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STUDY THE RELATIONSHIP BETWEEN EQUITY COMPOSITION AND FIRM'S EARNINGS STABILITY IN TEHRAN SECURITIES EXCHANGE

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ABSTRACT

The purpose of this research is to study the relationship between equity composition and firm's earnings stability in Tehran securities exchanges. This research is applied in terms of purpose, is descriptive-surveying in terms of method, and is correlation in terms of the relationship between variables. The statistical population of this research includes all Tehran listed firms. The number of firms is 480 that we selected 115 firms as statistical sample. We used 3 New Result software and information banks of Tehran securities exchange site for collecting data. We used annual reports and financial statements of Tehran listed firms for collecting data that are related to research hypotheses. Statistical analysis was conducted by E views soft ware. Finally, research hypotheses were tested by t test, F- Fisher and determination coefficient (R^2). Research findings show that there is not a meaningful relationship between equity composition and earnings stability when the variable of stock capital ratio is used as the alternative variable of equity composition, and there is a meaningful relationship between equity composition and earnings stability when one of the variables of aggregated earnings ratio, the ratio of legal savings and the ratio of arbitrary savings is used as the alternative variable of equity composition.

Keywords: Equity Composition, Stock Capital, Aggregated Earnings, Legal Savings, Arbitrary Savings, Earnings Stability

INTRODUCTION

The occurrence of industrial revolution and its continuation in Europe of 19th century, the establishment of large factories and the execution of great plans like the establishment of national railway network that required great monetary capitals led to the emergence of first stock companies. This new format (Stock company) was a suitable solution for providing huge capitals and distributing trade adventure. Growth and development of stock companies led to the emergence and increases of a class of owners who don't run firms directly, but manage firms via the selection of board of directors (Shabahang, 1998). Stock holders as the owners of trade unit want to increase their wealth. According to this fact that the increase of wealth result results from the performance of trade unit the evaluation of trade unit is very important for owners (Nauravesh, 2004). One of the qualitative features of earnings is earnings stability. Financial analysts and investors don't pay attention to accounting income in the determination of suture cash flows as the only determining index, but stability and repeatability of reported earnings are very important for them. According to the restrictions of information cost and their importance, it can be noted the more the reliability of information, the more useful information will be for users (Pareto and Pooryanasab, 2001).

Theoretical Foundations
Equity
Equity is representative of the interests of institutions main owners towards net assets of institution. Equity shows the reminder interests of institutions main owners in institution assets after deduction the liabilities of that institution. In a trade institution equity generally shows the interests of the main owners of institution.

In equity accounting, the following main purposes are followed:
-determine capital resources of institution
- determine legal and recorded capital
- determine dividend that can be distributed among stock holders (Demori, 2011).

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Earnings Stability

One of the purposes of financial reporting is to present useful information regarding financial performance of trade unit for a wide range of users. Statement of loss and gain is one of the main financial statements that meet this purpose. The product of statement of loss and gain is net profit which is one of the important financial information that is used by investors and other uses of financial statements for decision making (Demori *et al.,* 2011).

Earnings stability means to what extent special innovation is effective to achieve future earnings. The more the stability of earnings, trade unit has more power to maintain current earnings. Therefore, earnings quality of trade unit increases (Thaqafi and Kordestani, 2004). Consequently, the more the stability of earnings, its quality will be more. Accounting earnings is identified based on a commitment that is divided into two cash and commitment components. The results of research show that commitment items lead to the reduction of earnings stability with lower reliance power (Scot *et al.,* 2010).

Previous Researches

Kordestani and Majdi (2007) studied the relationship between qualitative characteristics of earnings and the cost of stock capital in Tehran listed firms. In this research the relationship between five qualitative characteristics of earnings including earnings stability, predictability, and relatedness of earnings to stock value, earnings timeliness and conservatism with the cost of stock capital was studied. Statistical sample of this research includes 70 firms during 1993-2003. The findings of this research showed the impact of some characteristics of earnings on the cost of stock capital. In this research controlling firm size, the ratio of book value to the value of stock market, and the coefficient of earnings changes (operational risk) variables the results of research showed that there is a negative relationship between qualitative characteristics of earnings including earnings stability, predictability, relatedness of earnings to stock value, and timeliness with the cost of stock capital.

This relationship is meaningful in terms of statistics, but there was not a meaningful relationship between conservatism of earnings and capital cost.

