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Predicting the Profit per Share Using Financial Ratios

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Abstract

The objective of this research is to test the effect of financial ratios on the accomplished profit per share. The results of this research have showed that the predictability of accomplished profit per share was reached using the financial ratio, economical ratio and commercial ratio. The use of working capital and peremptory cash ratio and rapid cash were not useful to predict the accomplished profit per share.

Keywords: Financial ratio, Economic ratio, Commercial ratio, Working capital, Rapid cash, Profit per share

1. Introduction

The predictability of profit per share is considered important for the investors' decisions and shareholders in different companies. If the shareholders or investors were able to predict the profit per share for companies, this indicated they will be able to make good investing decisions.

A convincing long-term return reversal effect has been shown in US studies (e.g. De Bondt and Thaler, 1985, 1987; Chopra, *et. al*., 1992) and in the UK market (Dissanaike, 1997 and 2002, and Arnold and Baker, 2007). Prior period extreme positive return shares (over 3 to 5 years) subsequently under perform the market, whereas those shares that perform the worst over a sequence of years then, on average, produce returns significantly greater than the market as a whole. Studies from around the world have drawn similar conclusions. The phenomenon is demonstrated to be robust to various risk analyses, the influence of size and market-to-book ratio.

Another strand of research takes the perspective that the firm’s fundamental values are indicated by information in financial statements. Share prices deviate at times from these, and only slowly gravitate toward fundamental values. Thus, analysis of published financial

statements can discover values that are not reflected in share prices. Several papers document the market's inability to fully process the implications of various financial signals (e.g. Foster, et. al., 1984, Sloan, 1996, Michaely, et. al., 1995, Piotroski, 2000 and Hirshleifer, et. al., 2004). Multiple pieces of information available from firm's financial statements are used to predict future excess returns (Ou and Penman, 1989a, 1989b, Holthausen and Larcker, 1992, Lev and Thiagarajan, 1993, Abarbanell and Bushee, 1997, Richardson, et. al., 2003 and Fairfield, et. al., 2003). Linked to this 'predictability anomaly' may be the observation that financial analysts pay less attention to poor-performing, low-volume or small firms (McNicholls and O'Brien, 1997, and Hayes, 1998). They have a bias in recommending those with a strong recent performance (Stickel, 2000, Jegadeesh et. al. 2004). One possible explanation for this is that, on an individual basis, the typical loser share will continue to under-perform. So, despite the documented out-performance of a loser portfolio analysts may risk ridicule and loss of credibility by recommending prior period losers as most of the these recommendations will turn out to be bad.

The objective of this research is to: (1) measure and analyze the profit per share through the period 2005-2010 and (2) measure the predictability of profit per share using the profitability ratios.

2. Methodology

Amman Stock Exchange Market data was used for ten companies in industrial sectors for the period 2005-2010. The ratios calculated included financial profit, economical profit, commercial profit, exchange ratio, rapid cash, liquidity peremptory, working capital, and profit per share. The research tested one major hypothesis and two sub-ones as follow:

The Major hypothesis:

There is not any statistical effect of financial ratios on real profit per share. This hypothesis testing the effect of ratios on predicting the profits gained per share in the ten industrial companies. Hypothesis testing will divided to two groups. The first groups testing the effect of profit ratio on the profit per share while the other will be the testing the effect of liquidity testing on the profit gained per share for the ten companies.

3. Results

Table 1 showed the financial ratios of the ten industrial companies for the study period. The companies' names were listed in abbreviation as C1 indicating company one up to C10 to indicate the tenth company in the industrial sector.

3.1 The effect of financial ratios on the accomplished profit per share

Table 2 shows linear regression of effect of financial ratios on predicting the profit per share.

Linear regression was used to test the effect of financial profit ratio on the accomplished profit per share. Table 2 shows positive effect of financial profit ratio on predicting the profit per share accomplished. The coefficient of financial profit was 3.106 and the impact on profit per share was positive. The model was significant with significance $p<0.05$. The regression

coefficient was small indicating the effect of other factors that contribute in predicting the profit per share value the function of prediction is:

Y = 3.1068 X1 + 0.232159, where

Y: Profit per share

X: financial ratio

3.2 The effect economical profit on accomplished profit per share

Table 3 shows the results of testing the prediction of accomplished profit per share using economical profit. Linear regression was used in this testing.

