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# **A study of the relative and incremental information content of financial statements in forecasting stock price: Iranian evidence**

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**The aims of this study is to determine and compare the relative and incremental information content of accounting variables in relation to the stock price or stock return. For this purpose, operating profit variables, net profit and the ratio of debit to stockholders' equity has been taken into consideration as independent variables and stock return as a dependent variable. Data were collected from Tehran Stock Exchange by accessible information. Statistical population of the study contains listed companies on Tehran Stock Exchange for the period of 2006 to 2010. The results indicate the correlation ratio of net profit and partial correlation of operational profit in relation to stock return and indicate unrelated quotient of debit to stockholder's equity in relation to dependent variable. The results also indicate that the net profit has information content in proportion to other two variables.**

**Key words:** Relative content, incremental content, balance sheet, profit and loss statement.

## **INTRODUCTION**

Stock Exchange as a market, prepares the required facilities for purchasers and sellers of the stocks, in the way that they can transfer their money to securities or vice versa. On other hand, this organization, under some circumstances, will supply financial resources for accepted companies (Salehi, 2008). The Stock Exchange is an organization for fitting savings and also guiding them to generating and useful investments for society and state economy, so, studying and researching about this organization is especially important (Salehi, 2009). This market is also one of the principal pillars of investment market, thus, the most important duty of this market is absorbing dispersed assets and allocating these resources to the units which are either in the way of development and or supply the considered profits of the investors (Salehi and Rostami, 2009). Investors with different motives play the main role in supplying financial resources. Business units are also following different goals to absorb dispersed assets, but the main common goal for both groups is accessing more revenue and making maximum wealth. Generally, the revenues that will be accessed by investors in this market are in the frame of payable interest and price increasing (Salehi et

al., 2009).

Therefore, the objective of investors is making maximum expectable return according to increasing initial risk, so, the researchers and financial analysts look to find operational criteria which, according to them, can be used to forecast return and its changes for the stock of a company with nearest estimation and if the investors can forecast stock return somehow, and sell the stocks with low future return and purchase stocks with high future return, they can maximize their fortune (Namazi and Salehi, 2010). One of the researches disturbances in financial and accountant affairs is identifying factors and indices which are applicable in determining the return and stock price and also determining information contents of each of these indices proportionately, in comparison to each other.

Up to now, many researches have been done on the usefulness of accounting information in making decision by users of financial statements. For example, we can mention many researches which review the relations between relative and incremental information content for forecasting stock price and return in order to specify what information might be needed by investors to make

decision in Tehran Stock Exchange (TSE).

### Research problem

When someone decides to invest in a stock market, the first thing they are faced with is selecting the considered stock. In TSE, investors, especially petty investors, decide as per non-official and non-correct information, which results in their loss, and finally, disappointment and exit from the market (Salehi et al., 2011). For continuation of investor's appearance as the main pillar in stock exchange, it is necessary to prepare some appliances.

These appliances can have legal and news transmission sights. As a legal sight, stock exchange trustees should protect stockholders equity; especially petty stockholders by some tools such as stock protect fund, and price ceiling. As news transmission sight, it should provide correct information and in time information for investors. However, because most investors have little information about the manner of investing and are not able to utilize all information about the companies, it is necessary to prepare some criteria by carrying out research until investors can use them and make decision precisely and fast (Moradi and Salehi, 2011). Up to now, many people have worked on information content of different items of financial statements but often reviewed two financial statements: profit and loss and cash flows statements (Salehi and Rostami, 2011). So, the present research will analyze these relations in view of balance sheet items.

According to aforementioned reasons, we consider reviewing and studying relative incremental information content of balance sheet and profit and loss statements for forecasting stock price, and generally, stock return to determine what investors in TSE need to make a decision. In fact, this subject was followed with the intention of wanting to know what group of information helps the investor to forecast stock price and return. Studies about incremental information content were carried out to check whether or not one or some accounting criteria generated more information than the other criteria. But relative information content ask another different question and this is whether one accounting criteria has more information content about the others or not?