Dehaliwal and Zhenli (2008) found when the quality of earnings increases, market reaction is lower to the changes of cash earnings. In other words, in the evaluation of firm by investors earnings quality is an important factor that influences information content of cash earnings.

Research results of Deko and Scrand (2007) showed that the decrease of relationship between stock return and earnings can be representative of earnings quality reduction so that the more the stability of earnings, the more the quality of earnings. Consequently, return reaction is more towards earnings.

Hypotheses

Main hypothesis: There is a meaningful relationship between equity composition and earnings stability of firms in Tehran securities exchange.

First subordinate hypothesis: there is a meaningful relationship between the ratio of stock capital and earnings stability.

Second subordinate hypothesis: there is a meaningful relationship between the ratio of aggregated gain (Loss) and earnings stability.

Third subordinate hypothesis: there is a meaningful relationship between the ratio of legal reserve and earnings stability.

Fourth subordinate hypothesis: there is a meaningful relationship between the ratio of optional reserve and earnings stability.

MATERIALS AND METHODS

Research Method

This research is applied in terms of purpose, is descriptive- surveying in terms of method. It is correlation in terms of relationship between variables. Statistical population of this research includes all Tehran listed firms from 2007 to 2012. Total number of Tehran listed firms is 480 that 115 firms were selected as statistical sample. We used 3 new Result software and information banks of Tehran securities exchange site for collecting data. We used annual reports and financial statements of Tehran listed firms for

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collecting data that are related to research hypotheses. Applied statistical model in this research is multi-variables regression model. We used combined data to test hypotheses. In combined data method generalized F tests (F Limer test) are used to select between panel and pooling methods. In the case of selecting panel method, Hasman test is conducted to select between fixed and random effects methods. Statistical analysis is conducted by E Views software. Finally, research hypotheses are tested via t test, F Fisher and determination coefficient (R^2).

Research Variables and the Manner of their Measurement
According to the subject of research and related hypotheses, the variables of this research including independent, dependent and control variables are as follows:

Independent Variables
Equity Composition
In this research equity composition has been considered as one of the independent variables that are defined by four indices:

a) The ratio of stock capital: in order to calculate the ratio of stock capital to total annual equity of firm, we use the following equation:

$$CTT_{it} = \frac{CS_{it}}{TE_{it}}$$

Where

CS_{it} is stock capital of firm I in t year,

TE_{it} is firm total equity of firm I in t year.

CTT_{it} is the ratio of stock capital to total equity of firm I in t year.

b) The ratio of aggregated gain (loss): in order to calculate the ratio of aggregated gain (Loss) to total equity of firm, we use the following equation:

$$ATT_{it} = \frac{AEL_{it}}{TE_{it}}$$

Where

AEL_{it} is the aggregated gain (loss) of firm I in t year.

ATT_{it} is the ratio of aggregated gain (Loss) to total equity of firm i in t year.

c) The ratio of legal reserve: in order to calculate the ratio of legal reserve to total annual equity of firm, we use he following equation:

$$LTT_{it} = \frac{LR_{it}}{TE_{it}}$$

Where

LR_{it} is the legal reserve of firm I in t year.

LTT_{it} is the ratio of legal reserve to total equity of firm I in t year.

d) the ratio of optional reserve: in order to calculate the ratio of optional reserve to total annual equity of firm, we use the following equation:

$$OTT_{it} = \frac{OR_{it}}{TE_{it}}$$

Where

OR_{it} is the optional reserve of firm I in t year. OTT_{it} is the ratio of optional reserve to total equity of firm i in t year.

Dependent Variable
Earnings Stability
We used the following regression model to evaluate earnings stability in which the earnings of current period are regarded as a function of previous period earnings. In other words, in this model earnings continuation is representative of earnings stability. This model has been designed by Decho and Dicho (2002).

$$E_{i,t} = \beta_0 + \beta_1 E_{i,t-1} + \epsilon_{i,t}$$

β_0 is an index for earnings stability. The coefficient of explanatory variable of $E_{i,t-1}$ i.e. β_1 in above model that is a regression model is representative of earnings stability, and $\epsilon_{i,t}$ is the reminder of

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regression model. $E_{i,t}$ is the earnings of current period, and $E_{i,t-1}$ is the earnings of previous period. This model has been estimated periodically for 8 years in order to evaluate annual earnings stability.