The results of testing showed significant positive effect of economical ratios on the accomplished profit per share. The constant value was 1.523 indicating that the increase of accomplished per share will increase by this value if the economical ratio improved by one unit. The model was significant with F value 21.30 and significant $p<0.05$. The regression model for this effect was:

Y = 1.524 X – 0.209; Where

Y: Accomplished profit per share

X: economical ratio

3.3 The effect of commercial ratio on accomplished profit per share

Table 4 represents the linear regression for the effect of commercial ratio on accomplished profit per share. The table provides model summary.

Linear regression testing shows positive effect of commercial ratio on the accomplished profit per share. The effect was significant. The improvement of commercial ratio will improve the accomplished profit per share by 5.45. The model was significant with F value 40.74 with significance $p<0.05$.

3.4 The effect of different ratios on accomplished profit per share

Table 5 represents the effect of commercial, financial and economical ratios on accomplished profit per share. The model predictability was acceptable as the regression coefficient was 0.426 indicating that these ratios can be used to predict accomplished profit per share ratio.

Linear regression analysis showed the positive effect of profit ratios on the accomplished profit per share. The effect was limited to the commercial ratio which shows significant effect on commercial ratio ($p<0.05$). This indicates that there is collinearity which affected the other factors to be included in one model to test the accomplished profit per share. In this concern, the previous regression models showed that each of the included ratio has positive effect on the accomplished profit per share.

3.5 The effect of exchange ratio and the accomplished profit per share

Table 6 shows the results of testing linear regression of exchange ratio on the accomplished

profit per share.

The linear regression testing shows positive effect of exchange ratio on the accomplished profit per share but the relation was not significant. Even though the model was not significant and the regression coefficient was small. These results indicate that the exchange ratio cannot be used to predict the accomplished profit per share.

3.6 The effect of rapid cash liquidity ratio on the accomplished profit per share

Table 7 shows the linear regression for the effect of liquidity ratio on the accomplished profit per share.

The results of testing the effect of rapid cash on the accomplished profit per share shows low regression coefficient 0.0788. The model was not significant with $p>0.05$. The effect of rapid cash on accomplished profit per share was not significant. These results indicate that there is no effect for rapid cash of the company on the accomplished profit per share.

3.7 The effect of cash peremptory on the accomplished profit per share

Table 8 shows the effect cash peremptory ratio on the accomplished profit per share.

The regression model for testing the effect of peremptory cash ratio on the accomplished profit per share was not significant ($p>0.05$). The regression coefficient was very low and close to zero and the effect of peremptory cash ratio coefficient was not significant.

3*.8 The effect of working capital on the accomplished profit per share*

Table 9 shows the linear regression of the effect of working capital on the accomplished profit per share.

The regression model showed not significant model for the effect of working capital on the accomplished profit per share ($p>0.05$). The regression coefficient was close to zero indicating that there is no effect and the effect of working capital was not significant.

The effect of the previous ratios (working capital, peremptory cash, and rapid cash) on accomplished profit was not significant using one model (Table 10).

4. Discussion

Predicting profit per share is considered one of the motives of financial markets. Profit per share is expected to be affected by financial ratios, economical profit and commercial ratios. The effect of rapid cash, cash peremptory, and working capital was tested on profit per share. The results of this research indicated that the profit per share can be predicted using the financial ratios. The model of testing was highly significant with significant effect of financial ratios on profit per share. Accordingly, the profit per share is triplicated by 3.11 the financial ratio.

The results indicated that the economical ratios can be used as predictor of profit per share. The linear regression showed significant model with significant effect of economic ratios on profit per share. The predicted effect indicated that profit per share would increase by 1.5 if

the economical ratio was one.

Moreover, commercial ratio has a positive effect on the profit per share. The testing model was significant and the t-test of the effect of commercial ratio was significant too. The model represents direct relation between the profit per share and commercial ratio. The collinearty among financial, economical and commercial ratios makes it impossible to test the effect on profit per share using the three factors in one model.

The results have shown that the effect of exchange ratio, cash peremptory and working capital was not significant, which is indicates that these ratios cannot be used for the prediction of profit per share.

5. Conclusions

The objective of this research is to test the effect of financial ratios on the accomplished profit per share. The predictability of profit per share is considered important for the investors' decisions and shareholders in different companies. If the shareholders or investors were able to predict the profit per share for companies, this indicated they will be able to make good investing decisions. The results of this research have showed that the predictability of accomplished profit per share was reached using the financial ratio, economical ratio and commercial ratio. The use of working capital and peremptory cash ratio and rapid cash were not useful to predict the accomplished profit per share.

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Table 1. The selected financial ratios for ten industrial company from ASE market for the period 2005-2010.

