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Extended Abstract

Financial Ratios and Cost of Equity

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Introduction

Fund or capital which is needed to finance a business or invest in a plan is prepared by different groups, those groups expecting a significant rate of return. Cost of equity of a business is equal to the minimum expected returns which a plan should include, and in this case investors will become eager to pay their fund for business. Research shows that various factors have effect on expected rate of return. Basu (1977) mentioned in his studies that those stocks that have larger P/E ratios will have a larger expected return. Bhandari (1988) described in his studies that depth ratio to total equity of shareholders as one of leverage ratios, have a relationship with expected return. Therefore, investors according to financial information published by companies and analyzing them through financial ratios, estimate risk of investment in companies and according to it, they demand specified expected return of their investment. And this rate is what we called cost of investment. Depending on the importance of the mentioned points, this research is representing the relationship between financial ratio and cost of stocks in Tehran Stock Exchange.

Hypothesis

1- There is a significant relationship between liquidity ratios and cost of equity

2- There is a significant relationship between profitability ratios and cost of equity

3- There is a significant relationship between net cash flows From operating activities to operation profit Ratio and cost of equity

4- There is a significant relationship between leverage ratios and cost of equity

5- There is a significant relationship between market ratios and cost of equity

6- There is a significant relationship between return of Shareholders equity and cost of equity

7- There is a significant relationship between return of asset and cost of equity

Methods

In this research we studied the relationship between financial ratios and the cost of equity during the period of 1382 to 1388. A sample of 60 TSE listed companies was selected and tested. Gordon Model was used to calculate equity cost and Multivariate Regression Model was used to test and analyze the hypothesis

Results, discussion and conclusion

The results of this research show that at a confidence level of 95%, there is a significant relationship between liquidity ratios, profitability ratios, leverage ratios, market ratios, and cost of equity.

Keywords: Cost of equity, Financial Ratios, Capital Assets Pricing Model (CAPM), Gordon Model

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