Control Variables
The rate of return on assets (ROA)
The rate of return on assets (operational profitability) is calculated via dividing operational income of firm by its total assets:

$$ROA_{it} = \frac{operational\ net\ gain\ (loss)}{total\ assets}$$

Firm Size (SIZE)
Firm size equals the log of firm's total assets:
$Size_{it} = Log\ (TA_t)$
TA_t is total assets of firm in t year.

RESULTS AND DISCUSSION
Findings
We used Pearson and spearman method to calculate correlation matrix of research variables. The result of estimating these two matrices are presented in the following table that the results of estimating correlation matrix by Pearson method are presented below main diagonal, and the results of estimating correlation matrix by Spearman method are presented above main diagonal.

Table 1: Covariance matrix of research variables

		$EP_{i,t}$	$CTT_{i,t}$	$ATT_{i,t}$	$LTT_{i,t}$	$OTT_{i,t}$	$ROA_{i,t}$	$SIZE_{i,t}$
$EP_{i,t}$	Correlation	1.000	0.0420	-0.0362	0.0086	0.0671	0.0225	0.0377
	Meaningfulness level	---	0.2701	0.3420	0.8205	0.0780	0.5545	0.322
$CTT_{i,t}$	Correlation	0.0321	1.000	-0.8966**	0.4013**	0.1029**	-0.3197	-0.0463
	Meaningfulness level	0.3995	----	0.0000	0.0000	0.0068	0.0000	0.2241
$ATT_{i,t}$	Correlation	-0.0374	-0.9704**	1.0000	-0.6327	-0.1415**	0.4293**	0.0534
	Meaningfulness level	0.3266	0.0000	----	0.0000	0.0002	0.0000	0.1607
$LTT_{i,t}$	Correlation	0.0343	0.8561**	-0.9551	1.0000	-0.0397	-0.2863**	0.0128
	Meaningfulness level	0.3674	0.0000	0.0000	----	0.2972	0.0000	0.7362
$OTT_{i,t}$	Correlation	0.1321**	0.0101	-0.0171	-0.0156	1.0000	-0.0535	-0.0408
	Meaningfulness level	0.0005	0.7900	0.6537	0.6820	----	0.1597	0.2836
$ROA_{i,t}$	Correlation	0.0164	0.0247	-0.0133	-0.0013	-0.0314	1.0000	0.0195
	Meaningfulness level	0.6668	0.5170	0.7268	0.9723	0.4096	----	0.608
$SIZE_{i,t}$	Correlation	0.0207	0.0392	-0.03773	0.03138	0.0385	0.0140	1.0000
	Meaningfulness level	0.5865	0.3037	0.3223	0.1405	0.3120	0.7129	----

** Correlation is meaningful at 0.01 levels (at 0.99 levels)

According to the presented results in above table it can be noted that considering Pearson correlation matrix at error level of 5 percent, there is a meaningful relationship only between the ratio of optional reserve variable and dependent variable (earnings stability). In addition, based on spearman correlation

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matrix there is not a meaningful relationship between any of variables and dependent variable (earnings stability).

The Results of Hypotheses Test

First subordinate hypothesis of research states that there is a meaningful relationship between the ratio of stock capital and earnings stability.

In order to study the meaningfulness of independent variable of the ratio of stock capital, we can state H_0 and H_1 at error level of 5 percent as follows:

H_0: there is not a meaningful relationship between the ratio of stock capital and earning stability.

H_0;β_1=0

H_1: there is a meaningful relationship between the ratio of stock capital and earnings stability.

H_1;$\beta_1 \neq 0$

According to the follow table the value of F Limer statistics probability is 0.000 that shows the use of panel data method, and according to the Hasman test the value of 0.3041 confirms the use of fixed effects method.

Table 2: The results of F Limer and Hasman tests.

$EP_{i,t} = \beta_0 + \beta_1 CTT_{i,t} + \beta_2 ROA_{i,t} + \beta_3 SIZE_{i,t} + \epsilon_{i,t}$

The kind of test	value	The meaningfulness level of statistics	Conclusion
F Limer test	0.796071	0.000	Panel data method
Hasman test	3.631876	0.3041	Fixed effects method

According to the calculated F statistics probability in the following table at error level of 5 percent H_0 is rejected (0.05>0.000), this means that the model is meaningful and at least one of the coefficients of regression model is opposite Zero. In addition, according to the following table the value of estimate determination coefficient shows that about 65 percent of dependent variable changes are explained by control and independent variables. This represents the high relation of control and independent variables with dependent variable.

