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Value Relevance of Accounting Information: Evidence from Sri Lanka

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Abstract: This paper investigates the value relevance of accounting information in Sri Lanka. The study uses book value per share (BVPS), earrings per share (EPS) and operating cash flow per share (OCFPS) as the independent variables and market value per share (MVPS) as the dependent variable. Sample of the study includes 310 firm-year observations from 5 largest industry sectors. Ohlson's (1995) price model and an alternative model with operating cash flow per share are employed. Study finds that BVPS, EPS and OCFPS all have a positive and statistically significant relationship with market value per share. This finding proves that the accounting information is value-relevant in Sri Lanka. Comparison of Ohlson model with the alternative model developed in this study reveals that both models are value relevant to Sri Lankan data. However, the alternative model with operating cash flow per share is more informative than the original Ohlson's (1995) price model in Sri Lanka.

Keywords: Accounting Information, Book Value per Share, Earnings per Share, Operating Cash Flow per Share, Value Relevance

Introduction

The main objective of accounting information through financial statements is to provide information about the financial position and performance of an entity that is useful to stakeholders in making economic decisions. Investors are among the most important users of such information. Since it is concluded that if financial statements meet investors need, it will also meet most of the needs of other users. High quality accounting information is a necessary for well functioning capital market and the economy as a whole. Hence, it should be of considerable importance to investors. A basic attribute of accounting quality is value relevance that is the relevance of accounting information for equity valuation.

Research on the relations between capital markets and financial statements is generally referred to as capital market-based accounting research (CMBAR). Modern CMBAR originated with Ball & Brown and Beaver in 1968 (Beisland, 2009, p. 7). One of the main purposes of CMBAR is to examine the value relevance of accounting information. According to Beisland, the value relevance research empirically investigates the usefulness of accounting information to stock investors. Accounting information is denoted as value relevant if there is a statistical association between the accounting numbers and market values of equity (Beisland, 2009, p. 7). Empirical research on the value relevance has its roots in the theoretical framework on equity valuation models. Ohlson (1995) depicted in his work that the value of a firm can be expressed as a linear function of book value, earnings and other value relevant information (Vishnani & Shah, 2008, p. 85). Ohlson model stands among the most important developments in capital market research in early 1990s and provides a foundation for redefining the appropriate objective of valuation research (Bernard, 1995 as referenced in Dung, 2010, p. 2).

There are a number of international studies conducted on value relevance of accounting information and most of them are based on developed and efficient capital markets in the world. Most researchers in the field of value relevance studies have

predominately used data from the United States (Rahman and Mohed-Saleh, 2008, p. 78). A very few researches (Perera & Thrikavala, 2010; Pathirawasam, 2010) were conducted using Sri Lankan data. Value relevance studies from different countries often show contradictory results, partly because accounting regulations differ between countries. Value relevance studies in Sri Lanka reveal that the accounting information is value relevant. However, the development in the field of accounting is rapid and there is a need for new research using fresh data.

The present study employs Ohlson's (1995) price model as the basis to investigate the usefulness of accounting information in equity valuation in comparison with the total information in the market place using the data of listed companies in the Colombo Stock Exchange (CSE).The study is based on the following three main objectives (a) to explore the value relevant variables among the financial related variables; (b) to identify the most significant value relevant variable among the financial related variables, and (c) to determine the best model for explaining the value relevance of accounting information.

Literature review

Brief and Zarowin (1999) compared alternative valuation models that relate share price to book value and earnings and to book value and dividends with USA data from 1978 to 1997. They found that, for dividend paying firms on the whole, book value has greater explanatory power for price than either earnings or dividends. However, the combination of book value and dividends has virtually identical explanatory power as book value and earnings. Moreover, earnings and dividends alone have about the same individual and incremental explanatory power. For firms with transitory earnings, dividend has greater individual explanatory power than earnings, but once again book value and earnings and book value and dividends have about the same explanatory power. Suwardi (2009) investigated the nature of the relationship between accounting numbers and share prices of firms listed on the Jakarta Stock Exchange (JSX) for the period 1992-2001. The results of this study showed that the book value of net assets seems

to have a stronger relationship with market value. Abayadeera (2010) tested the value relevance of financial and non-financial information in high-tech industries in Australia. The overall results provided evidence that book value was the most significant factor and earnings were the least significant factor in deciding share prices in high-tech industries in Australia.

