

Full Length Research Paper

Firm performance and earnings per share: A study of listed banks in Sri Lanka

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Abstract

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This paper focuses on identifying the relationship between firm performance and Earnings per Share of the listed banks in Sri Lanka. The data of this study composed of 7 listed banks from the banks, finance and insurance sector covering the period of 5 years from 2008 to 2012. Correlation method has been utilized to find out the relationship whereas simple regression method has been used to identify the impact of firm performance on Earnings per share. Findings reveal that there is no significant association between firms' performance and EPS. Furthermore r^2 values reveal that firm performance is not the determining factor of EPS of the listed banks in Sri Lanka.

Keywords: Firm Performance, Earnings per Share (EPS).

INTRODUCTION

It is generally agreed in theory that the financial goal of the firm should be shareholders' wealth maximization, as reflected in the market value of the firm's shares. There are two types of funds that a firm can raise: equity funds (equity) and borrowed funds (called debt). A firm sells equity shares to acquire equity funds. Shares represent ownership rights of their holders. Buyers of shares are called share holders and they are the legal owners of the firm. They invest their money in the shares of a company in the expectation of a return of their invested capital.

The return of share holders consists of dividend and capital gain. Share holders make capital gains by selling their shares. The payment of dividends to share holders is not a legal obligation (not required by the companies act); it depends on the discretion of the company's Board of Directors. Share holders can reap out the benefits of capital gain where the market value of the company's shares goes up. If the market value of the company's shares is a function of earnings per share, then maximization of the earnings per share will result in the highest possible price for the company's shares. In such

a case, share holders will definitely get benefited, as they can get lump sum of money as capital gain if they have higher number of shares. Furthermore, maximizing profit doesn't necessarily mean to maximize the earnings per share. Because, it is possible for a firm to increase profit after taxes by selling additional equity shares. In such a case there might be chances for earnings per share to decrease. By recognizing the importance of earnings per share, an attempt has been made to identify the cause and effect relationship between firm performance and earnings per share of the listed banks in Sri Lanka.

Objectives of the study

The main objective of the study is to identify the relationship between firm performance and earnings per share. The sub objectives are as follows,

- To identify the impact of firm performance on earnings per share.
- To find out the factors influencing earnings per share.

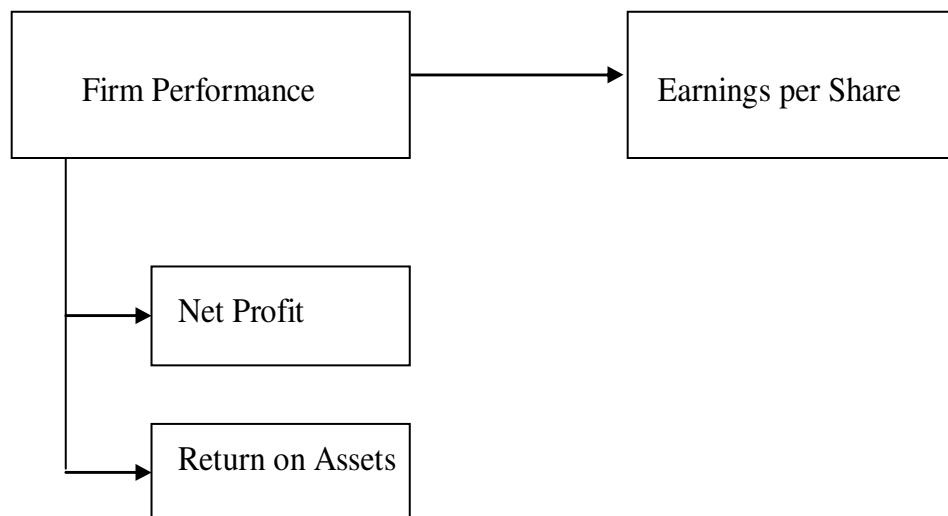


Figure 1. Conceptualization Model

Literature review

Ball and Brown (1968) found that a substantial part (about 85-90%) of the relevant accounting information (measured in terms of net income and EPS) leaked to investors before the formal release of accounting figures. In the case of good news from accounting releases, the average cumulative abnormal return began to rise 12 months before the actual earnings announcements. This can be explained partly by the issue of interim reports and statements which can provide investors more timely information than the annual reports. The average excess return concerning good news, that is positive changes in earnings, was about 7.5 %. A similar trend was also found with respect to bad news. In this case the average negative cumulative excess return was about 10 %, similar results to those of Ball and Brown have been reported by, for example, Brown (1970) and Emanuel (1989).

Ou and Penman (1989) conducted an analysis in which financial statement items were combined into one summarizing measure in order to predict future stock returns. Using 68 accounting descriptors, they found that financial statements capture fundamentals which are not reflected in prices.

