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Abstract

This paper tries to investigate the incremental informational content of cash flow from operations and earnings as well as the impact of high earnings on the informational content of cash flows and earnings by exploring the relationship between cash from operations and net earnings and companies' stock return. The study sample was chosen over the time period of 2006 to 2010 of listed companies on Tehran Stock Exchange and included 150 selected companies using systematic elimination method. According to the theoretical principles and literature of the topic for analyzing data, one main hypothesis and four sub-hypotheses are were proposed and were tested along with the corresponding models. Findings suggest that earnings in relation to cash flow from operations have greater informational content. The high earnings also has no negative impact on the informational content of earnings and when earnings is at its high level, there is no difference between informational content of high and low cash flow.

Keywords: Stock return, Informational Content, High Earnings, Low Earnings, High Cash Flows, Low Cash Flows

Introduction

According to the privatization discussion of state companies in recent years and the increasing number of listed companies on the stock exchange, as well as an increasing number of investors and funds directed to this position, the stock exchange has been taken into account as part of the country's capital markets. But constantly problems such as lack of companies' liquidity, most investors' blind following, economic instability and recently political issues that affect the performance of the stock market, have raised concerns for decision makers in this part of the capital market. The main objective of financial reporting is stating financial position and performance of the individual business units for the outside

people of business unit that in turn it helps them make financial decisions. Investors in order to assess future earnings and the prospects of the company's cash flows and also assessment of future cash flows that will be earned for them through dividends and increasing stock price, place a strong emphasis on the information of reported earnings. Therefore, the reported earnings elements should be provided completely and accurately in order to help users of financial statements to determine which items are expected to continue and what items are accidental and unstable in nature.

Cash flows statement includes important information about the cash flow arising from various activities, including cash flows from operating activities. Cash through normal activities and other sources of financing of enters profit-producing unit and is spent for performing operations, paying interests, repaying debts and expanding the profit-producing unit. Inflow and outflow of cash profit per unit is the reflection of management decisions regarding short and long term operating plans, investment plans and financing.

Stock return is one of the most important factors in choosing the best investment. Investment return represents the interests of that investment and investors are seeking investment opportunities to increase their investment return. To achieve this, investors need to consider many factors because they convert their ready capital into securities. If investors invest regardless of the number of factors, they will not achieve favorable outcomes from their investments. The main factor that investors take into consideration in their decisions is the rate of return, which means investors are in pursuit of the most efficient opportunities for investment of their additional resources in capital markets. Now the investors can analyze and predict the company's stock return by building a connective bridge among earnings, cash flows and stock returns. Given this, this paper investigates the impact of high earnings on the informational content of the cash flows from operating activities. It also examines the incremental informational content of cash flow from operations and earnings using variables of net earnings, stock returns and flows from operating activities. This research investigates this question that whether high earnings has an impact on the informational content of cash flows or not?

Literature Review
Informational Content and its Types
Information has no value by itself. Its value is due to change in how to make decisions. Appropriate information is the one, which is accurate and updated and improves decisions. The main objective of information expert (sender of the message) is that message is understood by the receiver in order to make change in decision-making. To achieve this objective, the expert should pay special attention to the presentation's appropriate features. Informational content can be divided into the following two categories:

Relative Informational Content
Relative informational content topic arises when the researcher is seeking to understand between two or more accounting criteria, which one has higher informational content than others do. In other words, when aim is ranking of accounting criteria, especially when these criteria are non-collective in decision-making models, the problem of relative informational content of the criteria is broached here.

Incremental Informational Content

In researches that deal with Incremental informational content of accounting items, the main objective is to answer the question whether one or more accounting criteria add something more than other variables or not, In other words, whether one or more accounting criteria provide information other than what others produce or not.

Relationship between Earnings and Company Value

Accounting Information users evaluate profitability and predict company's future cash flows based on the reported information in the financial statements and then by establishing a logical relationship between profitability and future cash flows evaluate company value make decision based on the predictions. The relatedness level of a variable in the value of shares is the explanatory power and predictive power of that variable (accounting information) in the value of shares. Thus, the relationship between accounting figures and variables with the price of shares and the value of the company will be reviewed in the two following aspects (Greg, 2001):

A: The relatedness level to the value of the company.