Oyerinde (2009) examined the value relevance of accounting information in the Nigerian Stock Market. His model used average price per share as dependent variable with EPS, earnings yield and ROE as independent variables. The sample consisted of top 30 companies from 2001 to 2004 in Nigerian Stock Market. The author found that the relationship between share price and EPS was high but the ROE was very low. However, combined model of all the variables reflected very high level of R^2 value of more than 95% each year. Perera and Thrikawala (2010) examined the value relevance of accounting information on Colombo Stock Exchange (CSE) taking 6 commercial banks listed in CSE from 2005-2009. Using the model used by Oyerinde (2009), they found that EPS and ROE were significantly related with share price and only EPS reflected higher explanatory power on market price. Pathirawasam (2010) investigated the value relevance of accounting information at Colombo Stock Exchange (CSE) in Sri Lanka. His study used earnings per share (EPS), book value per share (BVPS) and return on equity (ROE) as the independent variables and market price per share (MPS) as the dependent variable. Sample of the study included 129 companies selected from 6 major sectors at CSE. Cross sectional and time series cross-sectional regressions were used for the data analysis. Study found that EPS, BVPS and ROE had positive value relevance on market value of securities. However, the explanatory power of combined variables was below average. Value relevance of EPS and ROE had slightly increased when the sample included only accounting variables with positive values. But, BVPS did not comply with that finding. EPS was the most valve relevant variable out of the three variables, in Sri Lanka.

Pirie and Smith (2008) studied the relationships between stock prices and accounting information in

Malaysia. They found that current book values and current earnings each have incremental explanatory power for share prices beyond the other variable. This has implications for investors and managers, because it suggests that they should consider both the balance sheet and the income statement in their decision-making processes rather than concentrating on one or other of the statements alone.

Durán et al. (2007) examined the value relevance of Ohlson model with Mexican data. The accounting variables used were from 145 companies listed in the Mexican stock market from 1991 to 2003 (1,046 firm-year observations). Study found that the alternative model with operating cash flow per share provides extra information and better statistics than the original Ohlson model. Bo (2009) explored an empirical study on information content of accounting earnings and cash flow using the financial data of Chinese listed companies in manufacturing industry from 2003 to 2005, adopting price model and found that accounting earnings and cash flows all have relevant relations to stock prices; however, the relevance between cash flow and stock price was stronger, and cash flows had higher information quality.

Methodology

Sample and data collection

The sample of the study consists of 65 listed companies from five largest industry sectors excluding Bank, Finance & Insurance sector for the period of 5 years from 2006 to 2010. The selection of the sample is based on the following criteria.

1. The sample companies selected from 5 largest sectors excluding bank, finance and insurance sector. The sample selected from largest sectors, because these sectors would contribute significantly to the economy. Bank, Finance & Insurance sector is excluded from the sample even it is a largest sector in Sri Lanka. Because the accounting practices for the financial companies are different from other companies.

2. Companies, whose financial year ends other than 31st March of each year excluded from the sample. Most of the companies in Sri Lanka have their financial year end on 31st March. Therefore, companies with financial year end 31st March are selected for this study. This criteria is followed because, it is necessary to have common period for the calculation of market values accumulation across all the sample companies.

3. In order to have a balanced panel, companies those do not have financial statements for all sample years from 2006 to 2010 are excluded from the sample.

4. Companies without all required data such as market value per share, book value of equity, reported earnings and operating cash flows etc. are excluded.

Tab. 1 shows the number of sample companies under each selected industry sector.

Table 1:
Classification of the Sample

Industry Sector	Sample (Number of Companies from each Sector)
Beverage Food & Tobacco	9
Hotels & Travel	22
Land & Property	9
Manufacturing	17
Plantations	8
Total	65

All data used in this study such as market value per share, book value per share, earnings per share and operating cash flow per share are drawn from the financial statements of companies which are available in the CSE's website.

