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S Gangadhara
Research Scholar, Canara Bank School of Management Studies, PG Department, Bangalore University, Bangalore, India

K Janardhanam
Prof. Research Guide, Canara Bank School of Management Studies PG Department, Bangalore University, Bangalore, India

Correspondence
S Gangadhara
Research Scholar, Canara Bank School of Management Studies, PG Department, Bangalore University, Bangalore, India

Stock returns: An EPS perspective

S Gangadhara and K Janardhanam

Abstract
The price of equity shares depends on the two basic factors, demand and supply. Price fluctuates with the phenomenon of buying and selling. Prices usually move up with buying and go down with selling of equity shares. Many accounting variables affect market value of equity share and Earnings Per Share is one of them. The present study is a conceptual framework where it analyses the EPS as a fundamental factor in influencing the Stock prices.

Keywords: Earnings Per Share, Fundamental analysis, Returns, Prices

Introduction
Forecasting a firm’s earnings plays a critical role in financial management and investment analysis. Managers use these forecasts for budgeting and resource allocation decisions. Since the work of Ball and Brown (1968), investors apply earnings per share forecasts to assess a firm’s cash flows and its valuation. The Ball and Brown study inspired a number of researchers in the 1970’s and the 1980’s to examine the relative forecast accuracy of analysts versus time-series models. (Naresh Bansal · Jack Strauss · Alireza Nasseh 2012) [1].

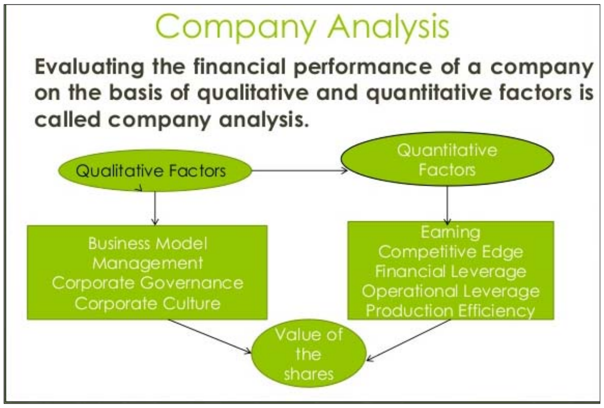
Relevance of eps in the company
Earning is an important variable affecting the market value of equity share. Company producing and selling goods and services useful to citizens in a society and earning revenue covering its cost of production adds to its reserve and builds up the same. Once a successful company starts building up reserves it will also look for expanding its scale of operations and thus boost its income. Once a company begins earning attractive sum, the equity share will have more and more demand which will result in increase in market value of the equity.
Earnings after interest, depreciation and tax belong to the equity shareholders. Earnings per share are usually derived by dividing earring (after deduction of tax, interest, Dividend and depreciation) on total number of outstanding shares. So earning per share is determined which the stock brokers and investors will watch carefully and consider it while deciding the market value of the equity share. In the above debate, we have measured the outcome of increase in earnings per share. The reverse will occur if the EPS falls down.
In equity market there are many factors that affect the market value of share. Chandra (1981) realized that at what level a factor is distressing the market value of share helps investors to make an investment verdict and their impact on equity share value is helpful to corporate, management, Government and investors. Equity is the residual claim of investors in assets after the payment of all liabilities. In case if liability exceeds from assets then there exists negative equity.

Objectives of the study
1. To Study the Earning per share and its relationship with stock return
2. To study how the EPS of a company is analyzed using various qualitative and quantitative factors

[1] Can we consistently forecast a firm’s earnings? Using combination forecast methods to predict the EPS of Dow firms

The importance of study of EPS

The test of relationship between Stock returns and accounting profit (or EPS) for the stock's firms in the Financial Market, earns itself a particular importance for the study, because the level of market efficiency and volume of information available to investors and quality the size of the accounting disclosure in annual reports of joint stock companies, especially that most of these studies were have been before the global financial crisis.



Qualitative factors
Business Model

It provides a description of the company's operations, mode of revenue generation, nature of expenses, organisation structure, and its sales and marketing efforts.

Management

The basic objective of the management is to attain the stated objectives of the company for the good of all stakeholders

Corporate Governance

Set of systems and practices put in place by company to ensure accountability, transparency, and fairness in dealings to safe guard the interest of stakeholders.