So many people have worked on different items of information content of financial statements items but often reviewed two financial statements: profit and loss and cash flows. Therefore, we will analyze these relations in view of balance sheet items; we reviewed balance sheet and profit and loss statements items. In balance sheet, we have considered the ratio of debits to stockholder's equity, and in profit and loss, we have considered net profit and operational profit. After reviewing information content of each of these items on which information of financial statements is more useful

for forecasting stock return, the following objectives were considered:

- 1) To determine and compare relative information content, net profit, operational profit and ration of debits to shareholder's equity in relation to stock price and return forecasting.
- 2) To determine and compare incremental information content of aforementioned items and determine the best compound of these variables to predict stock price and return to make decision for investing.

### LITERATURE REVIEW

Patell and Kaplan (1977) reviewed the incremental information content of cash flow data by application of operational floating capital percentage of changes as criteria of unexpected cash flow. Their results indicate that earnings is highly associated with operational floating capital and also, the mentioned association will be clearer when earning and cash flow series are observed as percentage of changes.

Lipe (1986) reviews the relations between components of accounting earnings and stock returns. He chose a very long time period for this study (from 1349 to 1980). In his study, he tested 6 commonly reported components of earning, and sought if there is additional information in relation to the amounts of earnings which were presented to the users or not.

The six variables which he analyzed in this research were: gross profits, general and administrative expenses, depreciation expense, interest expense, income taxes and other items. The conclusion of his result indicated that the mentioned variables provide users significant explanatory ability in relation to the explanation which earning amount can provide. The considerable reaction of stock returns versus huge changes of each one of theses 6 factors caused Lipe (1986) concludes every one of these factors prepares separate part of information for stock exchange. He believed that if we summarize anything in earnings amount and report these 6 variables totally in company's profit, some useful information for users will be lost.

Bowen et al. (1987) reviewed incremental information content of accruals and cash flows; the result of their study contains a 10-year period and expresses that: 1) the information of cash flows have incremental information content in relation to earnings, 2) information of cash flows have incremental information content in relation to earning and operational floating capital information, and 3) information of accruals separately, and also jointly, have incremental information content in relation to cash flows.

Livant (1990) studied incremental information content of ratios of cash flows statement in proportion to information content of ratios arising out of profit and loss,

and balance sheet. Studying the relationship between these ratios with stock's return, he concluded that ratios indicating information regarding cash flows statement holds incremental information content in several years in question. He also concluded that financial ratios of cash flow statement have more correlation and relationship with stock's return in comparison to financial ratios.

Ashiq (1994) studied incremental information content, floating capital arising out of operation and cash flows. The results obtained indicate incremental information content on floating capital arising out of operation and cash flows. The results also indicate that floating capital arising out of operation in cash flows has incremental information content.

Biddle et al. (1997) presented evidence about relative content and incremental content. Informational relative content tests in their research indicated that operational profit presenting a coefficient of determination of 13% in comparison to surplus profit with a coefficient of determination of 7%, economics value added (EVA) with a coefficient of determination of 6.5% and cash flows arising out of operations with a coefficient of determination of 2.8%, hold a more explanatory capacity in relation to total stock's return as dependent variable. In studying incremental information content, researchers divided up EVA to its parts and studied assistance rate of each part of EVA to explain return. Incremental information content tests indicated that increasing EVA informational content is very low in comparison to operational profit (OP). Biddle et al. (1997) concluded finally that although EVA could be an effective instrument in internal decision-making, operation evaluation, and a reward mechanism for some countries, it does not generate more profit than accounting profit in relation to stock's return.

Chen and Dodd (1997) studied value relationship of information content of operational profit, surplus profit and EVA. They concluded that one of these independent variables was standardized through initial stock's price. They also concluded that EVA in proportion to surplus profit and operational profit has an incremental information content or load. They claimed that surplus profit informational content is more incremental than informational content of operational profit. In studying relative information content, they also concluded that operational profit presenting a coefficient of determination of 6.2% holds a more explanatory capacity in relation to stock's return, as a dependant variable, in comparison to surplus profit with a coefficient of determination of 5% and EVA with a coefficient of determination of 2.3%.

