Value Relevance of Accounting Information: A Review of Recently Reported Evidences from Sri Lanka

Habeeb Mohamed Nijam and Athambawa Jahfer

Department of Accountancy and Finance, Faculty of Management and Commerce,
South Eastern University of Sri Lanka.
University Park, Oluvil. Sri Lanka
nijamhm@seu.ac.lk, jahfer@seu.ac.lk

Abstract.
The purpose of this paper is to explore the relationship between and communalities among recent empirical evidences reported on value relevance of accounting information of listed companies in Sri Lanka. This paper therefore reviews seven recent empirical studies conducted in Sri Lanka on value reverence of accounting information. The review finds that nearly all studies have used price regression model of Ohlson (1995) and thus used book value of equity per share and or earning per share as accounting information to predict market price per share. All studies reviewed have concluded that accounting information of companies listed in Colombo Stock Exchange (CSE) is value relevant. It is hence confirmed that accounting information significantly influence firms' equity valuation in Sri Lanka. It is also deducted that earning parameters which summarize the income statement better explain the share price than book value or similar measures that brief financial position statement. All these studies have covered the periods prior to the accounting reform in 2012 in which Sri Lanka enforced LKAS and SLFRS that were fully converged to respectively IAS and IFRS. It is therefore recommended to investigate the value relevance of accounting information in post IFRS adoption periods and to explore the impact of IFRS adoption on value relevance of accounting information

Keywords: Value Relevance, Book Value, EPS, Ohlson Model, Sri Lanka, CSE.

Introduction

The capital market of Sri Lanka is primarily of companies listed in Colombo Stock Exchange (CSE). As at 31 December 2014, 294 companies have been listed in CSE in 20 business sectors with total equity market capitalization of Rs. Bn 3,104.9 that amounts to 31.9% in the GDP and Rs. Bn 230.3 of Corporate Debt Market Capitalization. As per CSE's annual report for the financial year 2014, daily average turnover in the year 2014 was Rs. Bn 1,414.6. Further, public companies incorporated under the Companies Act No.7 of 2007 or any other statutory corporation, incorporated or established under the laws of Sri Lanka or overseas can seek a listing on CSE, subject to Exchange Control approval, and participate in this capital market raising their equity or debt capital. Efficient capital market function is fundamental for success of nearly every economy. Efficient capital market ensures that savings are efficiently and effectively mobilized towards right economic opportunities. However, mobilizing savings to investment opportunities is often complicated due to the prevalence of information asymmetry between reporting entity and

the users of financial statement as firms typically have better information than investors on the value of business investment opportunities (Chalmers et al., 2010). Overcoming this dire challenge is imperative for every economy for its effective and efficient function.

For meeting such economic requirement, financial statements of companies are expected to be *inter alia* timely, reliable and relevant for decision making. Such quality of financial statements is commonly judged based on value relevance, that is, the extent to which accounting numbers in financial statement ascertain security prices/returns. If there is no relationship between firm value and numbers in the financial statements, such statements have no value relevance implying that it is not useful for making economic decisions of inventors. The value relevance of accounting information thus constitutes to the validity and reliability of financial statements published by companies (Chandrapala, 2013). Ball and Brown (1968) report the first literature in this regards where they observed that unexpected earnings are significantly related to abnormal stock returns. Value relevance has evolved as one of the most fundamental issues being investigated in finance and accounting researches. Though the value relevance of accounting information from capital market in developed economies has been well investigated since the seminal work of Ball and Brown (1968), it continues to remain an empirical issue in developing economies (Chalmers et al.,2010). Value relevance studies usually examine the power of accounting earnings and book value of equity in explaining share prices (Collins et al., 1997). While some researchers focus on the association between the accounting earnings and stock returns (Ball and Brown, 1968; Collins and Kothari, 1989; Kothari and Zimmerman, 1995; Kothari, 2001), others examine the association between book value and market value of equity (Barth, 1991; Shelvin, 1991). Value relevance literature reveals that significance of accounting information in determining the stock price and return differs between jurisdictions. The relationship between accounting information and stock price or stock return may be determined by factors characterizing the firms, sectors, capital market and the overall economy.