Conceptual framework

Based on the literature review it is evident that the accounting information has an impact on the value of the firm. Previous researchers identified some important value relevant accounting information in their studies. Most of the studies used balance sheet and income statement as the source of accounting information. Currently, however, the main financial statements include comprehensive income statement, statement of financial position and cash flow statement. Thus the present study uses the model that includes all of the main financial statement measures as follows (Fig. 1):
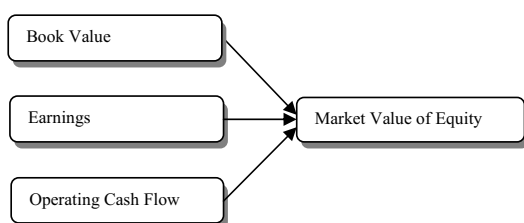

Figure 1: Conceptual Framework

Hypotheses

Based on the conceptual framework, the following hypotheses are developed in order to achieve the aim of this study.

H1: There is a positive relationship between book value and market value of equity.

H2: There is a positive relationship between earnings and market value of equity.

H3: There is a positive relationship between compound of book value and earnings, and market value of equity.

H4: There is a positive relationship between operating cash flow and market value of equity.

H5: There is a positive relationship between compound of book value, earnings and operating cash flow, and market value of equity.

Research model

This study uses Ohlson's (1995) price model as a basic model to examine the value relevance of accounting information. According to the literature review, the Ohlson's price model has been widely used in the previous studies. The model expresses the value of firm's equity as a function of its earnings and book value as follows:

$$P_{it} = \beta_0 + \beta_1 BV_{it} + \beta_2 E_{it} + e_{it}$$

Where:

P_{it} = Stock price of firm i three months after the financial year-ending in year t.

BV_{it} = Book value per share for firm i at the end of period t.

E_{it} = Reported earnings per share for firm i during period t.

e_{it} = Other value-relevant information of firm i for period t.

Based on the above Ohlson's (1995) price model the following alternative model with operating cash flow per share is developed for this study.

$$MVPS_{it} = \beta_0 + \beta_1 BVPS_{it} + \beta_2 EPS_{it} + \beta_3 OCFPS_{it} + e_{it}$$

Where:

$MVPS_{it}$ = Market value per share of firm i three months after the financial year-ending in year t.

$BVPS_{it}$ = Book value of equity per share of firm i for the financial year ending at year t.

EPS_{it} = Earnings per share of firm i during the financial year t.

$OCFPS_{it}$ = Operating cash flow per share of firm i for the financial year ending at year t.

e_{it} = Error term indicating other information for firm i for year t.

β_0 = Intercept (explanatory power of the constant).

$\beta_1....\beta_3$ = Explanatory power of the independent variables.

The following step wise simple and multiple regression models are developed in order to test the hypotheses of this study.

The equation [1] examines the relationship between market value of equity and book value of equity.

$$MVPS_{it} = \beta_0 + \beta_1 BVPS_{it} + e_{it} \qquad [1]$$

The equation [2] examines the relationship between market value of equity and reported earnings.

$$MVPS_{it} = \beta_0 + \beta_1 EPS_{it} + e_{it} \qquad [2]$$

The equation [3] examines the relationship between market value of equity and compound of book value of equity and reported earnings.

$$MVPS_{it} = \beta_0 + \beta_1 BVPS_{it} + \beta_2 EPS_{it} + e_{it} \quad [3]$$

The equation [4] examines the relationship between market value of equity and operating cash flow.

$$MVPS_{it} = \beta_0 + \beta_1 OCFPS_{it} + e_{it} \qquad [4]$$

The equation [5] examines the relationship between market value of equity and compound of book value of equity, reported earnings and operating cash flow.

$$MVPS_{it} = \beta_0 + \beta_1 BVPS_{it} + \beta_2 EPS_{it} + \beta_3 OCFPS_{it} + e_{it} \qquad [5]$$

Data analysis and presentation

Descriptive statistics

Descriptive statistics are calculated for dependent and independent variables in order to obtain an overview of the nature of data to be analyzed. This has been done after eliminating outliers. An outlier is an observation that lies an abnormal distance from other values in a random sample from a population, which will distort statistics. The reason for the outliers in this study is the existence of more extreme values than a normal distribution such as due to the scale of the company and performance of the company. To control the outliers for all tests, observations having standardized and residuals greater than 4 (with both signs) from each variable are removed. From the original full sample (325 firm-years observations), 15

cases are eliminated as outliers. All tests are performed in this study after controlling for the outliers.

