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# Impact of Accounting Ratios on Stock Market Price of Listed companies in Colombo Stock Exchange

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## Abstract

This study investigates the impact of accounting ratios on stock market price of top twenty companies based on the highest market capitalization listed in the Colombo Stock Exchange (CSE). The objectives of this study were to examine the impact of Earnings per Share (EPS) on stock market price; to examine the impact of Dividend per Share (DPS) on stock market price, to examine the impact of Price Earnings ratio (PE) on stock market price and to examine the impact of Market to Book ratio (MB) on stock market price. The panel data was collected from the top twenty companies for the period of five years from 2015 to 2019. EPS, DPS, PE and MB ratios were used as the proxies for the independent variables and stock price was used as the proxy for the dependent variable for this study. In order to perform the inferential analysis Pearson correlation analysis, panel regression with fixed effect, random effect and pooled linear regression were used. Hausman test was adopted in order to choose either random effect regression or fixed effect regression. According to pooled regression analysis, EPS, DPS and PE ratios had positive significant impact on stock market price. MB ratio had a negative significant impact on stock market price. According to fixed effect regression analysis, EPS, PE and MB ratios had positive insignificant impact on stock market price whereas DPS had a positive significant impact on stock market price. This study offers an insight to the potential investors to make the rational investment decisions in the stock market.

**Keywords:** Dividend Per Share (DPS), Earnings Per Share (EPS), Price Earnings (PE) Ratio, Market to Book (MB) Ratio, Colombo Stock Exchange (CSE)

## 1. Introduction

### 1.1. Background of the Study

General purpose financial statements are one of the modes of financial reporting. The objective of general-purpose financial reporting is to deliver the accounting information of the reporting entity that is valuable to

existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (International Accounting Standards Board, 2020). Thus, it ensures the quality of information and supports the decision-making process. Accounting information should be relevant and reliable to make the investment decisions for the investors. Accounting information can be recognized as one of the utmost important sources to analyze the share price and value of companies (Sarifudeen, 2016; Dorcas & Francis, 2010). Investors should be more aware of the stocks when they start to invest in the stock market. Stock price of a company is an important factor as it directs an investor to identify which company is most profitable company to invest (Dorcas & Francis (2010). IASB is emphasizing improving the quality of accounting information in order to increase the transparency in the financial reporting. Accounting information is essential in making proper investments and reduces the information asymmetry between managers and other stakeholders of an organization. Stocks enable companies to pursue long term financing. Stock exchange in every country quickens economic growth by improving domestic savings and quantity of investments. Accounting ratios play a significant role in determining the stock price. Accounting information parameters had significant impact on share price of a stock market (Modi & Pathak, 2014 & Ndubuisui, Fidelis, Chinyere & Leonard, 2018). This study identified four accounting ratios such as Earning per Share (EPS), Dividend per Share (DPS), Price Earnings (PE) ratio and Market to Book (MB) ratio. This research focuses on how these accounting ratios affect market price of top twenty listed companies in Sri Lanka.

### *1.2. Research Problem*

Stock market has become popular nowadays among the investors as they are more concerned about the forecasting of share prices. Most investors rely on accounting ratios to make their decisions. Also, companies which provide good quality information have an advantage of lower cost in share pricing. Investigation of the value relevance of accounting information is very important in deciding market price (Ndubuisui, Fidelis, Chinyere & Leonard, 2018). The accounting ratios provide investors with crucial information to assess their rational investments decisions. Therefore, it is envisioned to investigate the impact of accounting ratios on share price. The following research questions are derived from the research problem:

- Does the EPS impact on stock market price?
- Does the DPS impact on stock market price?
- Does the PE ratio impact on stock market price?
- Does the MB ratio impact on stock market price?

### *1.3. Relevant Literature*

This section gives the relevant empirical literature.

