri Lankan context deploying EPS, ROA, and ROE as a proxy of financial performance in terms of profitability. Therefore, EPS, ROA, and ROE were undertaken by the researchers to investigate the association between financial performance in terms of profitability and stock price to fill the knowledge gap.

### **3 Research Objectives and Methods**

#### **3.1 Research Objectives**

The main objective of this study is to investigate the effect of financial performance in terms of profitability on stock price with reference to the listed manufacturing companies in Sri Lanka.

#### **3.2 Research Methodology**

The quantitative approach was used to examine the effect of financial performance in terms of profitability on the stock price of listed manufacturing companies in Sri Lanka. As per the empirical evidence (Admi, 2019; Nadyayani & Suarjaya, 2021), financial performance in terms of profitability and stock price were well defined by the manufacturing companies while deploying numerous profitability ratios, and listed manufacturing companies properly disclosed the audited financial data on a continuous basis.

#### **3.3 Dimensions, Proxies and Measurements**

Table 1: Operationalization of variables

| Dimension   | Proxies             | Measurement   | Literature   |
|---|---------------------|---|--|
| Financial Performance: Profitability (Independent variable) | Earnings Per Share  | Profit After Tax/ Average Number of Shares Outstanding    | Asmirantho and Somantri (2017)                             |
|   | Return on Equity    | (Profit Before Taxes/Total Equity) ×100                   | Puspitaningtyas and Kurniawan (2012)                       |
|   | Return on Assets    | (Profit Before Tax/ Total Assets)*100                     | Utami et al., 2016   |
| Stock Price (Dependant variable)                            | Average Share Price | (Opening Share Price+ Closing Share Price)/2              | Menaje (2012)  |
| Control Variables   | Dividend Per Share  | Total Dividend Paid/ Average Number of Shares Outstanding | Christina and Robiyanto (2018)                             |
|   | Firm Size           | Natural Logarithm of Total Assets                         | Cheung and Ng (1992) and Senani et al. (2022)              |
|   | Debt to Equity      | Total Liabilities/Shareholder's Equity                    | Asmirantho and Somantri (2017) and Tomáš and Daniel (2017) |

### 3.3.1 Independent Variables

The achievement of a company's economic objectives through financial performance is a long-term approach (Combs et al., 2005). Meanwhile, Asmirantho and Somantri (2017) declare that a company's financial performance is its greatest achievement over a particular time period. Financial performance was the independent variable, and profitability was used in this research as a proxy for financial performance due to the financial performance well-defined by profitability, which has been used in many studies (Kasthury & Anandasayanan, 2020; Wijerathna et al., 2018) with regard to the listed manufacturing companies in Sri Lanka. Profitability means the determination of how much a firm's output is worth in excess of the resources needed to create it (Edwards & Duffy, 2014). ROE, EPS, and ROA were used as proxies of profitability as per the previous scholars following the approach adopted by Vora (2018), and Puspitaningtyas and Kurniawan (2012) since those ratios accurately and reliably measured profitability in listed manufacturing companies. Even though profitability has no long-term correlation with stock price, as per Alaagam (2019), profitability indicates a

significant association with stock price (Sitorus & Elinarty, 2017). Further, this study is limited to three indicators of profitability in terms of EPS, ROE, and ROA, despite the numerous indicators.

### **3.3.2 Dependant Variable**

Market participants determine the stock price in the marketplace, and the stock price is determined by the supply and demand of the relevant stocks in the marketplace (Anoraga & Pakari, 2003). Since the stock price reflects the corporate value, a higher stock price denotes a higher corporate value. Comparing stock prices would therefore assist investors in selecting what investments to undertake (Husnan, 2012). ASP is used as a proxy for stock price as it reflects the average stock price in each sample company as per the many studies (Anoraga & Pakari, 2003). Moreover, the study log transformed the average share price (ASP) since the data was not normally distributed following the approach adopted by Roehner (2000). This study couldn't use the direct stock price because the data was not normally distributed, thus, it is another limitation of this study.