Tab. 2 shows descriptive statistics of market value per share, book value per share, earnings per share and operating cash flow per share for the sample used in this study.

Table 2:
Descriptive Statistics

	MVPS	BVPS	EPS	OCFPS
Mean	63.658	63.658	5.309	4.873
Standard Deviation	71.728	71.728	9.698	10.385
Minimum	1.100	1.100	-17.540	-40.130
Maximum	505.250	505.250	54.190	52.210

Overall mean of market value, book value, earnings and operating cash flow per share are 63.658, 53.006, 5.309 and 4.873 respectively. Also, the standard deviation of market value, book value, earnings and operating cash flow per share are 71.728, 60.373, 9.698, and 10.385 respectively for the sample. This high value of standard deviation confirms the variability of the firm's size and the industry classification traded in the Colombo Stock Exchange.

Correlation

Tab. 3 shows Pearson correlation matrix for the sample (n = 310). The greatest correlation coefficient is 72.6% (between market value and book value) which is strong positive correlation. The correlation coefficient between market value and earnings is 54.9% which is also strong positive correlation, while the correlation coefficient between market value and operating cash flow is 36.6% (weak positive correlation). Considering the correlation coefficient between the independent variables, the correlation between book value and earnings is below average i.e. weak positive correlation (48.7%), book value is weakly correlated with operating cash flow (26.1%) and the correlation between earnings and operating cash flow is also below average (35.8%) i.e. weak positive correlation. Therefore, the correlation matrix appears

to suggest that there is no serious multicollinearity problem among independent variables.

Table 3:
Pearson Correlation

	MVPS	BVPS	EPS	OCFPS
MVPS	1.000	0.726	0.549	0.366
BVPS		1.000	0.487	0.261
EPS			1.000	0.358
OCFPS				1.000

Value relevance of book value

The pooled regression result shows that there exist strong positive relationship between share price and book value as the value of standardized β is 0.726. The result of the regression rejects the null hypothesis and accepts the alternative hypothesis i.e. there is a positive relationship between book value and market value of equity (Hypothesis One). According to the Beta coefficient, one unit change in BV causes 0.726 units change in share price. The adjusted R^2 shows that the book value of equity per share will explain 52.6% of share price variation.

Table 4:
Value-relevance of Book Value

Sample	No. of Observations	Standardized Beta	Adjusted R^2
Pooled	310	0.726**	0.526
2006	63	0.735**	0.533
2007	62	0.793**	0.622
2008	63	0.862**	0.739
2009	61	0.756**	0.565
2010	61	0.585**	0.331

** Significant at the 0.01 level (2-tailed).

In this model, BV during all years is significant at 99% confidence level and considering the Beta coefficient (standardized regression coefficient); it had always a noticeable impact on share price. The coefficient of independent variable for all years has the expected sign, indicating that BV is positively correlated with share prices. Further, reasonable explanatory powers (33.1% to 73.9%) were reported for sample years with this model, measured by adjusted R^2.

Value relevance of earnings

The pooled regression result shows that there exist strong positive relationship between share price and earnings as the value of standardized β is 0.549. The result of the regression rejects the null hypothesis and accepts the alternative hypothesis i.e. there is a positive relationship between earnings and market value of equity (Hypothesis Two). According to the Beta coefficient, one unit change in EPS causes 0.549 units change in share price. The adjusted R^2 shows that the earnings per share will explain 29.9% of share price variation.

Table 5:
Value-relevance of Earnings

Sample	No. of Observations	Standardized Beta	Adjusted R^2
Pooled	310	0.549**	0.299
2006	63	0.668**	0.438
2007	62	0.641**	0.401
2008	63	0.670**	0.440
2009	61	0.492**	0.229
2010	61	0.386**	0.135

** Significant at the 0.01 level (2-tailed).

In this model, EPS during all years is significant at 99% confidence level and considering the Beta coefficient (standardized regression coefficient); it had always a noticeable impact on share price. The coefficient of independent variable for all years has the expected sign, indicating that Earning is positively correlated with share prices. Further, reasonable explanatory powers (13.5% to 44.0%) were reported for sample years with this model, measured by adjusted R^2.

