

## The Impact of Earnings and Cash Flows in Explaining Stock Returns

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This study mainly focuses on the role of earnings and cash flows in explaining the stock returns. Further, the study tested the incremental impact of operating earnings and cash flows on stock returns, and also tested the significance of incremental operating cash flows (OCF) with stock returns, when earnings are transitory.

The study is based on the secondary data, which is taken from the annual reports of the selected companies and Compact Disk of share prices of listed companies in the Colombo Stock Exchange (CSE) for the period of 1996-2003. The sample represents 55 listed companies in 13 different sectors of the CSE. The entire sample was chosen at random, according to the availability of data to calculate operating earnings, operating cash flows and stock returns for the period of 1996-2003. In order to present and analyze the data, both descriptive and inferential statistical methods are used. Basically, the univariate and the multivariate regression models are used to analyze the data. In this study, the developed statistical software package known as MINITAB has been used for analyzing data.

The present study has been used stock returns as the dependent variables and the earnings (level and change), cash flows (level and change), firm size, and book to market value are used as independent variables.

The findings of the study indicate that three months lagged independent variables provide the highest relationship than current and six month lagged variables. Further, the operating earnings are explaining stock returns than the operating cash flows. However, the significance of the operating cash flows were important in explaining stock returns when earnings are transitory.

Key Words: Stock returns; Cash flows; Share price; Independent- variable; Earnings

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