Peixoto (2000) studied value relationship of information content of operational profit, surplus profit and EVA. In studying information relative content, he concluded that net profit presenting a coefficient determination of 53.86% in proportion to operational profit with a coefficient determination of 51.22% holds a more explanatory capacity in relation to total stock's return, as a dependent variable. Net profit compound with EVA was

introduced as the most logical operation criteria compound toward effectiveness, in information incremental content study conducted by him.

EVA information content was studied in comparison to operational profit and operational cash flows in a research carried out by Tracey and Worthington (2000). In studying information relative content, they concluded that operational profit presenting coefficient of determination of 23.67% holds a further explanatory capacity in relation to total stock's return in proportion to operational cash flows (18.10%) and EVA (14.29%). In studying informational incremental content, he introduced operational profit compound with EVA as the most logical operation criteria compound toward effectiveness.

Haw et al. (2001) studied profit relative and incremental information content, operational cash flows and accruals in capital market of China. Their research findings indicate that profit has a more explanatory capacity than operational cash flows. Based on their research, profit alone explains 5.8% of fluctuations in stock annual returns, while cash flows explain only 30%. They expressed that accruals are a cause for profit relative information content to be exceeded. In addition, the said research indicated that profit has incremental information content in proportion to cash flows and vice versa. The research indicates that Chinese investors pay attention to profit information more than cash flows in their evaluations process.

Financial ratios to predict stock's return was studied in a research conducted by Lewellen (2003). This research was conducted from 1995 to 2000. Prediction power of income to price relation, book value to market value and dividend return were analyzed in this research, using capital assets pricing model. The results obtained indicated that dividends could significantly predict stock's return rate, but income relation to price and book value to market value has a low ability to predict stock's return rate.

Olsen and Mossman (2003) studied stock's return prediction using financial ratios. Nervous networks model and ordinary minimum squares technique were used to predict stock's return in this research. The research was conducted from 1976 to 1993. Primary sample included 4570 observations. There were two limitations: i) accessibility of all data related to assets sale and capital to companies and ii) conducting 10 deals per year for each company. Therefore, sample's number was decreased to 2352 observations. Stock's return ratio was deemed as a dependent variable while accounting ratios, an independent variable, in this research. The conclusions indicated that the results of using neural network technique to forecast are more acceptable in relation to other techniques and decrease error of estimation significantly.

## RESEARCH METHODOLOGY

Whereas the objective of the study is the existence of correlation

between independent variables with dependents, the method of this research is correlational and ex post facto (using past information). Generally, correlation researches include all researches that try to discover and determine relation between different variables using coefficient of correlation.

In this research, we try to check information contents of the variables operational profit, net profit, and ratio of debits to shareholders equity in relation to stock returns. Thus, the following hypotheses have been considered:

**H<sub>1</sub>:** Ratio of net profit to operational profit and ratio of debits to shareholders equity have more explanation capacity in relation to stock returns.

**H<sub>2</sub>:** Ratio of operational profit to net profit and ratio of debits to shareholders equity have more explanation capacity in relation to stock returns.

**H<sub>3</sub>:** Ratio of debits to shareholders equity and the ratio of net profit to operational profit have more explanation capacity in relation to stock returns.

**H<sub>4</sub>:** Ratio of net profit to operational profit and ratio of debits to shareholders equity have incremental information content.

**H<sub>5</sub>:** Ratio of operational profit to net profit and ratio of debits to shareholders equity have incremental information content.

**H<sub>6</sub>:** Ratio of debits to shareholders equity and ratio of net profit to operational profit have incremental information content.

### Research variables

In this research, variables are divided into two general independent and dependent variables as given thus.

#### Independent variables

Independent variable which is sometimes called input variable or motive variable is an eventual or hypothetical cause of dependent variable. Independent variables in this research are net profit, operational profit and ratio of debits to shareholders equity:

- i) Net profit: Amounts of net profit has been extracted directly from profit and loss statement.
- ii) Operational profit: This amount has also been extracted from profit and loss and wherein that mentioned measure has not been specified definitely in profit and loss, for calculating, we have used the following function:

Operational Profit (Loss) = Sale - actual cost of good sold - operational expenses

- iii) Ratio of debits to shareholders equity: This ratio is simply calculate-able by virtue of balance sheet information.