#### *1.3.1. Empirical Literature*

Using 120 Nigerian companies for the period of three years from 2001 to 2003, Oyerinde (2009) examined a study on the impact of accounting ratios on stock market price. The findings of this study revealed that EPS had positive significant impact on share price. Majority of the companies' book value was sensitive to the market price of share. Another study conducted by Dorcas and Francis (2010) about the role of accounting figures in the Nigerian Stock Exchange found that there was a significant relationship between accounting figures and share prices of companies. Titiliyo, Salako, Folashade and Obiamaka (2015) explored a study on the impact of accounting information on stock prices in the Nigerian Stock Exchange using the value relevance of accounting information. The findings showed that accounting information had a significant relationship with share prices.

A study by Modi and Pathak (2014) on the value relevance of accounting ratios on the Indian stock market revealed that accounting ratios had significant impact on stock market price. The P/E ratio was positively correlated with the share price. Miah (2012) explored a study to investigate the empirical relationship between equity share prices and accounting variables in the 105 listed companies in Dhaka Stock Exchange for the period

of sixteen years from 2000 to 2015 using Book value per share, EPS, DPS, PE and Dividend payout ratio. The study found that EPS, DPS and book value per share had a significant impact on the market price of share. Khan, Gul, Rehman, Razzaq and Kamran (2012) studied the ability of EPS, dividend yield and MB in forecasting stock return for 100 non-financial companies listed on the Karachi Stock Exchange for the period of seven years from 2005 to 2011. Findings of this study revealed that the EPS had positive significant impact on stock return and MB ratio had negative significant relationship with stock return. Using 60 listed companies in Shanghai Stock Exchange in 2011, Wang, Fu and Luo (2013) explored a study to analyze the relationship between accounting ratios and stock market price. The findings revealed that EPS and ROE had positive significant impact on the stock price. Uwuigbe, Igbinoba, and Oni-Ojo (2016) investigated a study on the value relevance of financial information on the share price of 15 listed Banks in Nigeria for the period of five years from 2010 to 2014. The study analysis showed that EPS and book value per share had significant positive impact on the share price. Asif, Arif and Akbar (2016) studied the impact of accounting information on the share price for the companies listed in the Karachi Stock Exchange, covering the period of 8 years from 2006 to 2013. The study concluded that accounting information parameters had significant impact on the share price.

Using the valuation model, Hassan, Hasan and Haque (2017) studied the relationship between the value-relevance of accounting information and the share prices of 93 companies from six broad industries listed on the Dhaka Stock Exchange. Findings revealed that EPS and book value had a significant impact on share prices. For the period of 10 years from 2006 to 2015, Pražák and Stavárek (2017) investigated the impact of the microeconomic factors on the stock prices of energy industry companies listed in Prague Stock Exchange and Warsaw Stock Exchange. The analysis showed that financial leverage ratio had a positive significant impact on stock price and the liquidity ratio had negative significant impact on the stock price. Ndubuisui, Fidelis, Chinyere and Leonard (2018) examined a study to identify the effect of accounting information on the market price per share of listed companies on the Nigeria Stock Exchange over the period of 7 years from 2010 to 2016. The analysis found that EPS, DPS and ROE had positive significant impact on the market share price. Hung, Ha and Binh (2018) analyzed the impact of accounting information on financial statements on the stock price of 44 energy enterprises listed on Vietnam's stock market over the period of 11 years from 2006 to 2016. The findings revealed that return on assets, enterprise size, current ratio and accounts receivable turnover were positively correlated with the stock price.

Menike and Prabath (2014) investigated a study on the impact of accounting variables on the stock price of 100 listed companies in the Colombo Stock Exchange (CSE) for the period of years from 2008 to 2012. The study found that EPS, DPS, book value per share had positive significant impact on the stock price. Perera and Thrikawala (2010) investigated a study on the impact of accounting ratio on the share price of Sri Lankan banking sector from the year 2006 to 2009. Findings showed that EPS, earning yield and ROE had value relevance on market price. Vijitha and Nimalathasan (2014) explored a study to examine the impact of value relevance of accounting information on share price of selected listed companies in Sri Lanka. The analysis showed that EPS, net assets value per share and ROE were significantly associated with the share price. PE ratio was negatively correlated with the share price. Regression analysis found that EPS and net assets value per share had significant impact on share price and ROE and PE ratio were found insignificant impact on the share price. Using 65 listed companies in Sri Lanka from the food and beverage, tobacco, manufacturing, plantation, land and property and chemicals and pharmaceutical industries, Sarifudeen (2016) examined impact of EPS, DPS and Net assets value per share on stock prices for the period of 5 years from 2010 to 2014. Results revealed that coefficients of correlation between independent and dependent variables were significant

