

# CHAPTER I

## INTRODUCTION

### 1.1 Motivation of the Research

The research on the relation between capital markets and financial statements has been well known since the late 1960s after the seminal paper of Ball and Brown (1968). The valuation of a firm is an important area of research in accounting due to the demand of shareholders and investors whose obvious interest is the value of firm. In an efficient market, firms are valued as the present value of expected future net cash flows that are discounted by the appropriate risk-adjusted rate of return. Financial statements play an important role in the valuation of firms as sources of financial performance information, that have implications for the valuation process. Previous research in this area suggest that earnings are mostly used in the valuation of a firm and mostly used in studying information useful for stock valuation (Lev, 1989). However, there is evidence suggesting that earnings are manipulated by firms' managers (e.g. Healy, 1985; DeAngelo,1986; Jones,1991). Lev (1989) presents the low relationship between earnings and stock returns and he further points out a possible reason to explain the weak relationship; the incidence of earnings manipulation that mitigates information content of earnings. In addition, Lipe (1990) suggests that alternative information has an impact on the relationship between returns and earnings. The existence of alternative information influences the prediction of future

earnings and reduces the contemporaneous returns-earnings relationship. Therefore, not only earnings are useful in the valuation of a firm but also other non-earnings accounting numbers (Ou, 1990). For instance, cash flows have been raised as alternative useful information in a firm's valuation as it reflects economic realities of a company's performance (Lev and Ohlson, 1982).

Prior research on the usefulness of cash flows in the valuation of a firm emphasize on the operating cash flows (e.g. Rayburn, 1986; Wilson, 1986 and 1987; Bowen, Burgstahler, and Daley, 1987). Those studies provide evidence consistent with the existence of information content of operating cash flows and incremental information content of operating cash flows beyond earnings (Rayburn, 1986; Wilson 1986 and 1987; Bowen et al., 1987). Recently, the accounting profession has shown interest in cash flows information as the useful information for the valuation of a firm due to the availability of information regarding statements of cash flows. The accounting standard setters of many countries have issued accounting standards specifically for providing and reporting cash flows information of a company.<sup>1</sup> Then, the cash flows statements are required by the

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<sup>1</sup>For example, the Financial Accounting Standard Board (FASB) of the US released Statement of financial accounting standard (SFAS) No.95 *Statement of cash flows*, the Accounting Standards Board (ASB) of the UK released Financial Reporting Standard (FRS) 1 *Cash flows statements*, the International Accounting Standard Committee (IASC) released International Accounting Standard (IAS) 7 *Cash flows statements*, the Institute of Certified Accountants and Auditors of Thailand (ICAAAT) issued Thai accounting standard No.25 *Cash flows statements*.

standard setting bodies as a part of the full set of financial statements.<sup>2</sup> The accounting standard setting bodies also propose the convenient format in reporting cash flows (i.e. the statement of cash flows). Accordingly, cash flows ought to be presented based on business activities; those are cash flows from operating activities (hereafter by CFO), cash flows from investing activities (hereafter by CFI) and cash flows from financing activity (hereafter by CFF). As a result, the accounting standard setting bodies expect that not only operating cash flows are proposed to be useful in a firm's valuation but also investing and financing cash flows (the International Accounting Standard Committee [IASC], 1993; Certified Accountants and Auditors of Thailand [ICAAAT], 1994).

In Thailand, the Institute of Certified Accountants and Auditors of Thailand (hereafter by, ICAAT) issued Thai accounting standard No.25 *Cash flows statements* (hereafter by TAS No.25) which applies to financial statements from December 31, 1994. Further, the Stock Exchange of Thailand (hereafter by SET) requires quarterly reports of Cash Flows Statements starting by the year 1998. Cash flows information provided under the basis of TAS No.25 (i.e. the cash flows statements that presents various components of cash flows) is expected to facilitate the financial statement users, e.g. investors, creditors, managers, in making economic decisions. According to the theory of valuation of a firm, using the cash flows approach, the market value of a firm at any times is measured as the

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<sup>2</sup> The present study writes 'the cash flows statement' and 'the statement of cash flows' changeably by the same meaning of the financial statement that reports cash flows information.

discounted present value of future cash flows of that firm. As a result, the (decisions on the) valuation of a firm needs the relevant information to assess a company's ability to generate cash in the future (i.e. about amount, timing and certainty of cash). The cash flows statements inform users about the current cash generating ability of a firm through those three business activities. It also helps to predict the future cash flows of a firm. For example, current CFO can predict future CFO (Finger, 1994). CFI and CFF reveal cash management of a current period that affect future cash flows, e.g. cash receipts from investment or cash payback to funds' owners. As a result, cash flows information from the cash flows statements could be useful for investors in forecasting the future cash flows of a firm and useful to assess a firm's value.

Previous research about the information contents of cash flows, which is defined as the association between unexpected cash flows and unexpected returns<sup>3</sup>, have mostly focused on CFO, whilst rarely focusing on other components of cash flows, i.e. CFI and CFF. Further, the existence of incremental information content of cash flows beyond earnings is presented as a lack of consistency in previous studies (e.g. Rayburn, 1986; Wilson, 1986 and 1987; Bowen et al., 1987; Ali, 1994). Neill et al (1991), in their review of the usefulness of cash flows data, suggest that characteristics of a firm should be challenged

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<sup>3</sup> Beaver (1968) defines 'information content' as a change in expectations about the outcome of an event, e.g. information announcement. He suggests that an event is said to have information content if it leads to changes in investors' assessments of the probability distribution of future returns (or prices); that is a change in the equilibrium value of the market price on the announcement event day.

for future studies of the information content of cash flows data. Therefore, the present study intends to investigate the effects of a firm's characteristics on additional information contents of cash flows beyond earnings, i.e. to study the effects of a firm's characteristics as determinants of incremental information contents of cash flows beyond earnings, by providing empirical evidence from the SET.