#### Dependent variables

Dependent variable is an eventual or hypothetical effect which is sometimes called response or output variable. Dependent variable in this research is stock price and in other words, is total annual returns of stocks and its purpose is the changes of the beginning of period price and ending price together with other earnings result of purchasing stock like the benefits of preemption rights, bonds shares and cash dividends, divided by the stock price at the beginning of period.

#### Controlling variables

Controlling variables is attributed to those factors whose effects on

dependent variables are neutralized and deleted by the researcher. In the present study, the size of company has been considered as a controlling variable and for its deletion, we divided pre-said independent variables to company's assets for every year so that the conclusion of research have more reliable capacity.

### Data collection

We have used different methods to collect required information for the study. The method of gathering information in scientific researches should be elected in a way that enables you gather true and precise information. All information utilized in this research is gathered from secondary information, because they are gathered from financial statements. To access and review the companies' financial statements, we have used the software, Tadbir Pardaz, Sahra and published DVD by the organization. To access the relevant information of net profit and operational profit, we have used profit (loss) statement and the information of the ratio of debit to shareholder's equity of balance sheet of the companies and Tadbir Pardaz software. Also, the information of return was gathered from the archive of TSE website for 312 listed companies on TSE.

### Hypotheses testing

According to postulated hypotheses, the first three hypothesis aims to test the relative information content of the variables and the next three hypotheses aim to check incremental information content of variables. Multivariate regression with stepwise method shall be used to analyze the correlation of prediction type. Multivariate regression is a method used to study the share of one or some independent variables ( $X_i$ ) in forecasting dependent variables ( $Y$ ).

First, we check coefficient of correlation between independent and dependent variables and coefficients significance. In this process, Pearson correlation is calculated between dependent and independent variables which are specified by the type of relation the coefficient of correlation sign has (directly or indirectly). Also, its significance is checked by probability measure, probability measure lower than 0.05 indicates that there is a significant relation.

To test the first hypothesis, we used calculated coefficient of correlation by SPSS. To test second and third hypotheses, we used coefficient of determination and modified coefficient of determination.

### Descriptive statistics of research variables

Below, the table of description of research variables such as independent and dependent is submitted: Mean, Standard Deviation and Variance. Each one of variables is indicated in per considered years at first and then they are indicated in total. Table 1 is just indicating the limitation of utilized variables in this research. Inferential statistics results are presented in Table 2.

### Testing of first hypothesis (H<sub>1</sub>)

The result of the first hypothesis indicates that net profit has correlation and capacity of explaining in relation to stocks return.

### Correlation analysis

In this function, the hypothesis under consideration is given as:

**Table 1.** Descriptive statistics.

Year	Items	Return	Ratio of debit to stockholders equity	Net Profit	Operational profit
2006	Mean	0.2852	3.3409	0.1371	0.1722
	Number of company	62	62	62	62
	Standard deviation	0.6006	5.1072	0.1234	0.1261
	Variance	0.361	26.084	0.17	0.016
2007	Mean	0.4154	20.6326	0.1225	0.1542
	Quantity	62	62	62	62
	Standard deviation	0.6958	3.3459	0.1267	0.1317
	Variance	0.484	11.195	0.016	0.017
2008	Mean	0.3294	2.9111	0.1133	0.1523
	Number of company	62	62	62	62
	Standard deviation	0.6448	3.0112	0.2115	0.2346
	Variance	0.416	9.067	0.045	0.055
2009	Mean	0.1043	3.1011	0.1301	0.1615
	Number of company	62	62	62	62
	Standard deviation	1.6077	3.4646	0.2861	0.2939
	Variance	2.585	12.003	0.082	0.086
2010	Mean	0.1232	2.3881	0.0926	0.1251
	Number of company	62	62	62	62
	Standard deviation	0.4133	10.0141	0.1562	0.1439
	Variance	0.171	100.282	0.024	0.021
All years	Mean	0.2514	2.8748	0.1191	0.1531
	Number of company	312	312	312	312
	Standard deviation	0.8985	5.6062	0.1912	0.1970
	Variance	0.807	31.429	0.037	0.039

