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Theoretical study on the distribution of profit earnings and stocks returns

Mohsen Rajabi Mohamad Abadi [1], Hamid RezaVakili Fard [2]

[1]Saveh Science and Research Branch, Islamic Azad University, Saveh, Iran; [2] Science and Research Branch, Islamic Azad University, Tehran. Iran

Abstract

People make decisions in their daily life that are based on predictions made about the future. In fact, we are all trying to make a connection between two or more variables in a way that could be used for prediction. Profit and cash flow in a private profit making unit make the most fundamental part of information and are the base of most financial information users' decision making. And judgments and profit making prediction have always been one of the interesting subjects for financial information users, because correct estimation of these figures can play an important role in making the correct decisions (Jahankhani and Saffarian, 2003). Investors buy assets hoping that their expected return over the next period is achieved efficiently. These returns can be predicted, however, it may not be the expected return. In fact, one can predict the profit-making trend of a company by analyzing the previous trend and studying some of the economic variables. However, actual happenings are different from the numbers and data achieved in predictions. The roots of most of these differences lie in the variability of criteria that are the basis for predictive models (Azad, 2004).

Keywords: Distribution of Profit Earnings, Stocks Returns

Introduction

Investors still have their previous beliefs about risk and company stock. All these previous beliefs are based on information publicly available. Even if these beliefs are based on the information publicly available, there is no obligation that the previous beliefs are the same for everyone , because investors are different in their received amount of information and also in their ability to interpret them. Also, it is possible that these former beliefs include expectations about possible present and future profitability power of the company, because the securities returns depends at least partly to their profitability (Setayesh, 2007). Therefore, profit is one of the main important items of financial statements that that attracts the attention of users of financial statements. Investors, managers, employees, analysts, government, and other financial statements consumers use profit as a basis for investment decision making, lending money, profit payment policies, interest payments, appraisal companies, corporate taxes calculation, and other decisions related to the company. Therefore, Joint stock companies managers, potentially have incentives to report earnings with Smooth growth and this may be addressed and shall be subjected by investment market as something considerable (Arab Mazyar Yazdi *et al.*, 2009). The purpose of this study was to evaluate the basic theoretical distribution of profit and return.

Profit meanings

At the beginning of the creation of man, his nature was Profit-oriented. Along with the development of economics and accounting, "Profit-oriented" concept has found its place in a way that bilateral accounting began with theory of property. Theory of the character separation was proposed later on In this theory, the commercial unit character is separated from its owners character and purpose of the institution is creating accounting profits for shareholders and creditors followed by institutional

Corresponding author: Mohsen Rajabi Mohamad Abadi, Saveh Science and Research Branch, Islamic Azad University, Saveh, Iran. E-mail: Mohsen.rajabi110@yahoo.com.

theories, remained salary, and the remaining funds were introduced that each of them provide new divisions of accounting information, especially benefits and profits. In the theoretical aspect of fund, one can see that accounting profit has no meaning. In the theory of the firm, the business unit is considered as a social agent or foundation that creates and enterprises benefits for the public and its interest is not an accounting profit, but the increased value. Economists now say that profit is not the only motivation of Institute foundation, but they believe that institutes may also be established with welfare, social, political and economical objectives. However, besides the economists hypothesis, the theory is also available that the majority of commercial units and entities are established for profit making (Esmaili, 2006, 13).

A description of the accounting profit

From a practical perspective, the accounting profits are defined as the difference between revenue and cost achieved due to expired version of the trading period. Thisdescriptiondefines the five characteristics that the accounting profit has:

1. Accounting profits and earnings are based on actual transactions and dealings that the company has done (basically accounting profit is obtained by the difference between goods or services sales income and the expenses necessary to carry out the sales). Traditionally, the accounting profession has been using the dealing method to calculate the profits of trading. This deal can either internal or external in an organization.

2. Accounting profit based on the assumption of period, as an obvious matter, has been the company's financial performance over a specified period of time or a given point.

3. Interest and accounting profit which is based on the income realization principle, requires revenue to be defined, measured, and identified (registered). In general, the income realization principle is a criterion or test for income identification (registration) and thus to identify (register)the profit.