### **3.3.3 Control Variable**

The study used three firm-specific control variables, namely, Dividend per Share (DPS), Firm Size (FS), and Debt to Equity (DE) to control for other firm-specific factors. This can be possibly due to these three variables were better connected with this association as explained by Christina and Robiyanto (2018) and Asmirantho and Somantri (2017) particularly for the listed manufacturing companies in Sri Lanka. DPS has been determined by dividing the net profit attributable to ordinary shareholders by the number of ordinary shares outstanding during the period (Christina & Robiyanto, 2018). Moreover, FS was measured through total assets and FS was log-transformed due to the data was not normally distributed following the approach adopted by Cheung and Ng (1992). Nevertheless, the DE ratio was measured through total debt to total equity (Tomáš & Daniel, 2017).

This researcher concentrates on the investigation of this association over different time periods when selecting these three variables. Therefore, when compared to other factors, these three variables were a better fit for this exploration, as numerous studies claimed various findings in relation to such factors due to many reasons. According to the empirical evidence, even though DPS has a negative effect on stock prices (Al-Tamimi et al., 2011), Menike and Prabath (2014) concluded that DPS has a positive effect on stock prices. Further, FS has a positive effect on stock price (Cheung & Ng, 1992), despite indicating a negative effect on



stock price (Shafana et al., 2013). Nevertheless, the DE ratio partly contributes to the stock price (Kusmayadi et al., 2018).

### **3.4 Population, Sampling and Sample**

As this study relates to listed companies in Sri Lanka, the researchers purposefully selected manufacturing industry sector out of 20 sectors, as per the categorisation of the Colombo Stock Exchange (CSE) of Sri Lanka as at 30<sup>th</sup> June 2022 and thus, the population of the study was 34 listed manufacturing companies. Although this study initially intended to approach every manufacturing company as the sample, it was decided to narrow the sample to 29 companies considering the sufficiently available data to arrive at a reliable and comprehensive result and findings pertaining to the phenomenon being studied and to have helpful insights and interpretations. Thus, the researchers used a stratified random sampling technique for selecting the sample from the population. Here, the researcher separated the listed manufacturing companies into distinct groups depending on their level of income, and after deciding the sample size of each stratum, randomly selected sample companies from each stratum. Accordingly, the researchers could have an efficient sample of 29 manufacturing companies for this investigation, excluding the other companies from the population owing to the insufficient firm-level data on dividend distribution and stock prices, and the selected companies have greatly contributed to the Sri Lankan economy (CSE, 2022). Hence, there are 280 firm-year observations in the final dataset.

### **3.5 Data Collection and Analysis Methods**

Even though there are numerous data collection methods, this researcher used only secondary sources to collect data from the sampled companies to achieve the purpose of this investigation since such data can be measured quantitatively. The audited and published financial statements of the selected companies were used to collect data from 2011 to 2021.

The data were analysed using the statistical software Eviews 10 to investigate the effect of financial performance in terms of profitability on stock price, following the approach adopted by Alaagam (2019) and Christine and Apriliana (2021). Descriptive statistics were used to analyse the attributes of the selected variables. The Hausman test offered a basis for using the fixed effects model over the random effect model since the Hausman statistic's value exceeds the critical value. Nevertheless, on the basis of the individual-level assumption that particular impacts are not time-invariant, the fixed effects model is employed. Further, since this study

explores the association between exploratory variables and dependent variables within a group, a fixed effect model is most appropriate. Therefore, fixed-effect panel regression analysis was used to investigate how financial performance in terms of profitability affects stock prices. Moreover, variance inflation factors (VIF) were employed to detect the multicollinearity issues. Before undertaking the fixed-effect panel regression model, a number of assumptions were tested. Firstly, outliers were removed to observe accurate data and test normality, linearity, multicollinearity, and independence. Equation 1 indicates the regression equation used by the study.

$$SP_{it} = \alpha + \beta_1 ROE_{it} + \beta_2 EPS_{it} + \beta_3 ROA_{it} + \beta_4 DPS_{it} + \beta_5 L\_FS_{it} + \beta_6 DE_{it} + \varepsilon_{it} \text{-----} (1)$$

In equation 1, SP denotes the vector of stock price measures using the average share price. Moreover, ROE denotes the return on equity, while EPS and ROA indicate earnings per share and return on assets, respectively. Nevertheless, DPS indicates dividend per share, and L\_FS and DE denote log firm size and debt-to-equity ratio, respectively. Further, *i* indicates individual firms and *t* denote the time. Intercept, regression coefficients, and random error are denoted by  $\alpha$ ,  $\beta$ , and  $\varepsilon$ , respectively. The following are the hypotheses that were developed for this study as per the literature:

**H<sub>1</sub>:** There is a statistically significant association between financial performance in terms of profitability and stock price of listed manufacturing companies

**H<sub>1</sub>:**  $\beta_i \neq 0$

**H<sub>0</sub>:** There is no statistically significant association between financial performance in terms of profitability and stock price of listed manufacturing companies

**H<sub>0</sub>:**  $\beta_i = 0$

#### **4 Results and Discussion**

The study explores the effect of financial performance in terms of profitability on stock price using published data from the selected companies from 2011 to 2021. The descriptive statistics and fixed effect panel regression results are taken into consideration to determine whether the financial performance in terms of profitability has an effect on the stock price. Before undertaking panel regression, boxplots were used to identify outliers in the data set and remove them since the extreme outliers distort the results of the analysis. By analyzing

the data without removing outliers, the researchers cannot draw a more statistically valid conclusion regarding this association, as outliers boost the variability of the data and reduce its statistical power. Moreover, the data sorted for the desired study objectives were illustrated, while the discussion is mainly focused on the two parts. The 280 observations were examined using descriptive statistics in the first part, as depicted in Table 2, while the second part indicates the fixed effect panel regression analysis used to investigate the association between financial performance in terms of profitability and stock price, as indicated in Table 3. Eviews 10 statistical software was used for the fixed effect panel regression analysis, and the findings are indicated in the discussion along with the appropriate descriptive statistics, coefficients, and hypothesis testing.

#### **4.1 Descriptive Statistics**

Table 2 depicts the descriptive statistics that were derived without taking into account the detected outliers. As indicated in Table 2, EPS among the listed manufacturing companies has dispersed marginally. Further, ROA and ROE have also varied relatively during the study period. Therefore, these statistics imply that the financial performance in terms of profitability of listed manufacturing companies over the study period has not significantly changed. As per Table 2, DPS is moderately dispersed over the study period. This suggests that the dividend payments among the listed manufacturing companies have largely persisted low on average during the study period. However, the DE ratio has been more dispersed during the period. This suggests that the manufacturing companies have used a significant level of debt in proportion to the worth of shareholders' equity to finance their assets. Hence, such companies have to modify their DE ratio since it represents a greater risk of failing on their debts and could have a higher chance of obtaining advantageous funding arrangements. Nevertheless, L\_FS and L\_ASP among the manufacturing companies were also significantly varied during the study period, as implied in Table 2.

Table 2: Descriptive Statistics of variables

| Symbol | variable            | N   | Minimum | Maximum | Mean | SD    | CV % |
|--------|---------------------|-----|---------|---------|------|-------|------|
| EPS    | Earnings per Share  | 280 | -60.21  | 83.16   | 6.37 | 14.21 | 2.23 |
| ROE    | Return on Equity    | 280 | -99.96  | 67.74   | 6.61 | 16.70 | 2.53 |
| ROA    | Return on Assets    | 280 | -27.35  | 55.31   | 3.60 | 8.60  | 2.39 |
| DPS    | Dividend per Share  | 280 | -0.15   | 26.99   | 1.74 | 3.01  | 1.73 |
| DE     | Debt to Equity      | 280 | -0.08   | 15.39   | 1.23 | 1.73  | 1.41 |
| L_FS   | Firm Size           | 280 | 6.67    | 11.18   | 9.65 | 0.91  | 0.09 |
| L_ASP  | Average Share Price | 280 | -0.19   | 5.19    | 1.75 | 0.74  | 0.42 |

Note: SD and CV stand for standard deviation and coefficient of variation respectively.

## 4.2 Trend Analysis

Figure 1 shows that EPS greatly fluctuated during the study period, reaching its minimum in 2015 and its maximum in 2012. DPS and DE show a slide variance during the study period. The proportion of outstanding foreign debt to total central government debt significantly dropped to 40.0% at the end of 2020 from 47.6% at the end of 2019, which might have contributed to the fluctuation of DE through the declining capability of providing loans for domestic companies. Nevertheless, a significantly higher DE ratio in 2019 was caused by an increase in manufacturing lending from 21.9% and the introduction of loan schemes consisting of the General Loan Scheme and Technical Transfer Assistance Loan Scheme, which provide preferential financing, particularly to manufacturing firms.