B: Greater explanatory power of the company value, which is obtained by comparing two data sources.

Primary researches regarding predicting the company value are conducted using accounting variables such as earnings and book value. Considering that the book value is the final result of accounting system, if accounting measurements would be performed in such a manner that book value is the same with market value, financial analysts no longer need accounting variables like earnings and cash flows, for the same reason the price of shares is considered to be a appropriate criterion for evaluating the usefulness of accounting figures (Chen and Zhang, 2003).

Relationship between Operating Cash Flow and Company Value

Given the criticism that has been drawn on the earnings and that earnings alone do not affect the value of the company, additional information is needed to assess the value of the company. The question that can be raised is whether splitting earnings into accrual and cash components will be effective or not? And what role plays operating cash flows in the value of the company? Introducing cash flow statements and presenting supplemental information of earnings and loss statement, many of the evaluating models are inclined to this financial statement have used relevant variables and based on the confirmation theory, such surveys are at the beginning and according to the assumptions of accounting positive theory the price of shares is related to cash flows not to the reported earnings.

Regarding the relatedness level of the operating cash flows with the value of company as a component of cash, a number of researches have been conducted to examine the imagined goals for the cash flow statements. In related researches with determination of the value of the company which are carried out based on the accounting variables, providing valuable information to help consumers' making-decisions and financial analysts is followed. Some researchers consider separating earnings into cash and accrual components, as the cause for better predicting of market value and reducing predicting error and explaining of the company value that this is a reason for relatedness of the cash flows from the operations with the value of the company.

Relationship between Earnings and Operating Cash

Earnings are one of the criteria constantly that is used in accounting, financial and economic researches. Moreover, users of financial statements also use earnings as an index for evaluating companies. One of the other criteria that recently have been taken into consideration of users of financial statements is operating cash flows or in other others cash earnings. Although earnings (revenues) as an important factor in identifying financial performance, but finally institutions rely on the cash from operating activities as a criterion for maintaining and keeping their operations; because cash flows reflect the institute's ability to gather its operating cash. If the accounting operation system is in the form of cash, operating earnings will be equal with operating cash flows, but the accounting system that has public acceptance and is used is accrual accounting. Therefore, there will be difference between operating earnings and operating cash flows. For this reason earnings and loss statement can never explicitly reflect cash events associated with operating activities. Awareness of such events is possible only with reference to the cash flow statements.

Although accrual accounting system has public acceptance, but since earnings management as an effective way to strengthen and improve revenues and profitability has been prevalent, it is a reason for the claim that why investors place too much importance on the operating cash in their analyses. According to the financial statements relationship, finally it can be concluded that the basic financial statements overall provide some information that is useful for evaluating financial flexibility. For example, the cash flow statement provides the information through reporting cash flows from operations and disclosure of its relationship with earnings. This information can be useful in predicting future cash flows and generally the greater the amount of net future cash flows from operations for each business unit, the greater performance for that business unit would be for confronting adverse changes. Financial performance statements provide information to help evaluate the performance of the business unit to reduce costs while in revenue decline.

Background

Chew's results with the aim of exploring that whether the relative predictability of earnings, the reported operating cash flows according to the cash flow statement and two additional criteria of cash flows are useful or not, indicates that operating cash flows has the capability to predict cash flows in relation to the traditional criteria of cash flow. In addition, the earnings prediction capability and operating cash flows, to a considerable extent, increase with the size of the company. Hirshleifer (2009) in investigating that whether cash flows and accruals impacts, should be extended to stock markets or not, shows that innovations in accruals and cash flows contain information about changes in the discount rate, or companies in response to lower-than-market evaluations attempt to manage earnings. Ibrahim (2011) by exploring the comparison capability of cash flows of the current period cash flows and earnings to predict future operating cash flows in Egypt shows that the accumulated earnings have extraordinary ability to predict future cash flows. John (2011) carried out a research with the aim of comparing the relative ability of operating cash flow and earnings in predicting dividend earnings. His findings indicated that based on the selected model, criteria of cash flow per share is the indication of a better fit in relation to earnings of per share, but it cannot be said that it provide a far better fit.