According to the above literature it can be observed that most of the research studies have been conducted using panel data. Also, there are different accounting ratios were used to identify their impact on stock price and there was no any order of variables used. Throughout the keen literature review the current study identifies there is an existence of relationships between accounting ratios and stock prices.

#### *1.4. Objectives of the Study*

The objectives of this study are as follows:

To examine the impact of EPS on stock market price.

To examine the impact of DPS on stock market price.

To examine the impact of PE ratio on stock market price.

To examine the impact of MB ratio on stock market price.

#### *1.5. Hypotheses and Their Correspondence to Research Design*

Following Hypothesis built to achieve the stated objectives in the study.

H1: There is a significant relationship between EPS and the stock market price.

H2: There is a significant relationship between DPS and the stock market price.

H3: There is a significant relationship between PE ratio and the stock market price.

H4: There is a significant relationship between MB ratio and the stock market price.

The remaining of this research paper is structured as follows: Section 2 describes Methods and/or techniques; section 3 shows the results; section 4 shows the discussions and section 5 shows the conclusion of this study.

## **2. Methods and/or techniques**

This section covers the research approach, population and sample of the study, data collection, variables, conceptual framework and operationalization of the study variables, mode of data analysis, hypotheses of the study and econometric model used in this study.

### *2.1. Research approach*

This study adopted a descriptive approach. Quantitative method was employed in this study.

### *2.2. Population and sample of the study*

Target population is the all companies in CSE. As at 20<sup>th</sup> of January, 2019 there were 290 companies listed in CSE representing 20 GICS industry groups. The samples of this study represent top twenty companies as per the market capitalization based on the judgment sampling method.

### *2.3. Data Collection*

This study used secondary data. The data was collected from the selected companies annual reports from year 2015 to year 2019. This study analyzed the impact of accounting ratios on stock market prices over these five years. No. of observations used in this study were 100. In addressing these objectives, this thesis used the panel data set covered the longitudinal aspects.

### *2.4. Variables*

The dependent variable is stock market price. EPS, DPS, PE and MB ratios were used to investigate the effect of stock market price as dependent variables.

### *2.5. Conceptual framework*

The following Figure-1 exhibits the conceptual framework of this study:

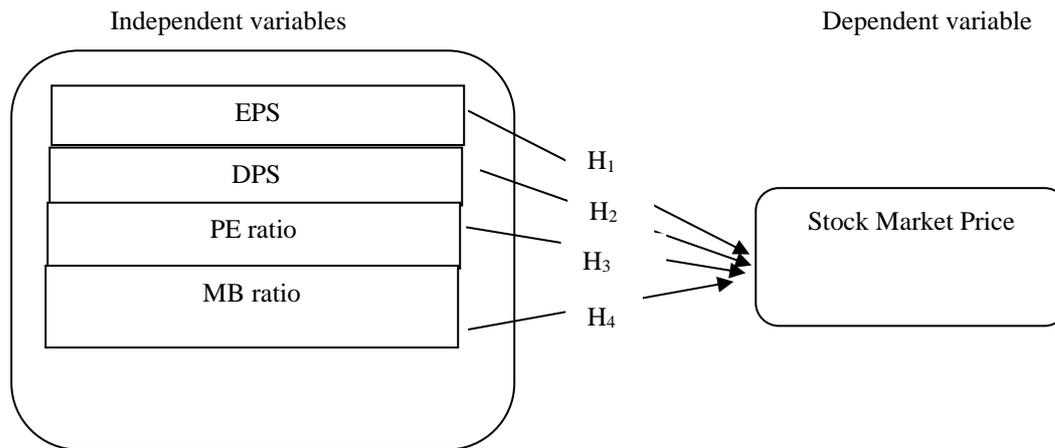


Figure 1: conceptual framework

Source: Researcher's own compilation based on Literature review.