4. Accounting Interest requires that the current price be measured in terms of historical cost or value, which should be considered accurate to the historical cost principle. An asset is recorded based on the cost until the sales process is finished and then one can make any changes in value recognized (recorded) and therefore the current costs are the expired assets or the cost of the purchased items that are expired.

5. Accounting profit requires that achieved revenues of the required period related to the appropriate or relevant costs, be considered. Hence, the accounting profit is based on the adaptation principle.

6. In fact, some of the costs, fees and other terms which are assigned to revenue as assets are transferred to the next period. It is assumed that the costs (cost of items) will be adapted to the course of income and are assigned to potentially become known as the expired service. (Esmaili,2006,15–18).

Informational content of accounting profit

One of the main goals in preparing financial statements is to report financial performance information. Financial performance includes controlled entity's efficiency gains. Financial performance information is provided in the form of comprehensive income (profit and loss statement). These data indicate to what extent an entity has succeeded to use of its resources. Financial performance analysis of data from different periods and changes to predict future profitability of the business unit is also useful.

Based on the theoretical concepts of financial reporting, financial performance statements help to meet the reporting purposes as follows:

A. providing information to users to enable them to review previous evaluations of the financial performance of prior periods and, if necessary, amend their assessments of performance in future periods.

B. Submitting a report of the results of the stewardship of management functions to enable users to evaluate past performance and create basis for forming expectations about future financial performance of the business units that are established with the aim of making a profit.Shareholders and investors aim to earn dividends profits of a branch. Therefore, they purchase the branch to encourage its accomplishment possibility. Profit is more important in business because of the lucrative profits, will compete. Also keeping pace with economic changes, is only possible when the profiting unities really profitable (Eghbali,2008)

Profit reporting objectives

Companies must prepare fundamental financial statements at the end of each operating period. One of these financial statements, the income statement which is about profit and loss and its last digit is the profit entity of the commercial unit.

But, the importance and benefits of applications for reporting purposes benefits include:

1. Profit is considered as a basis for calculating taxes and income redistribution between individuals.

2. Earnings is supposed to be a guidance upon which policies related to profit dividends and maintained benefits are developed. Earnings are considered as a measure of the maximum amount that can be reinvested or be distributed as dividends profit in the company.

3. Profit as a guide for investment decisions is taken into consideration. It is usually assumed that investors try to maximize the amount of return that seek to invest , of course with respect to an acceptable risk degree.

4. Profit is considered as a predictive tool or device that helps people in the prediction of future earnings and economic events. Operating profit includes gains or ordinary income, and profits or loss due to unforeseen events which its sum is equal to net income. It is assumed that the normal profit is a current routine and is continuous but profit and loss arising from unforeseen events are not like this. Research results show that for the prediction of future dividends, ordinary income or current profit is superior to net income.

5. profit is considered as a measure of performance and efficiency. Profit is a measure of earnings management stewardship and performance of the company's resources to accomplish and handle the company's routines, so that FASB offers this, as follows:

"One of the objectives of financial statements is providing useful information to judge the ability to manage, or optimize the use of resources and the effectiveness of performance in order to achieve the primary objective of the company over time to give back the highest cash to homeowners."

Profit reporting can be a tool for managers to plan for the future accordingly. (Zarif Fard, 1999)

Failure in informational content of earnings and accounting profit

Accrual accounting involves numerous personal judgments. In profit making, there are lots of conceptual and operational problems associated with multiple items transferable to future periods, apportionment and allocation and evaluation, but these judgments in calculating the cash flow effects are minimized. Due to different accounting procedures, in order to compare different firms, profit is being questioned. Critics charge and denunciate that the system takes into account economic events rather than content, the content will be keeping them up . Some economic events are not detected at all in the accounting system. While the economic importance of other events that they suspect are up there with all the details, the benefit and profit has greater reliance on accounting structures to the economic reality (Esmaeeli, 2006, 33).

Profit is an abstract concept but a source of cash income is real and the objective. However, it is believed that helping firms to survive is one of the first and considerations cash constitutes one of the most important factors in the survival of any business. Only firms that can also be profitable to survive must supply their needs. Understanding the situation of the firm's solvency and profitability is essential to provide this information clearly, although cash flow statement provides such information.