Ahmad (2011) in a research titled factors affecting the usefulness of analysts' prediction cash flows stated that analysts predict both cash flows and earnings when company's activities are complex and the size of companies is almost small. In addition, it was found that

the prediction of cash flows increases the usefulness of earnings and ability for predicting cash flows. In exploring that whether which one of the two accounting performance criteria i.e. cash flows or earnings is used more by non-professional investors in America and Mexico are used, Jooz (2012) shows that the majority of participants in America relied on earnings; while the majority of participants in Mexico, relied on cash flow. However, results for participants who benefit from earnings are mixed results. Wei Xu (2012) in examining the reported earnings quality by Chinese companies with the impact of ownership structure, empirically and simultaneously tested four criteria of earnings quality including earnings volatility, earnings variability in cash flows, the correlation between accruals and cash flows and the level of accruals. Findings suggest that although state companies are large and appear to be more profitable based on the reported earnings, but private, foreign and social companies outperform the state-owned companies from the standpoint of earnings quality and foreign companies have the highest earnings quality among all property groups.

In the empirical study of cash flow and portfolio of earnings momentum, Prodosh (2013) shows that strong information transmission both exists in temporary changes and risk sensitivity in relation to the average returns on cash flows and portfolio of earnings momentum. Christos (2013) in a research with the aim of investigating the impacts of IFRS on the explanatory power of earnings for stock returns shows that IFRS has multiple impacts on the value of the earnings. In particular, the informational content of earnings and its changes has been reduced after the introduction of IFRS. Reducing the informational content of earnings for return, can be attributed to IFRS and introduction of the principle of fair value. Eric and colleagues (2013) by investigating back accruals, earnings and stock returns, showed that accruals are comprised of at least two separate processes, one of the components of has positive serial correlation and the other has negative one. In the research, also it was found that reversal or rollback of accruals that implies negative serial correlation is good accruals that correctly predict fluctuations in working capital.

Methodology of Research

The present research from the standpoint of objective, types of data and the analysis of data is applied, post-event and descriptive-correlative respectively. In the research, the strengths and weaknesses of relationship between the independent and dependent variables is explored and also explaining ability of stock return is measured with factors such as earnings and cash flows. The statistical population of the research includes all of the stock industry, except industries which have financial (investment) activities, which were active from 2006 to 2010. To select an appropriate sample that was an appropriate representative for the population, the systematic exclusion method was used. For this purpose, four criteria have been considered and if a company has met all the criteria, the company has been selected. The criteria are as follows:

1. Before 2006 were listed on Tehran Stock Exchange.
2. In order to enhance the comparability of results, their fiscal year ended in March.
3. During the study period, they have not changed their fiscal year.
4. Necessary information was available for this research.

After considering all the above criteria, the target sample size was 150 companies and observations included 750 fiscal years of the companies. To gather information on theoretical topics such as literature and background, the library study method including books, journals, academic theses and foreign papers through the Internet was used. Data related to the variables was collected from different databases especially Rahavarde Novin software and

companies' financial statements. For performing necessary calculations and for conducting statistical tests, Excel software and Eviews were used respectively. According to the objectives of the research, the following hypotheses were suggested and tested:

The main hypothesis of the research:

High earnings have an impact on the informational content of cash flows.

The sub-hypotheses of the research:

Hypothesis 1: Earnings have an incremental informational content in relation to the operating cash flow.

Hypothesis 2: Operating cash flow has an incremental informational content in relation to the earnings.

Hypothesis 3: When earnings are high, an informational content exists for the high operating cash flow.

Hypothesis 4: When earnings are high, an informational content exists for the low operating cash flow.

Variables and Models

Since in the research, the researcher sought to find the impact of high earnings on the informational content of cash flows, therefore, the independent variables in the study are net earnings and cash flows from operating activities and the dependent variable is the stock return.

Measurement of Variables
Dependent Variable

Stock return is the dependent variable in the research. How to calculate stock return is as follows:

$$R_{it+1} = \frac{Pi.t+1(1+y+x) - pi.t - 1000y + D}{pi.t}$$

(1)

Where: $r_{i.t+1}$: rate of stock return i in the period t, $P_{i.t}$: stock prices i at the beginning of the period t, $P_{i.t+1}$: stock price i at the end of the period t, D: share dividends i, y: increase percent in capital from cash and demands, X: bonus shares or increase percent in capital from reserves in shares i and 1000: shows the nominal value of per share or subscription value of per share.