**Table 2.** Coefficient correlation and level of factor significance between variables.

Variable		Return	Ratio of debit to stockholders equity	Net profit	Operational profit
Return	Coefficient correlation	1	-0.023	0.176	0.169
	Significance	0	0.684	0.002	0.040
	Number of company	312	312	312	312
Debit ratio to stockholders equity	Coefficient correlation	-0.023	1	-0.022	-0.016
	Significance	0.684	0	0.696	0.777
	Number of company	312	312	312	312
Net Profit	Coefficient correlation	0.176	-0.022	1	0.936
	Significance	0.002	0.696	0	0.000
	Number of company	312	312	312	312
Operational profit	Coefficient correlation	0.169	-0.016	0.936	1
	Significance	0.400	0.777	0.000	0
	Number of company	312	312	312	312

$$\begin{cases} H_0 = \rho = 0 \\ H_1 = \rho \neq 0 \end{cases}$$

Null hypothesis ( $H_0$ ) indicates unrelated relation between net profit and return as well as alternative hypothesis indicates correlation. Coefficient correlation ( $\rho$ ) is between the independent variables of net profit and stocks return is equal to 0.0176; probability measure of checking significance is equal to 0.002 which is lower than 0.05, so, there is surely a direct and significant relation. Null hypothesis is therefore rejected and the opposite hypothesis is confirmed.

We can conclude that net profit has more capacity of explaining in relation to stock return in ratio of two other variables and thereupon, the first hypothesis is confirmed.

### Testing second hypothesis ( $H_2$ )

The result of the second hypothesis indicates that net profit has weak correlation and capacity of explaining in relation to stocks return.

#### Correlation analysis

In this function, the hypothesis under consideration is given as:

$$\begin{cases} H_0 = \rho = 0 \\ H_1 = \rho \neq 0 \end{cases}$$

Null hypothesis indicates unrelated relation between operational profit and return as well as alternative hypothesis indicates correlation. Coefficient correlation ( $\rho$ ) is between the independent variables of operational profit and stocks return is equal to 0.169; probability measure of checking significance is equal to 0.04 which is lower than 0.05, so, there is surely a direct and significant relation. Null hypothesis is rejected and the opposite hypothesis is confirmed.

We can conclude that though operational profit has a weak capacity of explaining the relation of stock return, because of the low correlation it has toward net profit in relation to return, the second hypothesis was rejected.

### Testing third hypothesis ( $H_3$ )

The result of the third hypothesis indicates that ratio of debits to stockholder's equity has no correlation and capacity of explaining in relation to stocks return.

#### Unrelated analysis

In this function, the hypothesis under consideration is given as:

$$\begin{cases} H_0 = \rho = 0 \\ H_1 = \rho \neq 0 \end{cases}$$

Null hypothesis indicates unrelated relation between operational profit and return as well as alternative hypothesis indicates correlation. Coefficient correlation ( $\rho$ ) is between the independent variables of operational profit and stocks return is equal to -0.023; probability measure of checking significance is equal to 0.684 which is lower than 0.05, so, the 95% possibility of direct and significant relation is rejected.

We can conclude that since no relation was found between this variable and the return explanation, the third hypothesis was rejected.

### Test of incremental information content

The next three hypotheses will test the incremental information content of accounting variables. We considered to coefficient of determination of variables in the model. According to the output data of SPSS, just net profit has appearance conditions in the model. As the results showed, net profit has the most correlation with stock return (dependent variable).

According to this, none of the other variables, except net profit, has the conditions to enter in the model. We can conclude that the next three hypotheses are rejected, because the next hypothesis is significance if also the other variables enter to the model. Tables 3 and 4 show the output and results of the model.