Market reaction reasons

Stock market is responding to the information provided by financial statements. Information content of net income has been subject to much empirical research (Scott, 2003). Note that the prediction on investor behavior is a subject which is in response to information relating to the financial statements.

1 - Investors have previous beliefs about the expected return and risk in company stock. These previous beliefs were based on all the information that is available to everyone (including market prices) , till the time that the company 's net profit for the year is announced [that will make investors to reconsider their beliefs] . There is no obligation that the previous beliefs are the same for everyone, because investors are different in the amount of information they receive and also in the way they interpret the data. Also, the former beliefs may involve expectations about future profitability and the company's current strength, because the future returns of securities, at least partly depends on its profitability (Freeman and Tse, 1992).

2 – After the net profit of the year is announced, some investors try to get more information and this number is owned by analyzing the profit. For example, if the net amount expected to be as high or higher, this may come as good news as the situation is , thus , investors using Bayes' theory reconsidered in their beliefs about the profitability and power efficiency of the company's future. Some investors (those who had higher expectations of current net

income), are likely to interpret the net profit number as bad news.

3- Investors who have revised their beliefs about future profit making and company's return increase, are more willing to buy a greater number of the company stock with the current market price and those who do not think the same, will do the opposite. Also, Investors evaluation to assess the risk of the stock will also appeal to them.

4 - We expect net profit to witness the announcement of the Company's shares trade on the rise. Furthermore, the greater the difference in investors' beliefs and interpretations of the past based on current financial information, the higher the volume of transactions will increase. If investors interpret the reported net profit as good news (and consequently have expectations about future returns and profitability increase) they will overshadow those who interpreted the net profit announcement as bad news and we expect to witness the increased market shares (and the reverse). (Scott, 2003)

Beaver (1968) studied the reactions due to the volume of contracts very visibly in his research and concluded that a net profit announcement of trading volume will increase during the week. It is possible that market reaction compared to the reaction of trading volume, indicates a stronger test about the usefulness of the information for decision making (Beaver, 1986). For example, Verrecchia and Kim model (1997) show that trading volume to price changes (as a measure of the usefulness of the information provided in the financial statements) is more challenging. Considering the fact that previous predictions based on decision theory and the theory of efficient markets are having a close relationship with each other, one can be more successful. If this theory is effective for accounting, their experimental predictions should be supported by experimental research. An experimental researcher can do its job by sampling the companies that issue annual reports and by studying the fact that if the price and trade volume reactions to the good or bad news are going the right way or not. These predictions can also be tested experimentally. To accomplish this, is not as simple as saying it, but for some reasons, the next section will discuss this matter (Scott, 2003).

Being informed of market reaction

Theory of efficient markets means that the market will react quickly to new information. Consequently, it is important to know when the first news of current year net profit reports breaks out and what it is all about. If the researcher wants to see the effect of this news on trading volume and stock price, it is too late to investigate about it even a few days later, because after that time, although there exist such a news, there cannot be seen any track of it. Researchers have attempted to solve this problem by using the date on which the net profit is reported in the financial media, including the Wall Street Journal. If the efficient market is to react, it needs to react from a small window, a short-lived period of history relating to the exact date. Usually, the good or the bad news of the reported net profit/income is being evaluated by the investors' expected net profit.

If for example a company announces its net profit to be $ 2 million, and that is the exact amount expected by the investors (considering each three months reports, company's senior managers' speeches, financial analysis' forecasts, prospective information for performing argument standards and management analysis and forecasts of the price per share) it is rarely possible that the net income reported includes lots of information. Investors have revised their beliefs on the basis of prior information, but if investors had expected a net profit of $ 2 million to be announced and the company reported a net profit of $ 3 million, the conditions would vary and would be different. This good news makes the investors to quickly revise their beliefs positively and be more optimistic to the company's future perspective. This means that researchers should try to find something that can replace the numerical result that investors expected to find and have in company's net profit. There is always a variety of events affecting on the trading volume, the stock/share, and its impact is obvious on the stock price. This means that one cannot simply be aware of the market reaction to the net profit declared. For example, assume that a company has declared its current year net profit. This report contains good news and on the same day, US government announces for the first time that budget deficit has decreased a great deal. It is highly probable that this public announcement affects all or most of the securities and exchanges in exchange market and consequently, it will distress the effect of costs related to the company's net profit announcement news. Hence, the optimal approach is to separate the effects of all market factors on stock returns from each other (Scott, 2003).

