

The Generalized Association Between Financial Statements And Security Characteristics

Timo Salmi, Ilkka Virtanen and Paavo Yli-Olli

Abstract

A strong relationship between the firms' financial ratios and their security characteristics is observed when canonical correlation analysis is applied instead of trying to measure the volatile relationships between the individual variables. It is seen from a sample of 32 firms for 1974-84 that the key ratios in the relationship differ over time. Furthermore, it is observed that accrual-based ratios relate more significantly than the cash-based ratios to the security characteristics. Cash-based ratios are incrementally significant, though. To establish a relationship between the financial ratios and the security characteristics a limited number of temporally varying key ratios is sufficient. Finally, it is observed that in assessing security characteristics the expected returns and beta are sufficient. Higher moments have no incremental significance.

Key words: Financial statement analysis, accrual basis, cash basis, market-based ratios, canonical correlations.

(Scandinavian Journal of Management, Vol. 13 (1997), No. 2, 121 - 136)