Lamont (1998) studied the relationship between earnings and expected returns. He reported that both dividends and earnings have the ability to forecast returns and that earnings contain information because they are correlated with business conditions. Furthermore, Su (2003) in a study of dynamic behavior of risks and returns in the Chinese stock fund that the volatility of stock returns to be high in china relative to developed markets and that returns are positively auto-correlated to a greater extent in Chinese stock markets than in developed markets. He also found that some of

the government policies in regards to the stock market contribute to the market volatilities.

Conceptualization Model

Hypotheses of the study

H₁ :- There is a positive relationship between firm performance and earnings per share

H₂ :- Firm performance has an impact on earnings per share.

Data collection and sampling design

The data for this study consist of the banks in Sri Lanka whose ordinary shares were listed on the Colombo Stock Exchange throughout the period of 5 years from 2008 to 2012 collected from the CSE data base via referring to different journals, article and previous studies. The sample of this study composed of 7 listed banks from the banks, finance and insurance sector.

RESEARCH METHODS

Quantitative research approach was employed to find out the findings of the research study. Correlation and simple linear regression methods have been utilized in order to arrive at the end result of the study. Dependent and independent variables used in the study are as show in Table 1 below;

Earnings per Share have been used as the dependent variable where as net profit ratio and return on assets have been used as the dependent variables in the study.

Table 1. Description of variables used in the analysis

Variables	Description
Independent variables	
Net Profit Ratio (NP)	The ratio of net profit to total sales.
Return on Assets (ROA)	Earnings before interest and tax divided by total assets and multiplied by 100
Dependent Variables	
Earnings per Share (E.P.S)	Profit attributable to equity share holders divided by number of ordinary shares.

Table 2. Correlation Matrix

Variables	ROA	NP	EPS
Spearman's rho			
ROA Correlation coefficient	1.000		
Sig (2-tailed)			
N	7		
NP Correlation coefficient	0.955**	1.000	
Sig (2-tailed)	0.001		
N	7	7	
EPS Correlation coefficient	0.030	0.090	1.000
Sig (2-tailed)	1.000	0.848	
N	7	7	7

**Correlation is significant at the 0.01 level (2-tailed).

Table 3. Predictors of EPS - Model Summary

Model	Dependent Variable	R	R ²	Adjusted R Square	Std Error of the Estimate
I	EPS	0.149	0.022	- 0.173	10.81
II	EPS	0.118	0.014	- 0.183	10.86

Predictors: (constant), ROA, NP

Performance indicators have not been assessed in a single regression model instead have been analyzed by developing two models in order to prevent multi co-linearity problems in the study. The following regression models can be developed based on the variables used in the study.

$$EPS = \beta_0 + \beta_1 X_1 + \varepsilon \quad \text{Model I}$$

$$EPS = \beta_0 + \beta_1 X_2 + \varepsilon \quad \text{Model II}$$

Where;

X_1 Net Profit

X_2 Returns on Assets

β_0 Constant

ε Error term

RESULTS AND ANALYSIS

The above mentioned Table 2 indicates the relationship between the independent variables and dependent variable used in the study. It is apparent from the table

that the relationship was found to be positive but statistically insignificant for all the variables used in the study. The r values consist of 0.03 and 0.09 for the association between ROA and EPS and NP and EPS respectively.

The R² values of 0.022 and 0.014 which are in the above mentioned Table 3 denotes that 2.2% and 1.4% of the observed variability in Earnings per share is explained by the variability in ROA and NP. The remaining 97.8% and 98.6% of variations are explained by factors other than ROA and NP which are not depicted in the models. Because, which is beyond the scope of my study. Furthermore, the r² values reveal that there may be other factors which can have impact on EPS other than the independent variables used in the study. Hence, this area is indicated as a scope for future research.

It is apparent from the Table 4 that the t values of the models were found to be insignificant for all the independent variables used in the study. The beta coefficient values reveal the existence of positive relation-

Table 4. Coefficient for predictors of EPS

Models	Unstandardized coefficients		Standardized Coefficients Beta	t-value	Sig
	β	Std.Error			
1- EPS					
Constant	16.833	10.033		1.678	0.154
ROA	1.272	3.765	-0.149	-0.338	0.749
2- EPS					
Constant	10.438	13.081		0.798	0.461
NP	0.209	0.788	0.118	0.265	0.801

Table 5. Hypotheses Testing

NO	Hypotheses	Results	Tools
H ₁	There is a positive relationship between firm performance and EPS	Rejected	Correlation
H ₂	firm performance has an impact on EPS	Rejected	Regression

ship between the independent and dependent variables but which was found to be statistically insignificant. (Table 5)

CONCLUSION AND RECOMMENDATION

This study examined the relationship between firm performance and EPS of the listed banks in Sri Lanka over the period of 5 years from 2008 to 2012. The major findings of the study are summarized below;

The r values reveal the existence of positive association between the indicators of firm performance and EPS but which was found to be statistically insignificant. Furthermore, the R^2 values reveal that firm performance has a very little impact on the EPS. It reveals that other factors are probably found to be better predictors of EPS than the independent variables used in the study. Hence, there is an enormous scope for further researches in this area to find out the factors influencing the EPS of the listed banks in Sri Lanka.

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