Independent Variables
1. Cash flows from operating activities

Cash flows from operating activities consist of cash from major cash-generating activities of the operating revenue of the business unit. The mentioned activities guarantees the production and sale of goods and providing services and the costs and its associated revenues in determining earnings and loss should be taken into consideration in the earnings and loss statement. Cash flows from operating activities primarily include incoming and outgoing cash flows associated with the mentioned activities.

2. Net earnings

It represents the results from operations and earnings (loss) of the business unit (enterprise) during the financial period that associated information with this variable is collected by Rahavard Novin software.

3 .The index of the net earrings to the market value of the company's shares (E/MV):

The index is used to classify the sample into two portfolios including both high and low earnings. Companies that their mean indices of earnings to the market value of shares at the end of the year are over the grand mean of sample are considered high earnings companies and the others as low earrings companies.

4. The index of cash flows from operating activities to the market value of the company's shares (CF/MV):

The index is used to classify the sample into two portfolios of high and low level of cash flows. Companies that their mean indices of cash flows to the market value of shares at the end of the year are over the grand mean of sample are considered high cash flow companies and the others as low cash flow companies.

4.2. Development of the models

Model 1 (change model): it is designed and tested to examine the incremental informational content of earnings and cash flows from operating activities.

$$R_{it} = \alpha_{0t} + \alpha_{1t}\Delta E_{it} + \alpha_{2t}\Delta CF_{1t} + \varepsilon_{1t}$$
(2)

Where: I = the distinctive character of the study company, t= the study period R= stock

return,   ΔE= earnings changes, ΔCF= cash flows and changes and ε_{it} = shows the error value of regression equation.

Model 2 (combining model of scale and change): it is designed and tested to examine the incremental informational content of earnings and cash flows from operating activities.

$$R_{it} = \alpha_{0t} + \alpha_{1t}\Delta E_{it} + \alpha_{2t}\Delta CF_{it} + \alpha_{3t}E_{it} + \alpha_{4t}CF_{1t} + \varepsilon_{1t}$$
(3)

Where: E= earnings and CF= shows cash flows from operations.

Model 3 (combining model of scale and change with dummy variable): The model examines the impact of high earnings on the informational content of cash flows and earnings (Will, 2012):

$$R_{it} = \alpha_{0t} + \alpha_{1t}\Delta E_{it} + \alpha_{2t}\Delta CF_{it} + \alpha_{3t}E_{it} + \alpha_{4t}CF_{it} + \alpha_{5t}D_{it} * \Delta E_{it} + \alpha_{6t}D_{it} * \Delta CF_{it} + \alpha_{7t}D_{1t} * E_{1t} + \alpha_{8t}D_{1t} * CF_{1t} + \varepsilon_{1t}$$
(4)

In which: D= dummy variable (0,1), If it takes 1 it means that the company has a high earnings and otherwise it has an average earnings.

Findings

According to the combination of the data, firstly F test (Chow test) is conducted in order to choose between two alternative methods of estimating model of Pooling and Panel. In the research, depending on the model, fixed cross-sectional and temporary effects are tested.

5.1. Chow and Hausman test

In the combined data, the temporal and cross-sectional effects of data, as well as their synchronous effects are tested. According to the fixed temporary effects model a *y*-intercept is offered for each year and according to the fixed cross-sectional effects model, a *y*-intercept is offered for each company. To be able to determine that the *y*-intercept whether have significant differences in terms of statistical matters or not, a Chow test is used. In all hypotheses, according to Chow test statistic regarding fixed cross-sectional effects, its probability is greater than 0.05, and about fixed temporal effects, its probability is lower than 0.05. Thus, the fixed temporary effects model is preferred. Research hypotheses using correlation of variables and regression equations using panel data were tested.

5.2. Analysis and hypothesis testing

The first and second hypotheses were suggested concerning incremental informational content of earnings and operating cash flow and using models 1 and 2 of part four were tested. The results of testing the first hypothesis test are presented in Table 1.