- Structure of the board of directors
- Financial and Information Transparency
- Corporate Culture

Quantitative factors
Earnings of the Company

- Operating Income
- Non-Operating Income

Measurement of Earnings

- Gross Profit=Sales- Cost of Goods Sold
- EBITTDA= Gross Profit- Operating Expenses
- EBIT= EBITDA- (Depreciation and Amortization)
- EAT=EBIT-Tax

This study will contribute to improving the methodology for field studies in this regard, as it will demonstrate the statistical test and verify whether different measure of profits used to describe the relationship between stock returns and profits affect the accounting profits explanatory power for stock returns (Dr. Ashraf Mahammad Al-Rjoub *et al*. 2013) [2].

[2] The Relationship between the EPS & the Market Stock Return (Case Study: Industrial Sector-Jordan); Information and Knowledge Managemen ISSN 2224-5758 (Paper) ISSN 2224-896XVol.3, No.11, 2013

Review of literature

Haddad (2003) [3] aimed to test the relationship between current accounting earnings and stock returns with the current accounting earnings and the future accounting profits of industrial company's listed public shareholding in the Amman Stock Exchange, and this relationship was examined using multiple regression method. Where the study sample consisted of 25 industrial companies 1999, has reached - listed on the Amman Stock Exchange during the period between 1985 study to the existence of a relationship between profits current accounting and the accounting profits future, and thus the existence of information content of earnings current accounting and the future profits.

Baruch Lev and S. Ramu Thiagarajan (1993) [4] contend that fundamental analysis is aimed at determining the value of corporate securities by a careful examination of key value-drivers, such as earnings, risk, growth, and competitive position. In the context of such analysis, we identify below a set of financial variables (fundamentals) claimed by analysts to be useful in security valuation and examine these claims by estimating the incremental value-relevance of these variables over earnings.

The research findings support the incremental value-relevance of most of the identified fundamentals; in fact, for the 1980s, the fundamentals add approximately 70%, on average, to the explanatory power of earnings with respect to excess returns. The results iterate that the returns-fundamentals relation is considerably strengthened when it is conditioned on macroeconomic variables, thereby demonstrating the importance of a contextual capital market analysis.

Jeffery. S *et al* (1997) [5] examine the underlying relations between account- ing-based fundamental signals and security prices. Based on associations between the individual signals and future earnings changes, there is an economic justification for analysts and investors to rely on many, but not all, of the fundamental signals identified by Lev and Thiagarajan [1993] when assessing future firm performance. In addition, some fundamental signals explain only long-term earnings growth, suggesting the possibility that they reflect both structural shifts and transitory profitability changes.

Approaches to determine appropriate capital structure

- EBIT-EPS Approach
- Valuation Approach
- Cash Flow Approach

EBIT-EPS Approach

- The EPS-EBIT approach to capital structure involves selecting the capital structure that maximizes EPS over the expected range of EBIT
- Using this approach, the emphasis is on maximizing the owners returns (EPS)
- The EBIT-EPS approach can help balance a company's debt with its equity

[3] The relationship between stock prices and future accounting profits: study applied to industrial companies Jordanian public shareholding

[4] Fundamental Information Analysis; Journal of Accounting Research Vol.31

[5] Fundamental Analysis, Future Earnings, and Stock Prices; Journal of Accounting Research Vol.35, No. 1 Spring 1997

- Effective business management requires careful planning and decision-making about the balance of debt and equity used in financing the business
- The EBIT-EPS approach is one method available to managers to guide them in making decisions about capital structure
- The EBIT-EPS approach is one tool managers use to decide on the right mix of debt and equity financing in a business's capital structure
- To benefit from the EBIT-EPS approach, it helps to understand the basics of how it works, as well as its advantages and drawbacks

Conclusion

There are different factors affecting the market value of a share. Among them one of the important factor taken in the study is Earnings per share. The phenomenon of the mean-reversion explore whether the stock price followed random walk. If the stock prices violate the trend of random walk, one possibility is the stock prices followed mean-reversion process. If the stock prices followed mean reversion in the long-run, the price movements should be predictable from the movements in firm fundamental values. In this sense, determining whether stock prices are mean-reversion is a very important issue for investors. Consequently, to analysis equity fundamentals, what is important is to verify whether the stock price moves with its firm’s fundamental.

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