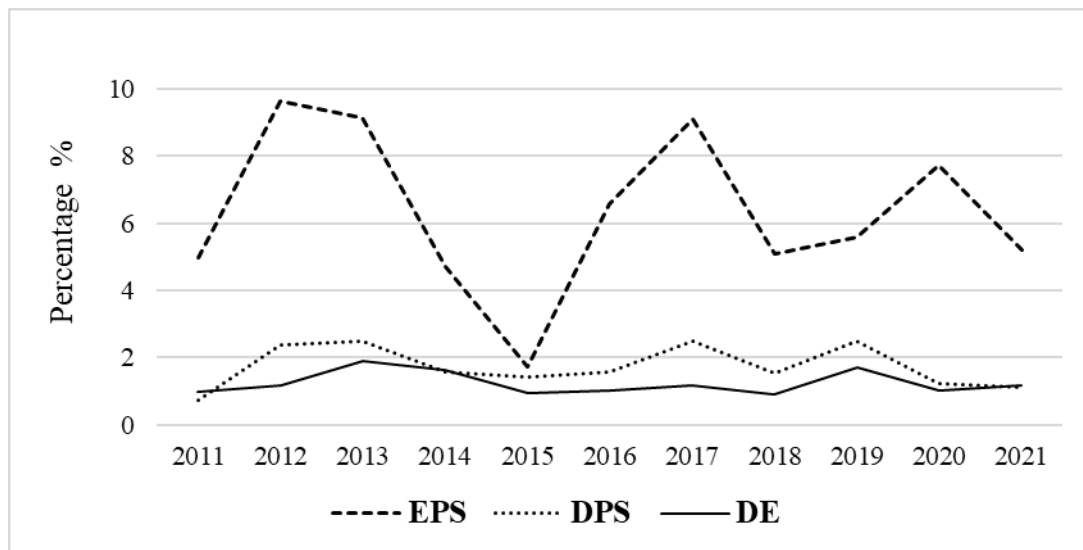


Figure 1: Trends of the selected variables during 2011-2021

Figure 2 suggests that ROE remained relatively low from 2017 to 2021. However, ROE reported an unusual peak in 2013, while the lowest was in 2019. The higher ROE in 2013 could be driven by a secure and reliable approach to efficient transaction settlement at both small and large value payment platforms without any significant systemic risk, the operational efficiency of manufacturing companies, financial leverage, and efficient use of assets. However, ROE has slowly increased from 2019 to 2021 despite the detrimental effects of the COVID-19 pandemic, and this is mainly due to the increased portfolio of products used to diversify revenue streams while retaining operational profitability in CSE. Moreover, as per Figure 2, firm size has also marginally fluctuated during the study period among the companies, while it has remained relatively high from 2011 to 2021.