## 2.6. Operationalization of Study Variables

Table 1 illustrates the operationalization of the selected independent and dependent variables.

Table 1: Operationalization of Study Variables

Type of variable	Proxies	Acronym	Measurement	Extant studies
Independent Variable	Earnings per share	EPS	Net profit (after tax) – <u>preference dividends</u> Weighted average common shares	Miah (2012), Khan, Gul, Rehman, Razzaq and Kamran (2012), Uwuigbe, Igbino, & Oni-Ojo (2016), Wang, Fu and Luo (2013), Hassan, Hasan and Haque (2017), Ndubuisi, Fidelis, Chinyere and Leonard (2018), Vijitha and Nimalathan, (2014) and Sarifudeen (2016)
	Dividend per share	DPS	<u>Total dividends</u> Number of shares outstanding	Miah (2012), Ndubuisi, Fidelis, Chinyere and Leonard (2018) and Sarifudeen (2016)
	Price Earnings ratio	PE	<u>Market stock price per share</u> Earnings per share	Miah (2012) and Vijitha and Nimalathan, (2014)
	Market to Book ratio	M/B	<u>Market capitalization</u> Total book value	Khan, Gul, Rehman, Razzaq and Kamran (2012)
Dependent Variable	Stock price	SP	Annual Report of the companies	

Source: Researcher's own compilation based on Literature review.

## 2.7. Mode of data analysis

In order to perform the inferential analysis, Pearson correlation analysis, panel regression analysis in terms of fixed effect, random effect and pooled linear regression were performed. Hausman test was adopted in order to choose either random effect regression or fixed effect regression analyzing the panel data set.

### 2.8. Empirical Model

Effectiveness of EPS, DPS, PE and MB ratios with the market price were analyzed by using the following econometric model:

$$SP = \beta_0 + \beta_1 \text{EPS} + \beta_2 \text{DPS} + \beta_3 \text{PE} + \beta_4 \text{MB} + \varepsilon$$

Where;

$\beta_0$ =Constant

$\beta_{1-4}$ =Parameters

SP= Stock price

EPS=Earnings per share

DPS=Dividend per share

PE=Price Earnings Ratio

MB=Market to Book Ratio

$\varepsilon$  = Error term

Results which are performed using Stata software are discussed in the next section.

### 3. Results

This section presents the descriptive statistics, multicollinearity test, correlation and multiple regression analysis. Panel model has been applied for data interpretation with the help of Stata 13 version.

#### 3.1. Descriptive statistics

Table 2: Descriptive statistics

Variables	Obs.	Mean	SD	Min	Max
EPS	100	25.2337	41.1670	0.18	306.21
DPS	100	12.2794	18.5304	0.05	80.00
PE	100	15.6617	15.2336	0.13	80.69
MB	100	5.5149	11.7059	0.03	64.45
SP	100	5.1492	1.3918	2.20	7.79

Table 2 describes the descriptive statistics for the accounting ratios (independent variables) and stock market price (dependent variable). The analysis includes 100 observations which were gathered from the annual reports of the twenty companies listed in CSE based on the highest market capitalization. According to table 2, it shows 25.2337 as the mean value of EPS. The EPS ratio spreads between the minimum value of 0.18 and maximum value of 306.21. Standard deviation of EPS is 41.167. Average DPS, PE and MB of company's sample are 12.2794, 15.6617 and 5.5149 respectively. The minimum DPS is 0.05 and 80.00 is recorded as the maximum. The minimum value of PE and MB are 0.13 and 0.3 and the maximum values are 80.69 and 64.45 respectively. The standard deviation of DPS, PE and MB are 18.53044, 15.23359 and 11.70589 respectively. SP indicates a mean value of 5.1492 with the standard deviation 1.3918 and the minimum and maximum values as 2.2 and 7.79 respectively.

