

The Value Relevance of Financial Statements and Their Impact on Stock Prices: With Reference to the Listed Companies in Colombo Stock Exchange

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This research aims to examine the value relevance of financial statements. Though, the generally accepted accounting principles attempt to reflect a true and fair view of financial statements, the reality may differ from the expectation over the existence of emerging concepts of creative accounting and window dressing that might result in deviating earning figures from their original values and may mislead the market participants and decision makers regarding the return earning relation. Thus, the problem of the present study is, whether the red flags affect the return earnings relation and whether there is an issue of earnings value relevance in Sri Lankan context. To realize this, a model that includes red flag ratios were developed, which has proved to be the possible fraud indicators of falsified financial statements in different contexts and by estimating accruals quality, measured both by discretionary and non-discretionary accruals as per the modified Jones model. The data was collected from a sample of 91 non-financial companies listed in the Colombo Stock Exchange over the recent five years (2014-2018) and the OLS regression models were used to analyze the data. The ratios of profitability, liquidity, solvency and asset utilization indicated poor financial performance and financial condition attesting that financial information disseminated by financial statements is less value relevant. The results indicated that ratios of net profits to total assets and receivables to sales negatively impact on stock returns, while ratios of net profits to sales and working capital to total assets affect positively. Moreover, both types of accruals have significant importance in explaining stock price movements while non-discretionary accruals become more important than discretionary accruals confirming that the business conditions and managerial interventions determine earnings variability while business conditions seemed to be more important than managerial interventions. The use of this study could be of assistance to investors, analysts, auditors, state authorities to have a comprehensive view of value relevance of financial statements produced to them and for the scholars who endeavor for further research.

Keywords: Accruals quality, financial statements, value relevance