External research

Hu (1995) believes that stock market volatility implications for the real economy is less known and requires further research. Using data from U.S. companies, he found out that investing on his capital placed directly a negative impact on stock market volatility and concluded that because of the strong correlation between stock market and investment fluctuations, corporations cannot ignore market uncertainty in their investment decisions. For example, when investors are not willing to buy shares of a company, the company reduces its stock price and consequently, market volatility boosts and so, that information asymmetry causes in turn investments decline. Therefore, the stock market valuation of a company's capital will be less than its true value and if this trend continues, merging trends and acquisitions increases.

Habib *et al.* (2011) studied the stock market reaction to firms' income smoothing for environments with high uncertainty in an investigation. Their level of income smoothing was measured using the relationship between changes in accruals and cash components of interest. Also, the response rate to calculate the profits of two criteria were based on the information content of earnings smoothing. The results showed that the capital market's reaction to information based on firms' income smoothing for environments with high uncertainty, is more than other companies. In this context, research findings, corroborates and verifies theory of capital market reactions to earnings smoothing.

Jorgensen *et al.* (2011) studied the relationship between stock returns with the distribution of current and future profits in a research. They assumed that the distribution of expected profits rise, is a sign of the increased uncertainty and thus increases the expected return to shareholders. The results showed that there is a direct and significant relationship between the distribution of current profits and expected returns. However, the relationship between stock returns and future earnings dispersion is reversing. This findings shows that investors tend to predict a company's future earnings and consider it as a basis for the expected returns.

Koch and Park (2012) examined the impact of profit sustainable development on the characteristics of the predicted management profit and earnings. They showed that in the time of the predicted management profit announcement, if the announced profit is the continuation of the reported profits growing chain, it will be more important to the investors and analyzers. These researchers and authors argued that if the company has a history of sustainable profit growth, the anticipated profits are more reliable and have more credibility. They showed that the prediction accuracy of earnings in firms with stable earnings growth rate is higher than other companies. The results of this research and study also suggests that the management symptoms presence and income and profit smoothing effect in company reports decrease the effect of stable earnings growth on validity of the predicted profit.

Internal research

Ghaemi *et al.* (2003) studied the effect of profit on Stock Exchange Listed Companies enhancing Their study shows that there is no significant differences between the flattening and non-flattening companies in terms of rather abnormal returns.

Shoovarvrzy and Nikoomaram (2010) studied the effect of dividends profit percent volatility on the companies' stock returns. In the present study, the effect of dividend profit percent volatility on the companies' stock returns has been studied. For this purpose, 86 companies that are accepted and listed on the Stock Exchange over a period of eight years (2008-2001) have been investigated. SPSS software has been used for data analysis, hypothesis testing, and regression models. The results of the study indicate that there is a meaningful relationship between the volatility of stock returns and the dividend

Reza Zadeh and Ashtab (2010) found a relationship between earnings and stock returns prediction accuracy of the companies newly introduced to Tehran Stock Exchange. This relationship is examined by considering the effects of the control variables. Therefore, the data were used from 107 new companies in Tehran Stock Exchange during 1999 to 2006. The results show that the Tehran Stock Exchange as well as other countries, discounter and Cheap Wholesalephenomenon exists and there is a significant relationship between the prediction error and the efficiency gains of new shares of income. Thus, it is clear that investors can recognize the profit forecasting errors and use them in pricing their stock.

Conclusions

A significant portion of the company's stock returns are affected by reported earnings and profits and shareholders' reaction to this information. It seems that when company's current profit change is high compared to the previous years, the investor deems it as a sign of company's performance criteria growth and so other companies are more willing to invest in the shares of such companies. Thus, the high variability of the company's profits, potentially an indication of management's efforts to achieve higher profits and capital markets are likely to be favorable to such fluctuations.

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