#### 3.2. Multicollinearity test

Table 3: Collinearity statistics

	Variance Inflation Factor (VIF)	1/VIF
EPS	1.46	0.685331
DPS	2.80	0.357051
PE	1.02	0.984506
M/B	2.16	0.464024

Table 3. shows the result of the VIF and the tolerance factor of the independent variables. It shows that there is no multicollinearity, as the highest value of VIF is less than 10 and the tolerance factor denotes below 1.

### 3.3. Correlation analysis

Table 4: Correlation analysis

	SP	EPS	DPS	PE	M/B
SP	1.0000				
EPS	0.4939	1.0000			
DPS	0.3122	0.5275	1.0000		
PE	0.2297	0.0251	0.1026	1.0000	
M/B	- 0.0100	0.2434	0.7139	0.1207	1.0000

As illustrated in the Table 4 shows the correlation between the independent variables. According to the result, it depicts 49.39% relationship exists between EPS and SP. At the same time, it describes the 31.22% relationship between DPS and SP and the 22.97% relationship that exists between PE and SP. MB depicts a negative relationship with SP. Therefore, the result denotes that there is a positive relationship between EPS and SP.

### 3.4. Multiple regression analysis

Table 5: Multiple regression analysis

	Fixed Effect	Random Effect	Pooled Regression
EPS	0.0021 (1.21)	0.0028 (1.63)	0.0130*** (3.98)
DPS	0.0146*** (3.04)	0.0141*** (3.03)	0.0270*** (2.63)
PE	0.0037 (1.10)	0.0046 (1.36)	0.0210*** (2.79)
MB	0.0117 (0.87)	0.0033 (0.28)	-0.0464*** (-3.22)
Constant	4.7947 (38.77)	4.8148 (16.65)	4.4086*** (24.58)
Number of obs.			100
F (4,95)			13.56
Prob>F			0.0000
R-Squared			0.3634
Adj R-Squared			0.3366

Notes: \*\*\* indicate statistical significance at the 1%; Numbers in parentheses are t-statistics;

As illustrated in the Table 5, according to the pooled regression analysis, the coefficient of Adjusted R- Square is 0.3366, which denotes that 33.66% of the variation of stock market price can be explained by the independent variables namely EPS, DPS, PE and MB, while remaining 66.34% of the variation of stock market price explained by other factors which were not included in this study. Based on the F value statistics 13.56 along with the P-value of 0.000 which is lower than 0.05. Therefore, it has been proved that the model utilized in the current study is significant at the 1% level. The constant value denotes the stock market price when all the other variables are remaining unchanged. In this study, the constant value depicts 4.4086 which illustrates that while EPS, DPS, PE and MB are being left unchanged with the stock market price is 4.4086.

The pooled regression equation can be expressed as follows:

$$SP = 4.4086 + 0.0130 \beta_1 + 0.0270 \beta_2 + 0.0210 \beta_3 - 0.0464 \beta_4 + \varepsilon$$

The outcome of the regression analysis indicated the three variables namely EPS, DPS and PE had a positive impact on the stock market price. MB had a negative impact on the stock market price. When it comes to the association between EPS and SP, the coefficient value was found 0.0130 at 0.000 where p value is less than 0.05. It is an indication that there is a positive significant relationship between EPS and SP. When it comes to the association between DPS and SP, the coefficient value was found 0.0270 at 0.010 where p value is less than 0.05. It is an indication that there is a positive significant relationship between DPS and SP. When it comes to the association between PE and SP, the coefficient value was found 0.0210 at 0.006 where p value is less than 0.05. It is an indication that there is a positive significant relationship between PE and SP. When it comes to the association between MB and SP, the coefficient value was found -0.0464 at 0.002 where p value is less than 0.05. It is an indication that there is a negative significant relationship between MB and SP. According to fixed effect analysis, the p value of EPS is 0.231 where p value is higher than 0.05 and insignificant. Thus, H1 is not supported. The p value of DPS is 0.003 where p value is less than 0.05 and significant. Thus, H2 is supported. The p value of PE is 0.274 where p value is higher than 0.05 and insignificant. Thus, H3 is not supported. The p value of MB is 0.386 where p value is higher than 0.05 and insignificant. Thus, H4 is not supported. According to pooled regression analysis EPS, DPS and PE had a positive significant impact on Stock price. MB had a negative significant impact on Stock price. According to fixed effect regression analysis, EPS, PE and MB had positive insignificant impact on stock price. DPS only had a positive significant impact on stock price.

