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The Earnings Quality and Stock Returns of Listed Manufacturing Companies in Colombo Stock Exchange

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Abstract

The earnings of the companies are imperative since it communicates information to stakeholders and to predict stock prices in future. However, as there is a greater possibility of managers to manipulate the recorded earnings as explain by the earnings management, the importance of recorded earnings has been eroded. Therefore, it is essential to consider the quality of earnings over reported earnings since it communicates the true portrait of the business for the stakeholders. With this milieu this study investigates the impact of earnings quality on stock returns of listed manufacturing companies in Sri Lanka during the period of 2010 to 2015. For this purpose, the study employs accruals as to measure the quality of earnings. In addition to that the study considered whether earnings or earnings quality is more influential to determine market return and whether size of the companies matters in measuring the above impact. The findings reveal that there is no significant positive impact of earnings or earnings quality on stock returns suggesting that the proxy used is not suitable to explain the impact of earnings quality on stock return. That is may be due to the lack of investors' ability to analyze financial statements; including earnings and quality of the items and have not sufficient knowledge of the earnings quality, and institutional framework and operational bottlenecks. In addition to that, the impact of company size is not a determining factor to quantify the impact of earning and earnings quality of the Sri Lankan listed manufacturing sector.

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Key words: Colombo Stock Exchange, Earnings quality, Earnings management, listed manufacturing sector, Stock returns.

1. Introduction

According to Meyer (2007) accounting plays a significant role within the concept of generating and communicating wealth of companies. The main objective of financial statements is to provide information on financial performance, financial position and changes in financial position to the stakeholders for their economic decision making.

Therefore, it can be argued that if such information is not relevant or rather if stakeholders are not using such information to take their economic decision making, the whole purpose of financial reporting becomes worthless.

Furthermore, the financial reporting standards of a country take part in an imperative role to enhance the relevance, reliability and comparability of the reported earnings by providing set of standards to follow.

However, the facts that reported earnings which are based on standards do not presume that earnings are quality. Because, there is a greater possibility of managers to be involved in earnings manipulations as to get bonuses, compensation and corporate image (Burgstahler & Dichev, 1997; Noronha, Zeng & Vinten, 2008; Schipper, 1989).

As cited by Kamarudin and Ismail (2014, para. 4) Schipper and Vincent (2003) indicate that debt agreements based on low and defective earnings will induce unintended wealth transfers and overstated earnings used as an indicator of managers' performance will result overcompensation to managers. Furthermore, Chan, Chan, Jegadeesh and Lakonishok (2006) stated that managers are keenly interested in maintaining growth in earnings because their compensations are often tied with firms' earnings. As cited in Kamarudin and Ismail (2014, para. 1) the quality of earnings is very important as the earnings figure is widely used in many contractual agreements and investing decisions. Further as denote by Chan et al., (2006) the quality of earnings reflects the operating fundamentals of the company which represents the true portrait of the company.

Dechow and Schrand (2004) state that when earnings conform to the spirit and the rules of generally accepted accounting principles, they are of high quality in the eyes of regulators and financial statement users may also define earnings quality in terms of the 'absence of earnings management'. This is because the intentional manipulation of earnings by managers, within the limits possible in accounting standards, may distort the usefulness of earnings to users.

With these definitions on earnings quality one can identify the importance of earnings quality over reported earnings since it communicates the true portrait of the business. At the same time

the accounting variables are worth to the extent that it reflects through the share price of the entity (Yee, 2006). Ball and Brown (1968) state that "an observed revision of stock prices associated with the release of the income report would provide evidence that the information reflected in income numbers is useful"(p.161). Therefore if earnings are reflecting through share price as it indicates the relevance of the accounting numbers to the investors.

As per the discussion above, it is clear that when earnings management is absent and when companies are not manipulating earnings the quality of the earnings is high. However, extracted literature reveals that the measure of earnings quality and scholars have the accruals as the main proxy to denote quality of the earnings.

Therefore, the main purpose of the current study is to investigate the impact of earnings quality measured by real earnings management on stock return in listed manufacturing sector companies in Sri Lanka.

1.1 Problem statement

Prior studies on investigating the relationship between earnings quality and the stock returns considered the entire market (Yamchi, Salteh & Nahandi, 2013 & Chan et al., 2006). Therefore, based on the literature analysis of the study, it is likely that the prior studies do not reflect the true relationship between earnings quality and the stock return because Abdelghany (2005) and Wasiuzzaman, Sahafzadeh, and Nejad (2015) have confirmed that one proxy to measure the earnings quality of the whole market is not suitable since there is impact from the nature of the industry and different proxies give different opinion on earnings quality. Therefore, the conclusions, recommendations and other implications arrived in those studies could be arguable.