In addition, this study examines the information content of quarterly reports of cash flows statements. The study of information contents of earnings presents that quarterly reported earnings convey useful information to the market. Stock prices response to quarterly reported earnings numbers around announcement dates (for example, Foster, 1977; Suchitra Vatcharachittipan, 1990; Pimpana Srisawasdi, 1996; Nimnaul Keorath, 1996). Since cash flows information is required to report on a quarterly basis, it is challenging to investigate whether it conveys information content in addition to earnings. In stead of using the long window association between stock returns and accounting numbers that are mostly used by prior studies, this study uses the event study method in order to explore the incremental information content of cash flows beyond earnings.<sup>4</sup>

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<sup>4</sup> An event study is an empirical study of a relationship between stock prices and an (economic) event (for example, earnings announcement, accounting change). The event study of an announcement of accounting numbers conducts the investigation of the relationship between cumulative abnormal stock returns and accounting numbers for a few days surrounding the announcement date (e.g. Pimpana Srisawasdi, 1996, Nimnaul Keorath, 1996). This shot-window study is said to be used to detect the information content of announcing accounting numbers, i.e. those numbers convey useful information to the market whilst the long-window study detects whether accounting numbers reflect the factors affecting stock prices (Watt and Zimmerman, 1986).

The characteristics of a firm examined in this study are transitory of earnings, growth of a firm, and the ratio of cash flows from financing to cash flows from investing (hereafter by CFI/CFF ratio). Transitory of earnings is suggested by previous studies about its effect on the incremental information contents of cash flows beyond earnings (Cheng et al., 1996; Charitou et al., 2001). The firms' growth perceived by a market is defined here as types of stock, namely a growth stock and a value stock. It is examined because previous studies suggest that market participants examine firms' growth opportunities when setting stock prices (Lakonishok et al., 1994). Besides, the growth of a firm has an effect on stock prices (Fama and French, 1992) and on the information content of accounting information, e.g. capital expenditure (John and Mishra, 1990; Anthony and Ramesh; 1992, Kerstein and Kim; 1995), issuing of debt and equity (Myers, 1977; Myers and Majluf, 1984; Pilotte, 1992, Cooney and Kalay; 1993), since firm's growth opportunities have an effect on the response of stock prices on such information due to the ability to generate future cash flows. The perception of investors about a firm's growth opportunities could have an impact on the information contained in cash flows components since cash flows information is used in assessing cash generating ability of a firm. For the CFI/CFF ratio, it reveals the appropriation of financial management of a firm that affects the future cash flows, i.e. the uses of internal and external sources of funds for new investments that reveal capital flexibility. A high ratio implies a higher capital flexibility. A firm with high capital flexibility has higher ability to face financial problems than a firm with low capital

flexibility. Therefore, the CFI/CFF ratio contains information in addition to CFI or CFF alone. For example, a high CFI implies high new investments that should generate higher net cash flows in the future compared to a low CFI. However, such statements may not be true if the company does not manage funds in an efficient way. Thus, the CFI/CFF ratio could be used to interpret the information contained in cash flows and, then, should have an impact on the incremental information content of cash flows beyond earnings.

The present study intends to explore such impacts to add more evidence regarding the information content of cash flows beyond earnings.

## **1.2 Research questions**

From the discussion above, it could be concluded that cash flows should consist of alternative information other than earnings. A number of studies have investigated the incremental information content of operating cash flows beyond earnings. However, there exists a lack of consistency in the results of those studies which suggests that some specific factors have impacts on such information content. Some factors which possibly have an impact are examined in this study. These are transitory of earnings, types of stocks and the CFI/CFF ratio. Further, CFI and CFF are rarely incorporated into a study, and most prior studies employ the long-window methodology, that explore if cash flows reflect the factors affecting stock prices adding to earnings. As a result, this study examines all of CFO, CFI and CFF by employs the different method in order to investigate whether cash flows convey

additional useful information beyond earnings and also incorporates the powerful factors effecting these information into the analysis that the questions of the study are below.

Whether cash flows data provided by the cash flows statements convey incremental information content beyond earnings to investors and do firm-specific factors (i.e. transitory of earnings, types of stocks and the CFI/CFF ratio) have impacts on the incremental information content of cash flows beyond earnings in the SET.

### **1.3 Contributions of the research**

This study provides evidence about whether cash flows data convey information in addition to earnings in setting stock prices in the SET. The findings in this study are interesting since investors are likely to use information regarding cash flows when setting stock prices at the SET. Furthermore, the findings might be useful for regulators to develop the disclosure of information.

This study analyzes the reported quarterly cash flows by applying the event study method that could explore whether quarterly reported cash flows convey additional useful information to the market beyond earnings. The quarterly reported cash flows have never been examined in the study on information content study whilst statement of cash flows is reported by quarterly basis. Therefore, this study contributes the explanation evidence of the usefulness of the quarterly reported cash flows data into this line of research.



This study provides explanatory evidence about the direct and joint impacts of factors comprising the incremental information contained in cash flows beyond earnings. The results of the research, then, might inform investors in the SET about the using of cash flows information relative to earnings in setting stock price. In other words, the results might help investors in the SET about using accounting data in setting stock prices efficiently.

A final contribution of this study is to perform the analysis of cash flows and returns at the market in Thailand. This kind of research is very rare for non-US settings, in particular for Asian markets.