Though there have been empirical studies in Sri Lanka investigating the relationship between accounting information and stock price and or return of listed companies, communalities and relationship between the findings of such works have not been documented. The objective of this study is therefore to explore the relationship between and communalities among recent empirical evidences reported on value relevance of accounting information of listed companies in Sri Lanka. For this purpose, this paper identifies seven recent empirical studies conducted in Sri Lanka on value reverence of accounting information. Papers taken for review include Chandrapala (2010), Perera and Thrikawala (2010), Karunarathne and Rajapakse (2010), Musthafa and Jahfer (2013), Tharmila and Nimalathasan (2013), Chandrapala (2013) and, Vijitha and Nimalathasan (2014) are reviewed in this research.

Review of Recent Value Relevance Literature in Sri Lanka

Chandrapala (2010) investigates the value relevance of accounting information examining whether accounting information such as earrings per share (EPS), book value per share (BVPS) and return on equity (ROE) of firms listed in Colombo Stock Exchange (CSE) in Sri Lanka explain Market price per share (MPS) with a sample of 129 firms drawn from 6 major sectors at CSE. Employing cross sectional and time series cross-sectional regressions, the study finds that EPS, BVPS and ROE have positive value relevance on market value of securities and the explanatory power of combined variables is however below average. He further reports that the value relevance of EPS and ROE has slightly

increased when the sample include only accounting variables with positive values. The study also finds EPS to be the most valve relevant variable out of the three variables, in Sri Lanka and the explanatory power of EPS and ROE has considerably improved while it is reverse for BVPS after the new information technology adoption at CSE. The study also claims to pioneer to investigate the impact of technological advancements on value relevance of accounting information in relation to CSE. Perera and Thrikawala (2010) examined relationship between Market Price per Share (MPS) and selected such accounting variables as Earning per Share (EPS), Return on Equity (ROE) and Earning Yield (EY) of Commercial banks listed in CSE over a period of five years from 2006 to 2009 and find a statistically relationship between Accounting Information and Market Price per Share. The study concludes that investors use accounting information for making their investment decisions. Karunarathne and Rajapakse (2010) studies hundred (100) companies sampled representing the all the business sectors in CSE except banking, finance and insurance over a period of five years from 2004 to 2008 and investigate the value relevance of earnings and cash flows against stock prices. This study also relates the firm size effect on value relevance. The study employed both Return model and Price model in order to determine the value relevance of financial statements' information (that is, earnings and cash flows). Analysis performed using pooled regression reveals that the value relevance of accounting information is more value relevant under the Price model than under the Return Model and they further report that Earning Per Share (EPS) and cash flows from investment activities are significantly value relevant at 0.01 level.

Musthafa and Jahfer (2013) examine the value relevance of accounting information in Sri Lanka employing Ohlson's (1995) price model and an alternative model with operating cash flow per share with a sample of 310 firm-year observations from 5 largest industry sectors in CSE. They report that book value per share BVPS, earrings per share EPS and operating cash flow per share (OCFPS) have a positive and statistically significant relationship with market value per share and confirm that the accounting information (BVPS, EPS and OCFPS) are value relevant in Sri Lanka. The study also conclude that the alternative model with operating cash flow per share is relatively more informative than the original Ohlson's (1995) price model in Sri Lanka. Tharmila and Nimalathasan (2013) examine the impact of value relevance of accounting information on market vulnerability, measured by vulnerability of market price per share of the listed manufacturing companies in Colombo stock exchange (CSE). Using sample of twelve companies observed over a five years period from 2009 to 2013, study report that earning per share EPS and net assets value per share NAVPS are significantly related with market price per share. Chandrapala (2013) studies the impact of ownership concentration and firm size on value relevance of two such accounting variables as earnings and book value reported by firms listed in Colombo Stock Exchange (CSE) in Sri Lanka from 2005 to 2009. Using pooled cross-sectional data regressions, the study reveals that the value relevance of earnings and book value is below average and the value relevance of accounting information of firms with ownership concentration is higher than that of ownership non-concentrated firms. He also reports that value relevance of earnings and book value is relatively higher for larger firms than smaller firms in CSE and that book value is more value relevant than the earnings in Sri Lanka. That is, book value explains better the share price than the earnings. Vijitha and Nimalathasan (2014) investigate the value relevance of accounting information such as Earning per Share (EPS), Net Assets Value Per Share, and Return On Equity and Price Earnings Ratio to Share Prices of manufacturing companies in Colombo Stock Exchange (CSE) and find that accounting variables under study have significantly explanatory power over share price.