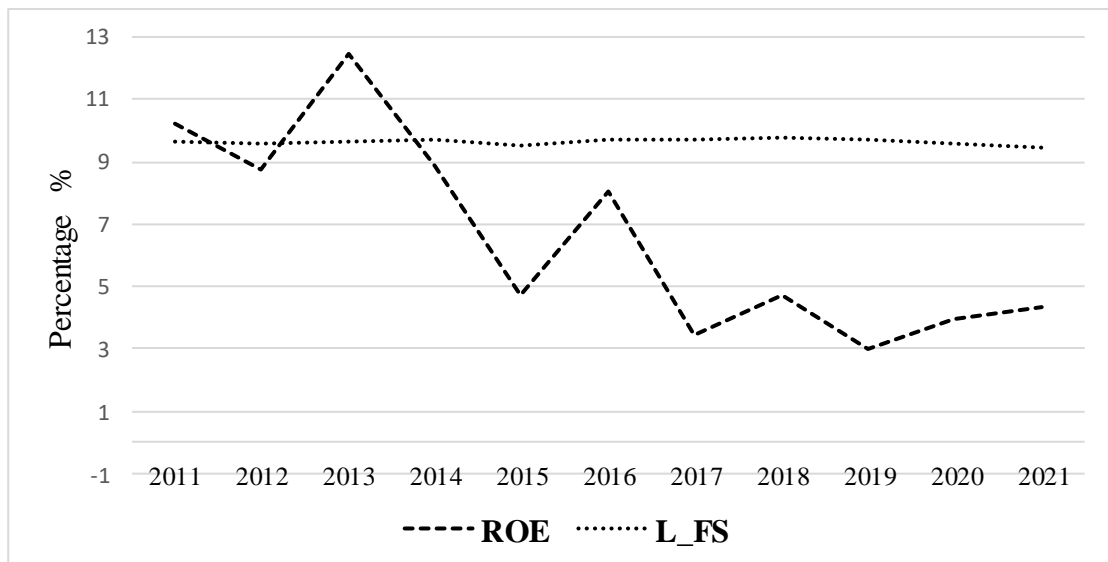


Figure 2: Trends of the ROE and L\_FS during 2011-2021

The imaginative economic policy framework of the government is anticipated to break down growth barriers and boost domestic manufacturing companies in 2020, particularly through the agricultural industry and other designated export areas, while fostering foreign exchange, which does not result in debt inflows. The challenges caused by the epidemic made it even more necessary to develop a novel strategy to achieve sustained economic development, expansion, and stability. However, due to the pandemic-induced global economic crisis, the economy of Sri Lanka dropped by 3.6% in real terms in 2020, marking the country's deepest recession since independence. Real economic activity in all manufacturing companies was impeded by travel restrictions and other containment measures implemented locally and internationally to stop the spread of COVID-19. The severe slowdown in manufacturing was

the main cause of the year's sharp contraction in industry activity. All of these factors might have contributed to the underwhelming financial performance through profitability in terms of ROE, EPS, and ROA.

Further, figure 3 illustrates the fluctuations in average share price among the listed manufacturing companies during the study period. According to Figure 3, the stock price has increased in 2021 compared to 2020. This can be mainly due to the growing involvement of Sri Lankan investors, mainly foreign investors, who were significant sellers on the market in 2021 as a consequence of shifting trends in the worldwide flow of capital and the outlook for the nation. Further, notwithstanding the recent rise in policy and interest rates in the market, the ASP has maintained its upward trend, expanding at an average rate of 80% (CSE, 2021).

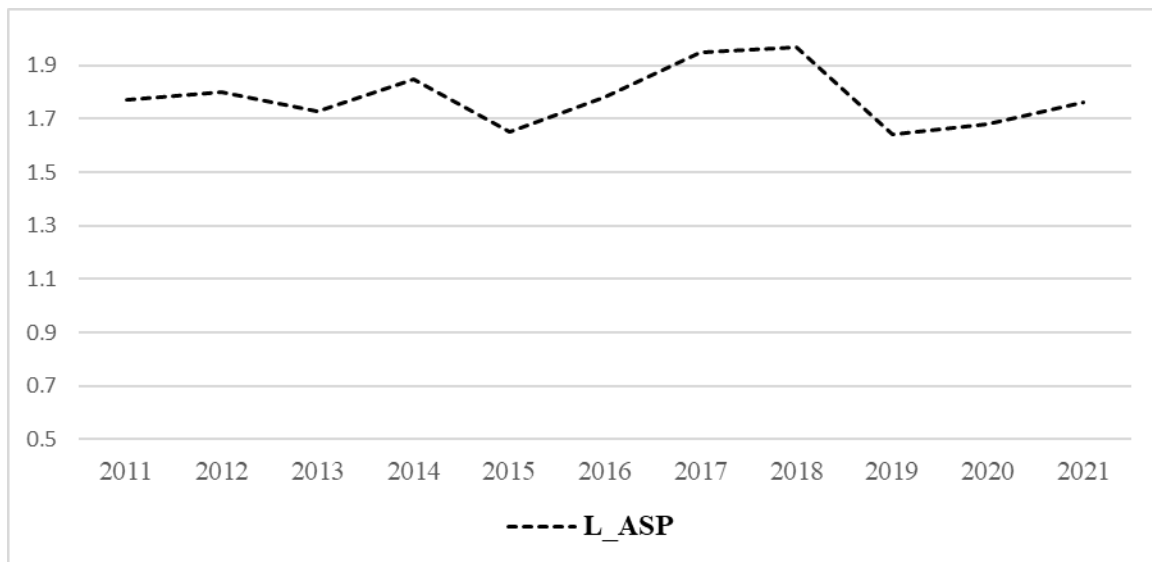


Figure 3: Fluctuations of L\_ASP during 2011-2021

#### 4.3 Regression Results

Fixed effect panel regression model specified in equation 1 was used to estimate the effect of financial performance in terms of profitability on the stock price of listed manufacturing companies in Sri Lanka using annually published data from 2011 to 2021. The regression results are indicated in Table 3. Accordingly, the overall regression model was statistically significant in predicting stock price ( $R^2 = .117$ ,  $F = 6.031$ ,  $p < .001$ ). Therefore, around 11.7 per cent of the variation in stock price is explained by the explanatory variables. The Durbin-Watson value was approximately 0.5, which suggests that the residuals have no autocorrelation issues and there is no severe multi-collinearity issues in all variables.