### 3.5. Hausman Test

Using the data with fixed effect, random effect and the result based on the pooled regression analysis was presented as a part of comparative analysis above table 5. Based on the Hausman test for as dependent variable SP Prob. >chi2 value, if this value is less than 0.05 fixed effect is appropriate and if it is greater than 0.05 random effect is appropriate.

H<sub>0</sub>: Random effect is suitable.

H<sub>1</sub>: The fixed effect is suitable.

According to the Hausman test results, since there was no enough evidence to reject the null hypothesis of deference in coefficients are not systematic, it is concluded that the fixed effect model is the most suited for understanding the impact of accounting ratios on stock price. According to the Hausman test for as dependent variables of SP prob.>chi2 value is 0.0000. since this value less than 0.05 then fixed effect method is more understanding the impact of EPS, DPS, PE and MB on SP. So H<sub>1</sub> is supported while H<sub>0</sub> is not supported.

## 4. Discussions

According to the fixed effect regression analysis, it was found that only DPS had positive significant impact on SP. The results are inconsistent with the findings obtained by Sarifudeen (2016) and Miah (2012). Other variables were found insignificant impact on SP. According to the pooled regression analysis, it was found that EPS had positive significant impact on SP. The results are in line with the findings obtained by Miah (2012), Khan, Gul, Rehman, Razzaq and Kamran (2012), Uwuigbe, Igbinoaba, & Oni-Ojo (2016), Wang, Fu and Luo (2013), Hassan, Hasan and Haque (2017), Ndubuisui, Fidelis, Chinyere and Leonard (2018), Vijitha and Nimalathan, (2014) and Sarifudeen (2016). DPS had positive significant impact on SP. The results are in line with the findings obtained by Ndubuisui, Fidelis, Chinyere and Leonard (2018). PE also had positive significant impact on SP. The results are in line with previous studies performed by Miah (2012) and contradict with finds obtained by Vijitha and Nimalathan (2014) who found insignificant impact of PE on SP. MB had negative significant impact on SP. The results are in line with the findings obtained by Khan, Gul, Rehman, Razzaq and Kamran (2012). The next section gives the conclusion to the study.

## 5. Conclusions

In this study an attempt has been made to investigate the impact of accounting ratios on stock market price in listed companies in CSE, Sri Lanka. Major findings of the study as analyzed by pooled regression analysis, EPS, DPS and PE had significant positive relationship with SP. There is negative impact of MB on SP. Finally, this study concludes that impact on accounting ratios to the stock market price. In line with the findings of the study it can be recommended to investors should pay their attention on the accounting ratios like EPS, DPS, PE ratio and MB ratio in assessing the companies' financial statements and making investment decisions. This will assure the investors for more secure investments.

The results of this study raise several policy implications that can be taken into consideration by stock market regulators and potential investors. The findings of the study can be used to generalize the other listed companies in terms accounting ratios and share price. There are some contributions from this research. This study, employing of 20 companies as sample size as well as a longitudinal approach for data analysis, could result in a comprehensive understanding with regard to the impact of accounting ratios on stock price of the companies listed in CSE. Further researchers should focus on more companies, cover longer year periods and include more accounting ratios as independent variables. Future studies could also be done including non-linear relationships among the variables.

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