

**ANALYSIS OF EARNINGS PER SHARE INFORMATION  
IN PREDICTING SHARE PRICES IN THE COLOMBO  
STOCK EXCHANGE**

**By**

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## CERTIFICATION

I hereby recommend that the thesis was prepared under my supervision by Abdul Azees Abdul Lathif (GS/MC/460/98) Tital 'Analysis of Earnings Per Share Information In predicting Share Prices In The Colombo Stock Exchange' has been accepted in partial fulfillment of the requirements for the degree of Master of Science in Management.



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## ABSTRACT

This research aimed to study the impact of earning per share announcements on share prices in the Colombo stock exchange. The research problem focused here was “What level of market impact of earning per share announcements on the share prices.” This research attempted to examine the impact of earning per share announcements on share prices in the Colombo Stock Exchange.

The sample consists of 280 earning per share announcements by 35 companies from 11 sectors listed in the Colombo stock exchange. The research covers eight years period from 1994 to 2001. To investigate the stock market response to earning per share announcement, the standard event study methodology is used. In this study the estimation of 100 days an event window of 21 days are used.

The analysis showed that, the Colombo Stock Exchange market is not efficient in the semi strong form sense. The study also concluded that earning per share announcements has no significant impact on stock prices. Since the results of this study indicate that the CSE is informationally inefficient so it has important implications for the investors, management of companies and stock market regulatory agencies. The investors could make use of reaction of earning per share announcements information to make decisions with regard to changes ( to buy or sell ) they have to make their portfolio in order to make profits or avoid potential losses.

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## LIST OF ABBREVIATIONS

|              |                                      |
|--------------|--------------------------------------|
| AAR          | -Average Abnormal Returns            |
| AR           | -Abnormal Returns                    |
| ASPI         | -All Share Price Index               |
| MPI / SPI    | -Milanka / Sensitive Price Index     |
| CAAR         | -Cumulative Average Abnormal Returns |
| CSE          | -Colombo Stock Exchange              |
| EMH          | -Efficient Market Hypothesis         |
| NYSE         | -New York Stock Exchange             |
| USA          | -United State of America             |
| UK           | -United Kingdom                      |
| SEC          | -Security and Exchange Commission    |
| DPS          | -Dividend Per Share                  |
| EPS          | -Earning Per Share                   |
| T-STAT       | -T- Statistics                       |
| STD          | -Standard Deviation                  |
| BANK         | -Banks Finance and Insurance         |
| BEVERAGE     | -Beverage Food and Tobacco           |
| CHEMICALS    | -Chemicals and Pharmaceuticals       |
| CONSTRUCTION | -Construction and Engineering        |
| DIVERSIFIED  | -Diversified Holdings                |
| HOTEL        | -Hotels and Travels                  |
| LAND         | -Land and Property                   |

# CHAPTER 1

## INTRODUCTION

### 1.1 Background of the Study

The investors are expecting optimum return from their investment through price gain and dividends. They are interested in price reactive information. The information needed by the share market can be classified into two broad categories: (i) internal and (ii) external information. Internal information consists of data and events made public by companies concerning their operations. It mainly takes the form of interim and annual financial statements to shareholders, and statements of the officers and managers of the firm. The financial statements comprise of profit and loss Account, Balance sheet and cash flow statement. Financial statement information is one of many potential sources that the capital markets may use in revising the values of common stock.

The questionnaire survey conducted by Chang, Most and Brian (1983) in USA, UK and New Zealand has provided strong evidence in support of this view. In their study institutional investors, individual investors and financial analysts in all the three countries gave the most consistently high ranking for the corporate annual reports as the source of information. Other than the financial statements, there are several key categories of firm specific internal information that are influencing the market's decisions on price of a particular share<sup>1</sup>. The impact of most of these firm specific information on prices of shares have been extensively studied in financial literature.

The empirical studies on market price behaviour have yielded theory of market efficiency. Research evidences show that in many of the capital markets, the forces which set the prices of individual shares cause pricing efficiency to occur. "Efficiency" in this context means that all available information concerning a particular security's future prospects is at all times fully and rationally reflected in the share prices. In the literature a

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<sup>1</sup> These categories of firm oriented information can be classified as follows: earning related announcements, forecasted earning announcements, dividend announcements, financing announcements, investment announcements, labor and legal announcements, marketing, production and sales announcements and merger and takeover announcements.

distinction is made between three levels of efficiency, each level relating to a specific set of information. These are namely, the weak form of the efficient market hypothesis, the semi-strong form and the strong form.

So far we have discussed share market reaction to internal information. Other than the internal information external information such as economical and industrial factors also have an effect on share prices. King (1966) observed that, on average, over half the variations in a share's price could be attributed to the general economic and industry influences of the country. These influences are common to all shares traded in the stock exchange. Therefore, the market performance is directly related to overall economic performance and the particular industry performance. That is, the success of the economy will ultimately depend on the success of the overall market. Therefore financial managers should know the ways in which securities are traded and priced in the capital markets. They should also know the procedures to be followed in issuing securities.

Stock market analysts have found that changes in capital structure have impacts on earning per share (EPS). Share price, price earning ratio (PE ratio) and cost of capital of a company. It is the objective of every investor to drive maximum return from investments.

## **1.2 Problem Statement**

Stock price behavior is rapidly changing during the last few years (ASPI/MPI lines have grown rapidly during the time period from 1990 to 1994 and decreased from the time period 1995 to 2001). Examining these changing situations carefully, though, some listed companies' shows the favorable returns throughout the year their market share prices have come down. The problem is why those share prices have come down even though their companies' show the higher returns? In case of foreign stock markets, researchers have identified the answers to these questions. In the long run, they identified some factors, which affect share prices. In Sri Lankan situation some factors have also considerably changed since the last decade. From 1994 the stock prices have decreased continuously. In this context, therefore, some factors affect the stock market activities

day by day. Hence stock returns in the stock market in Sri Lanka presents a veritable problem to be reckoned with which might not yet been addressed.

In a semi-strong form efficient market all the publicly available information should be reflected in share prices instantaneously. Therefore, if the CSE is semi-strong form efficient, we should be able to observe a quick and unbiased price reaction to EPS announcements by studying price reaction of shares traded at the Colombo Stock Exchange to the specific information of announcement, and awareness can be created about share price behaviour among investors, management of the companies, brokers and companies in particular and public in general.

### **1.3 Objectives of the Study**

The main objective of this study,

1. To examine the impact of earning per share announcements on share prices in the Colombo Stock Exchange (CSE).
2. To examine the market efficiency of the Sri Lanka Colombo Stock Exchange (CSE).

### **1.4 Methodology**

For the study the secondary data are used as a major source of data collection. The data are obtained from the Colombo stock Exchange and other relevant sources. For the purpose of this research the sample consists of 280 earning per share announcements by 35 companies from 11 sectors listed in the Colombo stock exchange. The research covers an eight year period from 1994 to 2001. This study employs well-known event study methodology to examine the stock price reaction to the information contained in EPS announcements by companies. An event study is the name given to an empirical investigation of the relationship between security prices and firm specific economic events. Most event studies have focused on the behavior of share prices in order to test whether their stochastic behavior is affected by the disclosure of firm specific events.

To investigate the stock market response to earning per share announcements, the standard event study methodology is employed. In this study an estimation of 100days an