Value relevance of book value and earnings

The pooled regression result shows that there exist strong positive relationship between share price and book value as the value of standardized β is 0.601 while the relationship between share price and earnings is weak positive as the value of standardized β is 0.256 which are statistically significant at 99% confidence level. The result of the regression model-3 for the sample rejects the null hypothesis and accepts the alternative hypothesis i.e. there is a positive relationship between compound of book value and earnings, and market value of equity (Hypothesis Three). According to the Beta coefficients, one unit change in BV causes 0.601 units change in share price while one unit change in EPS causes 0.256 units change in share prices. The adjusted R^2 shows that the compound of book value of equity per share and earnings per share will explain 57.5% of share price variation.

variables for all years had the expected sign, indicating that BV and EPS are positively correlated with share prices. Further, reasonable explanatory powers (39.1% to 74.8%) were reported for sample years with this model, measured by adjusted R^2.

Value relevance of operating cash flow

The pooled regression result shows that there exist weak positive relationship between share price and operating cash flow as the value of standardized β is 0.366. The result of the regression model-4 for the sample rejects the null hypothesis and accepts the alternative hypothesis i.e. there is a positive relationship between operating cash flow and market value of equity (Hypothesis Four). According to the Beta coefficient, one unit change in OCF causes 0.366 units change in share price. The adjusted R^2 shows that the operating cash flow per share will explain 13.1% of share price variation.

Table 6:
Value-relevance of Book Value and Earning

Sample	No. of Observations	Standardized Beta		Adjusted R^2
		BVPS	EPS	
Pooled	310	0.601**	0.256**	0.575
2006	63	0.526**	0.372**	0.623
2007	62	0.631**	0.293**	0.677
2008	63	0.755**	0.158	0.748
2009	61	0.684**	0.142	0.572
2010	61	0.525**	0.269*	0.391

** Significant at the 0.01 level (2-tailed).
* Significant at the 0.05 level (2-tailed).

Table 7:
Value-relevance of Operating Cash Flow

Sample	No. of Observations	Standardized Beta	Adjusted R^2
Pooled	310	0.366**	0.131
2006	63	0.253*	0.049
2007	62	0.221	0.033
2008	63	0.588**	0.335
2009	61	0.367**	0.120
2010	61	0.352**	0.109

** Significant at the 0.01 level (2-tailed).
* Significant at the 0.05 level (2-tailed).

In this model, BV during all year is significant at 99% confidence level and considering the Beta coefficient of BV (standardized regression coefficient); it had always a noticeable impact on share price. While the EPS is significant at 99% confidence level for years 2006 and 2007 and for the year 2008 to 2009 EPS is not significant. Again in the year 2010 it is significant at 95% confidence level. The coefficients of independent

In this model, OCF is significant at 99% confidence level only for the years 2008, 2009 and 2010. The coefficient of independent variable for all years has the expected sign, indicating that OCF is positively correlated with share prices. Further, less explanatory powers (3.30% to 33.5%) were reported for sample years with this model, measured by adjusted R^2.

Value relevance of book value, earnings and operating cash flow

The pooled regression result shows that there exist strong positive relationship between share price and book value as the value of standardized β is 0.586 while the relationship between share price and earnings is weak positive as the value of standardized β is 0.215 and the relationship between share price and operating cash flow is also weak positive as the value of standardized β is 0.136 which are statistically significant at 99% confidence level. The result of the regression model-5 for the sample rejects the null hypothesis and accepts the alternative hypothesis i.e. there is a positive relationship between compound of book value, earnings and operating cash flow and market value of equity (Hypothesis Five). According to the Beta coefficients, one unit change in BV causes 0.586 units change in share price while one unit change in EPS causes 0.215 units change in share prices and one unit change in OCF causes 0.136 units change in share prices. The adjusted R^2 shows that the compound of book value of equity per share, earnings per share and operating cash flow per share will explain 58.9% of share price variation.