1.2 Research objectives

Based on above research problem, the following research objectives can be derived:

- To investigate the impact of earnings quality on stock returns in listed manufacturing companies in Sri Lanka.
- To investigate whether earnings or earnings quality is more influential in determining the market return of the listed manufacturing companies in Sri Lanka.

To achieve above objectives, study used quarterly data of listed manufacturing companies at Colombo Stock Exchange from year 2010 to 2015 to test the following hypotheses.

H_1: Earnings quality has a significant positive impact on stock return.

H_2: Recorded earnings have a significant positive impact on stock return

2. Methodology

2.1Variable definition

The dependent variable of the study is stock return of the individual firms (R_{it}) which is calculated by taking the quarterly closing price difference divided by the previous quarter price of the selected companies (Chan et al, 2006; Penman, 2001).

There are two main independent variables in the study namely recorded earnings, and the earnings quality. The recorded earning is the net income after tax as appeared in the quarterly financial statements of the listed manufacturing companies during the sample period. The other main independent variable is earnings quality which measured through the difference between earnings and cash flow from operating activities (Hribar and Collins, 2002). Further the study considers the size as a controlling variable which measured by logarithm of total assets as total assets has a nonlinear relationship with the stock return.

2.2 Data and sample

For the purpose of analysis, quarterly data of manufacturing companies listed on CSE during the period of 2010 to 2015 have taken including both years. A company to be included in the sample it should be a listed entity throughout the sample period. Therefore, 26 manufacturing companies listed at the CSE are taken as the sample which includes 624 quarterly observations.

2.3 Data analysis

After collecting the data it is essential to explore the nature and the behavior of data in order to execute the study. Therefore, the study carries out descriptive statistics, correlations analysis and graphs through the E views 7.

After identifying the nature of the variable, the next step of the study is to specify the models that are necessary to test the hypotheses which ultimately lead to achieve the set objectives of the study.

Therefore, to implement the first hypothesis developed in the study i.e. to examine the impact of earnings quality on stock return it is required to identify the applicable model. Apart from that, the lag impact of earnings quality also considered since scholars have proven that there is an impact from lag variables (Ou & Penman, 1989).

The earnings quality is calculated as the difference between earnings and the cash flow from operating activities.

$$\text{EQ} \quad = Earnings - CFO \ldots\ldots\ldots\ldots\ldots\ldots\ldots.\mathbf{3.1}$$

Then to quantify the impact from earnings quality on stock return the following regression is used.

$$R_{it} = \beta_0 + \beta_{1it}EQ_{it} + \varepsilon_{it} \ldots\ldots\ldots\ldots..\mathbf{3.2}$$

Where,

R_{it}= Stock return of the i^{th} Company at quarter "t"

β_0= Constant

β_{1it}= coefficient

EQ_{it} = Earnings_{it} - CFO_{it}

ε_{it} = Error term

4 Findings and conclusions

The summary of the results obtained is outlined in table 4.1.

Table 4. 1: The impact of earnings quality on stock return

Quarter	t (R)		t - 1 (R)		t - 2 (R)		t - 3 (R)	
	Coeffi.	P value	Coeffi.	P value	Coeffi.	P value	Coeffi.	P value
LOGEQ	0.004	0.993	-0.092	0.436	0.019	0.880	0.091	0.470
Intercept	0.108	0.979	0.839	0.403	-0.107	0.919	-0.725	0.498
F statistic	0.000		0.628		0.024		0.542	
P value	0.993		0.428		0.878		0.462	

Notes: Number of observations is 624. All estimates are based on Random Effects Model.

Based on regression results there is no impact from earnings quality on stock returns as well as on share price. Then the lag impact of earnings (up to third lag) on stock return also cannot establish since there is no significant impact from lag variables. Therefore, the study cannot establish the above impact and study does reject the first hypothesis of the study.

Table 4.2: The impact of log earnings on stock return

Quarter	t (R)		t - 1 (R)		t - 2 (F)		t - 3 (R)	
	Coeffi.	P value	Coeffi.	P value	Coeffi.	P value	Coeffi.	P value
LOGEARNINGS	-0.050	0.215	0.010	0.187	0.028	0.078	-0.009	0.214
Intercept	0.348	0.029	0.022	0.451	-0.039	0.494	0.072	0.008
F statistic	1.544		1.766		0.821		1.575	
P value	0.215		0.185		0.721		0.210	

Notes: Number of observations is 624. (F) = estimates are based on Fixed Effects Model. (R) = estimates are based on Random Effects Model.

According to the results of the analysis there is no impact from earning on stock returns as well as on share price. Further the lag analysis on earnings also does not provide evidences on impact of earnings on stock returns up to third lag. Further, study inspects the impact of the size in this analysis as well. According to the results size of the companies measured by the log assets does not have any influence on the impact of earnings as well as earnings quality and stock return. Therefore, size of the companies also is not a determining factor to investigate the impact of earnings on stock return.

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