### Reviewing the optimum model

The best model that can be used to explain the mentioned variables in relation to stocks return is net profit model, and according to linearity of regression model, this model is confirmed (according to Table 5, significance is equal to 0.002, and because it is lower than 0.05, linear regression is significant). We can extract the optimum model from the coefficients table through the observed coefficients, and the optimum model will be presented as follows:

$$R = 0.153 + 0.828NI$$

### Analyzing the model

In extracting the optimum model, we first considered the significance of the coefficients in the coefficient table, and then according to the first model ( $R = \beta_0 + \beta_1 NI + \epsilon$ ), the optimum model was extracted. The coefficient table indicates that the constant of model ( $\beta_0$ ) is significant because the calculated significance for it is 0.011 which is lower than the study's significance level (0.05), so the

**Table 3.** Input and output variables in the model.

Model	Input variable	Output variable	Utilized method
1	Net profit	-	Stepwise

**Table 4.** Summary and result of the two Models.

Model	Coefficient correlation	Coefficient of determination	Modified coefficient of determination	Standard error of estimation	Durbin Watson
1	0.176	0.031	0.028	0.8859	1.952

**Table 5.** Analysis of variance (ANOVA).

Model	Variable	Total of Squares	Degree of Freedom	Mean of Squares	F-Statistic	Significance
1	Regression	7.750	1	7.750	9.876	0.002
	Residual	241.699	308	0.785		
	Overall	249.449	309			

**Table 6.** Coefficients.

Model	Variable	Not standard coefficients		Standard coefficients	T-statistic	Significance
		B	Error	Beta		
1	Constant	0.153	0.059	-	2.574	0.011
	Net profit	0.828	0.264	0.176	3.143	0.002

**Table 7.** Output variables.

Model	Variable	Beta In	T-Statistic	Significance	Partial correlation
1	Ratio of debit to stockholders equity	-0.019	-0.344	0.731	-0.020
	Net profit	0.031	0.193	0.847	0.011

**Table 8.** Statistics of residuals.

Variable	Minimum	Maximum	Mean	Standard deviation	Number
Foreseen value	-0.226992	1.639624	0.25137742	0.158373180	312
Residual	-1.85362	11.99249	0.000	0.884418360	312
Standardized foreseen value	-3.021	8.766	0.000	1.000	312
Standardized residual	-2.092	13.538	0.000	0.998	312

measure of it in the first model is significance. The results of this part are presented in Tables 5 and 6 After consecutive checking,  $\beta_1$  is considered as significant, because  $\text{sig}=0.002$ , and according to this point, if it is lower than the considered significance level (0.05), it is significant. The coefficients of significant variables were extracted from the table of coefficients. According to this subject,  $\beta_0$  is equal to 0.153, and  $\beta_1$  is equal to 0.828.

Tables 7 and 8 portray the results of the study.

## CONCLUSIONS AND REMARKS

The result of the first hypothesis indicates that the net profit has correlation and capacity of explaining in relation to stock return. This correlation was seen in totality when

the hypotheses of the first 3-year study were reviewed. There was, indeed, some sort of correlation in the last 2-year, which was not significant. This subject indicates that investors can forecast return according to net profit. We can also conclude that net profit has relative information content in ratio to other two variables. In Lipe (1986), it was seen that the profit has explanation capacity in ratio to stock return.

The result of the second hypothesis indicates that in total review, the operational profit has a little correlation and capacity of explaining in relation to stock return and this correlation is significant. In other reviews, the correlation was not significant. It can therefore be concluded that operational profit has little capacity of explaining ratio to stock return, but we cannot use it to forecast stock return. The results of this hypothesis agree with those of Peixoto (2000), though he indicated more correlation of the net profit's ratio to that of the operational profit in relation to stock return. Correlation of operational profit with return is also seen in Biddle et al. (1997). In this research, this correlation is seen in a lower level, which seems a little different from other results because of the conditions ruling stock exchange. The result of the third hypothesis indicates that the ratio of debits to the shareholder's equity has not correlation and capacity of explaining with stock return in any periods of the study. It seems that this ratio of balance sheet has never been worked upon, but in this research, it was reviewed. It was recognized that in all considered periods, none of the variables, except net profit, had the condition of entering into the model, whereas these three hypotheses reviewed the increment contents of variables in relation to each other, and it was observed that when the variables had incremental information content in relation to each other, they were able to enter into the model together. In this research, we conclude that the best model of variables to forecast stock return is net profit model. It was also in observed Lipe's (1986) research that profit has explanation capacity in ratio to stock return.

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