

**STUDY ON THE RELATIONSHIP BETWEEN LIQUIDITY AND  
PROFITABILITY OF LISTED COMPANIES IN COLOMBO  
STOCK EXCHANGE  
(A COMPARISON STUDY AMONG THREE SECTORS)**



**MARABADDE RATHNAYAKA MUDIYANSELAGE CHANDANI  
KUMARI RATHNAYAKA**

**1724**



## ABSTRACT

Profitability and liquidity are the most prominent issues in the corporate finance literature. The ultimate goal for any firm is to maximize profitability. However, too much attention on profitability may lead the firm into a pitfall by diluting the liquidity position of the organization. In this way, the present study is initiated to find the relationship between liquidity and profitability. The study covered thirty listed companies which were selected from manufacturing, services and trading sectors in Colombo Stock Exchange over the period of five years from 2011 to 2015. Liquidity was measured by using current ratio and quick ratio and profitability was measured by using return on assets, return on equity and return on capital employed. Descriptive analysis, correlation analysis and regression analysis were used in analysis and finding suggests that there is significant and weak negative relationship between liquidity and profitability of selected manufacturing companies in CSE and companies in services sector have very weak negative relationship between liquidity and profitability while that relationship is statistically insignificant. There is partially significant and negative relationship between liquidity and profitability of trading sector in CSE. Finally it was concluded that, level of liquidity and profitability varied from sector to sector and also strength of negative relationship between liquidity and profitability varied from sector to sector. However, the findings of this research are based on a study conducted on the selected companies from three sectors. Hence, the results are not generalizable to companies in other sectors. The finding is more useful to financial managers of companies for taking sound decisions on proper tradeoff between liquidity and profitability.



## Table of Contents

Acknowledgement.....	I
Abstract.....	II
Table of Contents.....	III
List of Tables.....	VIII
List of Figures.....	IX
Abbreviations.....	X

### Chapter One

1.1 Background of the Study.....	01
1.2 Problem statement.....	03
1.3 Research questions.....	04
1.4 Objectives of the Study.....	04
1.5 Scope of the Study.....	04
1.6 Significance of the Study.....	05
1.7 Summary.....	05

### Chapter Two

2.1 Introduction.....	06
2.2 Liquidity.....	06
2.2.1 Liquidity management.....	06
2.3 Factors that affect liquidity requirement of an organization.....	07
2.3.1 Nature and size of business.....	07
2.3.2 Manufacturing cycle.....	08
2.3.3 Business fluctuations.....	08
2.3.4 Production policy.....	09
2.3.5 Credit terms.....	09
2.4 Liquidity ratios.....	10
2.4.1 Current ratio.....	10
2.4.2 Quick ratio.....	11
2.5 Profitability.....	12
2.6 Profitability ratios.....	12

2.6.1	Return on capital employed .....	13
2.6.2	Return on assets .....	14
2.6.3	Return on equity .....	14
2.7	Liquidity and profitability relationship .....	15
2.8	Empirical review .....	16
2.9	Summary .....	20

### Chapter Three

3.1	Introduction.....	21
3.2	Conceptualization.....	21
3.3	Defining Variables.....	22
3.3.1	Independent variable .....	22
3.3.1.1	Current ratio .....	22
3.3.1.2	Quick ratio .....	22
3.3.2	Dependent variable .....	23
3.3.2.1	Return on capital employed .....	23
3.3.2.2	Return on assets .....	23
3.3.2.3	Return on equity .....	24
3.4	Operationalization.....	24
3.5	Summary.....	26

### Chapter Four

4.1	Introduction.....	27
4.2	Study setting, Study design and Method of Survey.....	27
4.2.1	Study setting.....	27
4.2.2	Study design.....	27
4.2.3	Method of data collection.....	28
4.3	Study population and sample.....	28
4.3.1	Study population.....	28
4.3.2	Sampling.....	28
4.4	Data collection.....	29
4.5	Method of measurement.....	29
4.6	Hypothesis of study.....	30



4.7	Method of data presentation .....	31
4.8	Method of data analysis and evaluation .....	31
4.8.1	Univariate analysis .....	31
4.8.1.1	Descriptive statistics .....	31
4.8.2	Bivariate analysis .....	31
4.8.2.1	Correlation analysis .....	32
4.8.2.2	Simple regression analysis .....	33
4.9	Summary.....	33

## Chapter Five

5.1	Introduction.....	34
5.2	Descriptive analysis .....	34
5.2.1	Descriptive analysis of liquidity .....	34
5.2.1.1	Descriptive analysis of liquidity in manufacturing, services and trading sectors .....	34
5.2.1.2	Mean values of current ratio and quick ratio of three sectors .....	35
5.2.2	Descriptive analysis of profitability .....	37
5.2.2.1	Descriptive analysis of profitability in manufacturing, services and trading sectors .....	37
5.2.2.2	Mean values of return on assets, return on equity and return on Capital employed .....	38
5.3	Correlation analysis .....	40
5.3.1	Correlation analysis of research variables in manufacturing sector .....	41
5.3.2	Correlation analysis of research variables in services sector ...	42
5.3.3	Correlation analysis of research variables in trading sectors ...	43
5.3.4	Summary of correlation analysis .....	44
5.4	Regression analysis .....	44
5.4.1	Regression analysis of manufacturing sector .....	44
5.4.2	Regression analysis of services sector .....	45
5.4.3	Regression analysis of trading sector .....	46
5.4.4	Summary of regression analysis .....	47

5.5	Summary of tested hypothesis .....	48
5.6	Summary .....	48
<b>Chapter Six</b>		
6.1	Introduction.....	49
6.2	Discussion on descriptive statistics .....	49
6.2.1	Discussion on independent variable .....	49
6.2.2.1	Discussion on liquidity level .....	49
6.2.1.1.1	Manufacturing sector .....	49
6.2.1.1.2	Services sector .....	50
6.2.1.1.3	Trading sector .....	50
6.2.1.1.4	Comparison of liquidity level among three Sectors .....	50
6.2.2	Discussion on dependent variable .....	51
6.2.2.1	Discussion on profitability level .....	51
6.2.2.1.1	Manufacturing sector .....	51
6.2.2.1.2	Service sector .....	51
6.2.2.1.3	Trading sector .....	52
6.2.2.1.4	Comparison of profitability level among three sectors .....	52
6.3	Discussion on bivariate analysis .....	52
6.3.1	The relationship between liquidity and profitability .....	52
6.3.1.1	Manufacturing sector .....	53
6.3.1.2	Services sector .....	53
6.3.1.3	Trading sector .....	53
6.3.1.4	Comparison among three sectors .....	54
6.3.2	The impact of liquidity position on profitability .....	54
6.3.2.1	Manufacturing sector .....	55
6.3.2.2	Services sector .....	55
6.3.2.3	Trading sector .....	55
6.3.2.4	Comparison among three sectors .....	56
6.4	Summary .....	56

## Chapter Seven

7.1	Introduction.....	57
7.2	Conclusions.....	57
7.3	Recommendations.....	58
7.4	Suggestions for the further research.....	60
7.7	Summary.....	60

<b>References List.....</b>	<b>61</b>
-----------------------------	-----------

## Appendix

Appendix - 1: The data set used for the study

Appendix - 2: The Output of the SPSS Analyses

Appendix - 3: Index of Statistical Definitions