Table 3 implies that the EPS has a statistically significant positive effect on stock price ( $\beta = .015$ ,  $p < .001$ ). This can be partly due to the CSE's surge in earnings, driven by an active

market that saw record participation from investors and issuers. This suggests that the higher profit of the firms generates higher returns for the shareholders while attracting investors due to such companies having improved operating cost efficiency while simultaneously improving financial performance and management. However, this finding is contrary to the findings of Neha and Kanchan (2017), since EPS does not affect the stock price due to other factors that affect the stock price.

Moreover, as indicated in Table 3, ROE indicates a statistically significant negative effect on stock price ( $\beta = -.014$ ,  $p < .001$ ). This suggests that higher profitability in terms of ROE indicates higher financial performance and a lower stock price. This result is in line with the findings of Hendra (2017). However, this finding is contrary to the finding of Vora (2018) due to the fact that such studies were conducted in different countries during different periods. Further, ROA indicates a statistically significant positive effect on stock price ( $\beta = .017$ ,  $p = .06$ ). This result is in line with the findings of Vora (2018), Abdel and Al-Slehat (2020), and Carmela (2015).

There are three firm specific control variables to control the other factors that affect the stock price, namely, FS, DPS, and DE ratio. As indicated in Table 3, FS has a statistically significant positive effect on stock price ( $\beta = .095$ ,  $p = .05$ ). This implies that larger companies are more profitable. As a consequence, manufacturing firms' stock prices increase due to their greatest ability to generate profit. Nevertheless, this result might have been caused by the higher EPS, ROE, and other profitability ratios of manufacturing firms.

Furthermore, the DE indicates a statistically significant positive effect on stock price ( $\beta = .059$ ,  $p = .030$ ). This suggests that firms with higher debts relative to their equity are able to maintain higher stock prices. This result is slightly different from the finding of Dimas et al. (2014). However, DPS does not indicate a statistically significant effect on stock price ( $\beta = -.012$ ,  $p = .459$ ) despite the CSE encouraging services relating to corporate action, such as dividend payments. Overall, this study suggests that there is a straightforward association between financial performance and stock price. However, the effect of financial performance in terms of profitability may vary with the different indicators of profitability as aforementioned. Therefore, the null hypothesis ( $H_0$ ) is rejected. Therefore, the null hypothesis ( $H_0$ ) is rejected.

Table 3: Results of the fixed effect panel regression model during 2011-2021

| Symbol   | Variable           | Coefficient |     | Std. Error |
|----------|--------------------|-------------|-----|------------|
| $\alpha$ | (Constant)         | 0.725       | *   | 0.467      |
|          |                    | (1.550)     |     |            |
| EPS      | Earnings per Share | 0.015       | *** | 0.003      |
|          |                    | (4.409)     |     |            |
| ROE      | Return on Equity   | -0.014      | *** | 0.005      |
|          |                    | (-2.997)    |     |            |
| ROA      | Return on Assets   | 0.017       | *   | 0.009      |
|          |                    | (1.844)     |     |            |
| L-FS     | Log of Firm Size   | 0.095       | **  | 0.049      |
|          |                    | (1.952)     |     |            |
| DE       | Debt to Equity     | 0.059       | **  | 0.027      |
|          |                    | (2.175)     |     |            |
| DPS      | Dividend per Share | -0.012      |     | 0.016      |
|          |                    | (-0.741)    |     |            |
|          | R <sup>2</sup>     | .117        | *** | p <.001    |
|          | F                  | 6.031       |     |            |

Source: Eviews 10 – Panel regression analysis coefficients of stock price, ROE, EPS, ROA, L\_FS, DE, DPS (2011 – 2021).