Table 8:
Value-relevance of Book Value and Earning

Sample	No. of Observations	Standardized Beta			Adjusted R^2
		BVPS	EPS	OCFPS	
Pooled	310	0.586**	0.215**	0.136**	0.575
2006	63	0.548**	0.321**	0.104	0.623
2007	62	0.625**	0.292**	0.029	0.677
2008	63	0.703**	0.115	0.152*	0.748
2009	61	0.653**	0.135	0.091	0.572
2010	61	0.529**	0.165	0.236*	0.391

** Significant at the 0.01 level (2-tailed).
* Significant at the 0.05 level (2-tailed).

In this model, BV during all years is significant at 99% confidence level and considering the Beta coefficient of BV (standardized regression coefficient); it had always a noticeable impact on share price. While the EPS is significant at 99% confidence level for year 2006 and 2007 and from the year 2008 to 2010 EPS is not significant. Considering the Beta coefficient of EPS (standardized regression coefficient); it had the expected sign for all sample years. OCF is only significant at 95% confidence level for year 2008 and 2010. Considering the Beta coefficient of OCF (standardized regression coefficient); it also had the expected sign for all sample years. The coefficients of independent variables for all years had the expected sign, indicating that BV, EPS and OCF are positively correlated with share prices. Further, reasonable explanatory powers (42.8% to 76.0%) were reported for sample years with this model, measured by adjusted R^2.

Findings and discussion

The first objective of the present study is to find value relevant variables among the financial related variables. The result shows that the book value per share, earnings per share and operating cash flows per share are value relevant variables. It has been proved in many empirical studies all over the world that book value per share and earnings per share are value relevant variables. The result also shows that book value per share had a positive relationship with market value per share. This finding is consistent with earlier Sri Lankan finding of Pathirawasam (2010). And also, all the literatures reported in this study agree the same finding. Similar to book value per share, the finding reveals that earning per share had a positive relationship with market value per share during the studied period. This finding is also consistent with earlier Sri Lankan studies of Perera and Thrikawala (2010) and Pathirawasam (2010). All other international studies reviewed in the present study, found the same positive relationship between EPS and MVPS. The third variable, operating cash flow per share found in this research as a value relevant variable which had statistically significant positive relationship with MVPS for the sample. This finding is consistent with Durán et al. (2007) and Bo (2009).

The second objective of this study is to identify the most significant value relevant variable among the financial related variables. The research has found that the book value per share is the most value relevant

variable among the other variables. It is consistent with prior studies of Brief & Zarowin (1999), Suwardi (2009) and Abayadeera (2010) with USA, Indonesian and Australian samples respectively. Even though, this finding is inconsistent with Pathirawasam (2010) whose sample includes Bank, Finance and Insurance sector, whereas the present study excludes this sector from the sample.

The third objective of the present study is to determine the best model for explaining the value relevance of accounting information. To achieve this purpose the stepwise regression has run and the best model found which consisting three variables. Those are book value per share, earnings per share and the operating cash flow per share. This is the alternative model improved by adding Operating Cash Flow per share as an independent variable to the original Ohlson's price model. The basic Ohlson model and the alternative model were revealed approximately the same explanatory power of Adjusted R^2 for the studied period from 2006 to 2009. But in year 2010 the alternative model showed a higher explanatory power (Adjusted $R^2 = 42.8\%$) than the Ohlson model (Adjusted $R^2 = 39.1\%$). According to the pooled regression results also, the alternative model revealed a higher explanatory power (Adjusted $R^2 = 58.9\%$) than the Ohlson model (Adjusted $R^2 = 57.5\%$). Therefore, it can be concluded that the alternative model with operating cash flow per share provides extra information and better statistics than the original Ohlson model. This finding is consistent with prior study of Durán et al. (2007) with Mexican data.

Conclusions

The present study reached the following conclusions:

i. Book value per share, earnings per share and operating cash flow per share are individually and jointly have the positive and statistically significant relationship with market value per share. Therefore these three variables are identified as value relevant variables in Sri Lanka.

ii. The book value per share is identified as the most value relevant variable than earnings and operating cash flow per share in Sri Lanka.

iii. Both, the original Ohlson's (1995) price model and the alternative model with operating cash flow per share are value relevant. However, the proposed alternative model is more informative than the original Ohlson model for Sri Lankan data.

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