Table 1

Analysis of the first hypothesis - The first model

Estimation period: 2006-2010				
	Adjusted coefficient of determination		0.060098	
	F statistic		7.917966	
	Probability		0	
	Durbin-Watson statistic		2.065839	
Confidence level	Probability	*t* statistic	Coefficient	Explanatory variable
Non-significant	./3043	./028015	./424303	Earnings changes (ΔE)
Non-significant	./8927	./134908	./042955	Operating cash flow changes (ΔCF)
%99	0	12/32622	32/83438	*y*-intercept

According to the F statistic and its probability, it can be concluded that the regression equation is significant at confidence level of 99%. The results of the Durbin-Watson test for the model show relative independence of data. According to Table 1, the adjusted coefficient of determination of the model is 0.06; therefore, averagely 6% of the dependent variable changes are explained by this model. To examine the incremental informational content of earnings and cash flow, coefficients of the variables of the above model are used. Because the value of coefficient of earnings changes variable is more positive and significant than cash flow changes from operations; therefore, earnings has higher informational content than cash flows from operations.

The results of testing the second hypothesis are presented in Table 2. According to the F statistic and its probability, it can be concluded that the regression equation is significant at confidence level of 99%. The results of the Durbin-Watson test for the model show relative independence of data. The adjusted coefficient of determination of the model is 0.10; therefore, averagely 10% of the dependent variable changes are explained by this model.

Table 2
Analysis of the second hypothesis - The second model

Estimation period: 2006-2010				
	Adjusted coefficient of determination		0.063402	
	F statistic		6.270141	
	Probability		0	
	Durbin-Watson statistic		2.067393	
Confidence level	Probability	*t* statistic	Coefficient	Explanatory variable
Non-significant	./3043	1/028015	./434203	Earnings changes (ΔE)
Non-significant	./8927	./134908	./042955	Operating cash flow changes (ΔCF)
%95	./0497	1/965835	./870661	Earnings (E)
Non-significant	./5663	-./5738	-./32904	Operating cash flow (CF)
%99	0	11.98742	32/80177	*y*-intercept

In the second model, the sum of the estimated coefficients of changes and earnings level ($\alpha_1 + \alpha_3$) show the informational content of earnings and the sum of the estimated coefficients of changes and cash flows level ($\alpha_2 + \alpha_4$) show informational content of cash flows. Therefore, according to that the sum of the coefficients of related to earnings are more positive and significant than the sum of coefficients of related to cash flows; therefore, according to this model, earnings have higher informational content than cash flows. Thus, according to the results of model 1 and 2 it can be argued that earnings have greater informational content in relation to cash flows. As a result, hypothesis 1 is confirmed and hypothesis 2 is rejected.

To examine hypotheses 3 and 4, the study companies are classified into two groups of companies with high cash flow and companies with low cash flow, based on the cash flow from operations to the market value of shareholder's rights at the end of the period. Thus, the third model in the two groups is tested one for companies with high cash flow and companies with low cash flow. In addition, the dummy variable D, which is an indicator variable (0 and 1) are used respectively to determine high and low earnings. To examine the impact of high earnings on the informational content of earnings and cash flows in this model, companies with high earnings obtain code one can obtain and other companies assign code zero. To test the third hypothesis, the third model is used and in it ($\alpha_5 + \alpha_7$) indicates the sum of the coefficients of changes and the earnings level and ($\alpha_6 + \alpha_8$) shows the sum of the coefficients of changes and cash flows level when earnings are high.

According to the F statistic and its probability, it can be concluded that the regression equation is significant at confidence level of 99%. The results of the Durbin-Watson test for the model show relative independence of data. The adjusted coefficient of determination of the model is 0.10; therefore, averagely 10% of the dependent variable changes are explained by this model.