Table 1: Summary of Selected Recent Sri Lanka Literature on Value Relevance of Accounting Information of Listed Firms in CSE

Investigator/s	Accounting Information (Explaining Variables)	Dependent Variable Explained Variable(s)	Sample Size	Periods Covered	Major finding/s
Chandrapala, P (2010)	Earnings Per Share, Book Value per Share and Return on Equity	Market price per share	129 firms drawn from 6 major sectors listed in CSE	2006 to 2009	Accounting Information are value relevant
Perera, and Thrikawala (2010)	Earnings per Share, Return on Equity, and Earning Yield	Market price per share	06 Commercial banks listed in CSE	2006 to 2009	Accounting Information are value relevant
Karunarathne and Rajapakse (2010)	Earnings per Share and cash Flow Information	Market price per share and Stock Return	100 firms representing the all the business sectors listed in CSE	2004 to 2008	Accounting information are value relevant Price model better explain than Return Model
Musthafa and Jahfer (2013)	Book Value per Share, Earnings per share EPS and operating cash flow per share	Market price per share	65 firms from 5 largest industry sectors listed in CSE	2006 to 2010	Accounting information are value relevant. Model with operating cash flow per share is explains better than Ohlson's (1995) price model
Tharmila and Nimalathasan (2013)	Earnings per share and Net Assets Value per Share	Market price per share	12 companies in Manufacturing sector listed in CSE	2009 to 2013	Accounting Information are value relevant
Chandrapala, (2013)	Ownership Concentration and Firm Size	Value Relevance of Accounting Information (earnings and book value)	924 firm/year observations of companies in the CSE	2005 to 2009	The value relevance of ownership concentrated firms is higher than that of ownership non-concentrated firms. Value relevance for larger firms is higher than for smaller firms. Book value is more value relevant than the earnings in Sri Lanka.
Vijitha and Nimalathasan (2014),	Earnings per Share, Net Assets Value Per Share, Return on Equity and Price Earnings Ratio	Market price per share	20 companies in manufacturing sector listed in CSE	2008 to 2012	Accounting information are value relevant

Discussion and Conclusion

This study sought to review selected recently reported empirical researches on value relevance of accounting information in Sri Lanka with the objective of exploring common findings articulated therein. It is observed that Sri Lankan empirical studies on value relevance of accounting information have comparatively preferred price regression models than return models. There are also few studies that have employed both price and return models. Karunarathne and Rajapakse (2010) who employed both models however claim that price regression model works better than return model in Sri Lanka. Researches have employed different proxies for accounting information. Notably, all most all studies have used book value of equity per share (BVEPS) and earning per share (EPS) as accounting information to predict the share price or return. This might be because of that BVEPS and EPS provide accounting summary of respectively financial position statement and income statement. Majority of studies reviewed report that beta of EPS or other earning parameters is greater than that of book value of equity (BVEPS) or similar measures. This implicates that earning parameters which summarize income statement better explain the share price than book value or similar measures that brief financial position statement. All studies under review have concluded that accounting information of companies listed in CSE is value relevant thereby confirming that accounting information significantly influenced firm's equity valuation. All these studies have covered the periods prior to the accounting reform in 2012 in which Sri Lanka enforced LKAS and SLFRS that were fully converged to respectively IAS and IFRS. It thus creates a need for future research on value relevance also covering the periods followed by IFRS adoption in Sri Lanka. When comparing value relevance of accounting information before and after the IFRS adoption, the impact of IFRS adoption in Sri Lankan can be ascertained.

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