Note: \*\*\*, \*\* and \* respectively indicate that statistical significance is a 1%, 5%, and 10% level

*t* statistics are indicated within parentheses

## 5 Conclusion and Implication

The study examines the effect of financial performance in terms of profitability on the stock price of listed manufacturing companies in Sri Lanka from 2011 to 2021. Investors are extremely concerned about profitability and stock price volatility in the current global financial context as they seek to maximize their return on investments. Numerous scholars have investigated how profitability affects the stock price, particularly in developed countries, and they have discovered conflicting findings. Thus, the purpose of this study was to investigate the effect of financial performance in terms of profitability on stock price in the emerging Sri Lankan context.

As per the regression analysis, the model is well-fitted, and the F statistic shows that ROE, ROA, and EPS may have an influence on stock price simultaneously or jointly. Nevertheless, since the R<sup>2</sup> value only focuses on 11.7% of the stock price fluctuation, other variables that are not explored in this study might be responsible for the remaining 88.3% of the variation. Further, the coefficient table indicates how much volatility in stock prices can be anticipated based on changes in the number of independent variables. Even though the ROE implies a statistically significant negative effect on the stock price, EPS and ROA have a statistically significant positive effect on the stock price. Thus, the results of this study provide strong



evidence to claim that financial performance in terms of profitability has a significant effect on stock price, and the effect of financial performance in terms of profitability on stock price varies with the different measurement indicators of financial performance. This result is somewhat different from those of Alaagam (2019), since they concentrated on the banking sector while employing various measurement indicators of profitability, including ROE, ROA, and net profit margin, and using 308 observations. Whereas this result is in line with the findings of Murniati (2016), even though debt to assets were employed as proxies while using 11 sample companies in the food and beverage industry.

The stock price is one of the most crucial market-based performance indicators companies pay attention to. However, a variety of macroeconomic (gross domestic products, interest rate, and inflation) and microeconomic variables (demand and supply, regulations, and taxes) may have an impact on the stock price. Despite there being an abundance of literature on the influence of microeconomic factors on stock price, there are a few investigations on the influence of macroeconomic factors on stock price. Thus, the study will provide recent evidence on the effect of financial performance in terms of profitability on stock prices in Sri Lanka. Moreover, the findings of this study provide insights for investors since they can analyze these findings before making their investment decisions as they help them understand the real connection between those variables.

Interested parties can get better knowledge regarding this association through this investigation and they can improve financial performance and stock price while applying appropriate strategies according to the different variables as such variables indicate the divergent relationship in terms of profitability. Hence, investors can make informed decisions through a comprehensive understanding of the company's financial position, profitability, and equity position while evaluating the profitability of the investment. Further, listed companies can make their investment decisions and create corporate strategies pertaining to financing and investment by considering these findings. Moreover, companies can finance their assets through leverage, and firms can utilize financing via debt to invest in their operations in an effort to create value for shareholders and improve their overall financial performance. However, companies and investors need to carefully examine this association in a timely manner for different industry sectors. Further, policymakers are able to formulate appropriate policies to improve the financial performance of the economy as well.

## **6 Limitations and Research Directions**

### **6.1 Limitations**

Notwithstanding the aforementioned contributions, this study is limited to manufacturing companies in Sri Lanka. There are numerous manufacturing companies headquartered in Sri Lanka that are not registered with the CSE. In light of the inconvenience of gathering data from all of these manufacturing companies, the researchers, however, only refers to a sample of manufacturing companies listed in the CSE. Therefore, it will be more advantageous if future investigators focus on a similar area of concern based on all such manufacturing companies operating in Sri Lanka. Moreover, this study used data from 29 manufacturing companies from 2011 to 2021, thus, the findings of this study may not be suitable for every sector and every company in the manufacturing sector as well. Further, only secondary sources were used for collecting data from the selected companies, despite primary data sources.

### **6.2 Research Directions**

This study focused only on financial performance via profitability in terms of ROE, ROA, and EPS, despite the availability of many indicators of profitability and financial performance. Nevertheless, this study neglects the supplementary approaches, which survey data, and only concerns the secondary sources of data in selected listed companies of CSE. Therefore, future researchers can extend their further investigations by employing different measurement indicators of financial performance, particularly profitability and stock price, in addition to the indicators used by the current study to explore the association between financial performance and stock price, employing both primary and secondary sources of data. Moreover, future researchers can select numerous industries over the manufacturing companies, with a large sample size covering long durations since the current study investigated the data from 2011 to 2021.

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