Table 3
Analysis of the third hypothesis - the third model

Estimation period: 2006-2010				
	Adjusted coefficient of determination		0.10241	
	F statistic		1.995202	
	Probability		0	
	Durbin-Watson statistic		1/834914	
Confidence level	Probability	*t* statistic	Coefficient	Explanatory variable
Non-significant	0/7803	0/279832	1/462942	Earnings changes (ΔE)
Non-significant	0/4999	./677493	./439374	Operating cash flow changes (ΔCF)
Non-significant	0/4404	-./77491	-13/3219	Earnings (E)
Non-significant	0/1125	-1/60285	-1/39499	(CF)
Non-significant	0/6749	-0/42088	-2/20882	$D_{it}*\Delta E$
Non-significant	0/9928	0/0091	./006282	Dit*ΔCF
Non-significant	0/3955	0/853815	14/64755	Dit*E
Non-significant	0/4999	0/677493	./439374	$D_{it}*CF$
%95	0/0291	2/217724	14/23942	*y*-intercept

When earnings are high enough, the sum of positive and insignificant coefficients of changes and cash flows level (equal to 0.44) show that the informational content does not exist for high cash flow and therefore the third hypothesis is rejected. The positive and significant coefficients of changes and earnings level (equal to 12.046) indicate that high earnings do not result in a negative impact on the informational content of earnings.

Test results of the fourth hypothesis are presented in the following table. According to the F statistic and its probability, it can be concluded that the regression equation is significant at confidence level of 99%. The results of the Durbin-Watson test for the model show relative independence of data. The adjusted coefficient of determination of the model is 0.16; therefore, averagely 16% of the dependent variable changes are explained by this model in companies with low cash flow.

Table 4

Analysis of the fourth hypothesis - the third model

Estimation period: 2006-2010				
	Adjusted coefficient of determination			0.167252
	F statistic			9.439647
	Probability			0
	Durbin-Watson statistic			1.872418
Confidence level	Probability	*t* statistic	Coefficient	Explanatory variable
Non-significant	0/2719	1/099672	0/994515	Earnings changes (ΔE)
Non-significant	0/5316	0/625919	0/377408	Operating cash flow changes (ΔCF)
Non-significant	0/9719	-0/03525	-0/07239	Earnings (E)
%95	0/0476	1/984975	6/273496	(CF)
%90	0/0908	-1/69382	1/90819	D_{it}*ΔE
Non-significant	0/5861	0/544759	0/477315	Dit*ΔCF
Non-significant	0/5691	0/569712	1/176506	Dit*E
%95	0/0195	-2/3411	-7/55559	D_{it}*CF
%99	0	10/48821	21/71259	*y*-intercept

When earnings are high, therefore the sum of the negative coefficients of level and changes of cash flows (equal to -7,0.7) show that the informational content doe not exist for low cash flow; thus, the fourth hypothesis is rejected. The positive and significant coefficients of changes and earnings level (equal to 3.0846) indicate that high earnings do not result in a negative impact on the informational content of earnings.

Discussion and Conclusion

According to the results of models of 1 and 2, it can be argued that earnings have greater informational content than cash flows. As a result, hypothesis 1 is confirmed. The results of the research are in accordance with Yazdi (2006); Weil's (2012) researches. According to the examination and test of the second hypothesis, it can conclude that the cash flows have not higher informational content than earnings, thus, the second hypothesis is rejected. The results of this hypothesis are in accordance with Mohammad Arab Mazar Yazdi's research (2006) but it is not in accordance with Weil's results (2012). According to the examination and test of the third hypothesis, it can concluded that high earnings have not a negative impact on the informational content of earnings and when earnings are high, informational content does not exist for high cash flow, thus, the third hypothesis is rejected. The results of this hypothesis are in accordance with Weil's research (2012).

According to the examination and test of the fourth hypothesis, it can concluded that high earnings have not a negative impact on the informational content of earnings and when earnings are high, informational content does not exist for low cash flow, thus, the fourth hypothesis is rejected. The results of this hypothesis are not in accordance with Weil's research (2012).

According to the results of the research, the following suggestions are recommended:

1. Financial analysts should be more active in the market so that information would be analyzed in various aspects and Tehran Stock Exchange should become closer to the job market.

2. According to the results of the research, it is suggested that a suitable information system should be established in Tehran Stock Exchange so that the necessary information needed to perform necessary analyses would be provided timely and appropriately to the investors, analysts and use of the information should not be confined to any particular group.

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