		Working capital	Profit per share	Liquidity peremptory	Rapid cash	Exchange Ratio	Commercial profit	Economicl Profit	Financial Profit
C1	2010	867116	0.25	0.08	1.60	1.60	0.11	0.46	0.17
	2009	1047154	0.22	0.10	1.70	1.70	0.10	0.39	0.17
	2008	1064654	0.26	0.33	1.63	1.63	0.12	0.40	0.16
	2007	1080073	0.30	0.48	1.84	1.84	0.14	0.61	0.18
	2006	1135082	0.28	0.53	1.81	1.81	0.13	0.52	0.19
	2005	1493639	0.25	0.79	2.11	2.11	0.11	0.48	0.18
C2	2010	1958172	5.76	0.32	6.04	6.04	0.52	1.29	0.27
	2009	1768842	5.22	0.60	6.26	6.26	0.46	1.37	0.11
	2008	1254892	3.20	0.90	4.64	4.64	0.28	0.83	0.15
	2007	1334138	0.24	5.06	7.90	7.90	0.03	0.09	0.01
	2006	1387161	2.13	3.98	5.94	5.94	0.19	0.70	0.10
	2005	1349482	6.77	3.18	5.22	5.22	0.58	1.85	0.30
C3	2010	5107758	0.19	0.16	2.20	2.20	0.12	0.30	0.10
	2009	3354754	0.01	0.02	1.50	1.50	0.01	0.01	0.00
	2008	4126164	0.07	0.25	2.27	2.27	0.04	0.15	0.04
	2007	4369614	0.09	0.66	3.08	3.08	0.07	0.29	0.05
	2006	4773781	0.16	0.94	2.85	2.85	0.12	0.41	0.08
	2005	4121221	0.08	0.55	2.75	2.75	0.07	0.21	0.04
C4	2010	30697941	0.39	0.83	4.30	4.30	0.24	0.83	0.21
	2009	31846245	0.36	1.37	5.33	5.33	0.25	0.98	0.21
	2008	30187753	0.33	1.53	5.63	5.63	0.23	1.00	0.15
	2007	28723629	0.54	1.69	6.11	6.11	0.25	1.16	0.17
	2006	26263388	0.44	1.56	5.55	5.55	0.22	0.92	0.15
	2005	24008435	0.38	1.81	5.63	5.63	0.21	0.88	0.14
C5	2010	15810423	2.14	0.87	4.03	4.03	0.99	0.78	0.26
	2009	16638827	0.48	0.00	6.72	6.72	0.23	0.14	0.08
	2008	23628082	0.56	1.17	16.99	16.99	0.18	0.14	0.05
	2007	20682805	0.58	0.00	5.36	5.36	0.17	0.14	0.07
	2006	20408306	0.76	0.00	5.62	5.62	0.20	0.18	0.10
	2005	18882061	0.57	0.00	4.12	4.12	0.19	0.13	0.09
C6	2010	1638366	0.46	0.01	2.62	2.62	0.20	0.61	0.22
	2009	1547982	0.36	0.86	3.43	3.43	0.20	0.77	0.18
	2008	1461318	0.39	1.14	3.74	3.74	0.23	1.00	0.16
	2007	1379267	0.31	0.75	3.94	3.94	0.19	0.91	0.15
	2006	1297689	0.40	0.31	3.63	3.63	0.23	1.12	0.21
	2005	973290	0.27	0.22	2.38	2.38	0.18	0.52	0.16
C7	2010	2645714	0.09	1.99	10.09	10.09	0.04	0.45	0.04
	2009	2626096	0.10	1.05	7.34	7.34	0.04	0.37	0.03

	2008	2625787	0.09	1.60	6.27	6.27	0.04	0.28	0.05
	2007	2569598	0.09	1.31	5.05	5.05	0.04	0.21	0.04
	2006	2541091	0.14	0.92	3.30	3.30	0.06	0.18	0.07
	2005	2444457	0.12	0.66	3.79	3.79	0.07	0.21	0.06
C8	2010	5250280	0.18	1.83	4.02	4.02	0.26	0.81	0.13
	2009	5402303	0.14	2.39	4.33	4.33	0.22	0.78	0.04
	2008	6119560	0.20	3.44	5.71	5.71	0.31	1.41	0.11
	2007	7498466	0.11	4.07	6.30	6.30	0.27	0.76	0.08
	2006	6440674	0.18	6.32	8.60	8.60	0.36	1.52	0.10
	2005	5712068	0.17	5.79	8.19	8.19	0.33	1.51	0.10
C9	2010	90458244	1.11	1.99	3.06	3.06	0.33	1.19	0.58
	2009	70144651	0.86	1.99	3.26	3.26	0.31	1.12	0.62
	2008	24803813	0.45	0.74	1.84	1.84	0.19	0.59	0.20
	2007	-6740163	0.27	0.13	0.86	0.86	0.13	0.31	0.14
	2006	12704774	0.15	0.10	1.39	1.39	0.08	0.15	0.09
	2005	23469149	0.06	0.33	1.84	1.84	0.04	0.06	0.03
C10	2010	4931068	0.64	0.14	1.16	1.16	0.17	0.17	0.52
	2009	16989329	0.41	0.76	1.90	1.90	0.16	0.12	0.34
	2008	11067259	0.14	1.83	3.26	3.26	0.12	0.11	0.11
	2007	6432480	0.12	1.41	2.09	2.09	0.11	0.14	0.09
	2006	5273932	0.12	1.13	1.85	1.85	0.11	0.15	0.10
	2005	5669991	0.09	1.00	1.71	1.71	0.08	0.08	0.08

