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THE VALUE RELEVANCE OF FINANCIAL STATEMENTS AND THEIR IMPACT ON STOCK PRICES: WITH SPECIAL REFERENCE TO LISTED FIRMS IN COLOMBO STOCK EXCHANGE



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JS Kumari

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Abstract

The aim of this paper is to examine the relevance of financial reporting. In order to achieve this, a model that includes specific ratios is developed, and examine those specific ratio affecting return earnings relation and issue of earnings relevance, in the firms of the Sri Lankan Stock Market, and its effects on the return-earnings relation.

Red flag ratios and accruals were used to measure the issues of value relevance which have proved to be indicators of falsified financial statements capital market, and by estimating accruals quality, measured both by discretionary and non-discretionary accruals.

The data were collected from a sample of 90 non-financial firms listed at the Colombo Stock Exchange. The time frame spans from 2002 to 2012 and the methodology used is correlations and OLS regression models.

The results indicated that the ratios of working capital to total assets (Liquidity ratio) and net profit to sales (profitability ratio) have a negative impact on stock returns. While the ratios of net profit to total assets (profitability ratio) and sales to total assets (efficiency ratio) affect the returns positively. Total debt to total assets (Leverage ratio) has positive return earnings relation. Additionally, both types of accruals have incremental importance with the non-discretionary (Business Condition) appearing to be more important compared to the discretionary one (Management Condition) in explaining stock return movements. Thus, it is concluded that the Colombo stock market depicts prices accruals. All the variable other than the inventory to sales have correlations which are similar to attributors of possible to manipulated financial statements found in previous research. Thus, it may be said that there is more possibility for falsifying financial statements.

Red flag ratios and accruals are importance in explaining stock price movements and good indicator of identifying issue of value relevance. The present study adds to the existing literature by examining the issue of financial reporting relevance within the context of an emerging capital market such as Sri Lanka.

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