Table 2. Linear regression of effect of financial ratios on predicting the profit per share

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.285522895	0.081523	0.065688	1.286787

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.524233	1	8.524233	5.148038	0.027009
	Residual	96.03766	58	1.655822		
	Total	104.5619	59			

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.232159	0.260409		0.891516	0.376336
	Financial profit	3.106808	1.369284	0.285523	2.268929	0.027009

Table 3. Regression analysis for the effect of economical profit on profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.518305308	0.26864	0.256031	1.148255

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	28.08955	1	28.08955	21.30435	2.22E-05
	Residual	76.47235	58	1.318489		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.20888	0.244259		-0.85517	0.395976
	Economical ratio	1.523797	0.330136	0.518305	4.615664	2.22E-05

Table 4. Linear regression for the effect of commercial ratio on accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.642375356	0.412646	0.402519	1.029017

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	43.14706	1	43.14706	40.74796	3.15E-08
	Residual	61.41484	58	1.058877		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.37093	0.212423		-1.74618	0.086074
	Commercial ratio	5.454293	0.854448	0.642375	6.383413	3.15E-08

Table 5. the regression model for the effect of financial, economical and commercial ratio on accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.652910265	0.426292	0.395557	1.034995

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	44.57388	3	14.85796	13.8702	7.08E-07
	Residual	59.98802	56	1.071215		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-0.46517	0.246124		-1.88999	0.063939
	Financial ratio	-0.05251	1.231587	-0.00483	-0.04264	0.966144
	Economical ratio	0.466316	0.406916	0.158613	1.145978	0.256678
	Commercial ratio	4.566233	1.19566	0.537785	3.819007	0.000338

Table 6. Linear regression for the effect of exchange ratio on the accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.159613777	0.025477	0.008674	1.325467

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.663877	1	2.663877	1.51627	0.223155
	Residual	101.898	58	1.756862		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.353835	0.32025		1.104871	0.273778
	Exchange ratio	0.078839	0.064025	0.159614	1.231369	0.223155

Table 7. The linear regression for the effect of rapid cash on the accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.159613777	0.025477	0.008674	1.325467

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.663877	1	2.663877	1.51627	0.223155
	Residual	101.898	58	1.756862		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.353835	0.32025		1.104871	0.273778
	Rapid cash	0.078839	0.064025	0.159614	1.231369	0.223155

Table 8. Linear regression results for the effect of cash peremptory on the accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.04708566	0.002217	-0.01499	1.341191

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.23182	1	0.23182	0.128875	0.720905
	Residual	104.3301	58	1.798794		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.630645	0.23403		2.694718	0.0092
	Peremptory cash	0.044652	0.124382	0.047086	0.358992	0.720905

Table 9. Regression coefficient for the effect of working capital on accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.037564133	0.001411	-0.01581	1.341733

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	0.147544	1	0.147544	0.081957	0.775682
	Residual	104.4144	58	1.800247		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.720811	0.209318		3.443622	0.001072
	Working capital	-3.1E-09	1.08E-08	-0.03756	-0.28628	0.775682

Table 10. Regression coefficient for the effect of working capital, rapid cash and peremptory cash on accomplished profit per share

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.171363329	0.029365	-0.02263	1.346234

ANOVA(b)						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.070501	3	1.0235	0.564738	0.640531
	Residual	101.4914	56	1.812346		
	Total	104.5619	59			

Coefficients(a)						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.398095	0.339566		1.172363	0.246015
	Rapid cash	0.090491	0.074531	0.183204	1.214129	0.229794
	Peremptory cahs	-0.03698	0.142689	-0.03899	-0.25914	0.796479
	Working capital	-4.3E-09	1.08E-08	-0.05216	-0.39459	0.694644