According to the extent of presented Durbin- Watson statistics in the following table, we can find that in the presented model there is not first type self- regression. Consequently, model is suitable in terms of meaningfulness and the power of fitness. In addition, self- regression is not seen in the model. Finally, according to the presented results in the following table first subordinate hypothesis of research is rejected.

Table 3: The result of model estimation

$EP_{i,t} = 0.128131 + 0.002882 CTT_{i,t} - 0.209010 ROA_{i,t} + 0.023584 SIZE_{i,t} + \epsilon_{i,t}$

Explanatory variable	Coefficient	Standard deviation	t statistics	The probability of t statistics (meaningfulness level)
constant	0.128131	0.606797	0.211160	0.8328
$CTT_{i,t}$	0.002882	0.002259	0.276174	0.2024
$ROA_{i,t}$	-0.209010	0.135400	1.276174	0.1232
$SIZE_{i,t}$	0.023584	0.044980	0.524317	0.6003
Determination coefficient	0.643836	Statistics The probability of statistics		0.0000
Adjusted determination coefficient	0.570984	Durbin- Watson statistics	1.653587	

Second subordinate hypothesis of research states that there is a meaningful relationship between the ratio of aggregated gain (Loss) and earnings stability.

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In order to study the meaningfulness of independent variable of the ratio of aggregated gain (Loss), we can state H_0 and H_1 at error level of 5 percent as follows:

H_0: there is not a meaningful relationship between the ratio of aggregated gain (Loss) and earnings stability.

H_0: $\beta_1 = 0$

H_1: there is a meaningful relationship between the ratio of aggregated gain (Loss) and earnings stability.

H_1: $\beta_1 \neq 0$

According to the following table the value of F Limer statistics probability is 0.000 that shows the use of panel data method. In addition, the value of Hasman test statistics probability is 0.3336 that confirms the use of fixed effects method.

Table 4: The results of F Limer and Hasman tests

$EP_{i,t} = \beta_0 + \beta_1 ATT_{i,t} + \beta_2 ROA_{i,t} + \beta_3 SIZE_{i,t} + \epsilon_{i,t}$

The kind of test	value	The meaningfulness level of statistics	Conclusion
F Limer test	2.792167	0.000	Panel data method
Hasman test	3.402977	0.3336	Fixed effects method

According to the calculated F statistics probability in the following table at error level of 5 percent H_0 is rejected (0.05>0.000), this means that the model is meaningful and at least one of the coefficients of regression model is opposite Zero. In addition, according to the following table the value of estimate determination coefficient shows that about 65 percent of dependent variable changes are explained by control and independent variables. This represents the high relation of control and independent variables with dependent variable.

According to the extent of presented Durbin- Watson statistics in the following table, we can find that in the presented model there is not first type self- regression. Consequently, model is suitable in terms of meaningfulness and the power of fitness. In addition, self- regression is not seen in the model. Finally, according to the presented results in the following table Second subordinate hypothesis of research is accepted.

Table 5: The results of model estimation

$EP_{i,t} = 0.130976 - 0.002794 ATT_{i,t} - 0.209010 ROA_{i,t} + 0.023584 SIZE_{i,t} + \epsilon_{i,t}$

Explanatory variable	Coefficient	Standard deviation	t statistics	The probability of t statistics (meaningfulness level)
constant	0.130976	0.613235	0.213583	0.8309
$ATT_{i,t}$	-0.002794	0.001411	-2.449619	0.0146
$ROA_{i,t}$	-0.212258	0.136396	-1.556183	0.1202
$SIZE_{i,t}$	0.02307	0.045415	0.519806	0.6034
Determination coefficient	0.645849	F-Statistics		8.915653
		The probability of F statistics		0.00
Adjusted determination coefficient	0.573409	Durbin- Watson statistics		1.653869

Third subordinate hypothesis of research states that there is a meaningful relationship between the ratio of legal reserve and earnings stability.

In order to study the meaningfulness of independent variable of the ratio of legal reserve, we can state H_0 and H_1 at error level of 5 percent as follows:

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H$_0$: there is not a meaningful relationship between the ratio of legal reserve and earnings stability.
H$_0$:β_1=0
H$_1$: there is a meaningful relationship between the ratio of legal reserve and earnings stability.
H$_1$:$\beta_1 \neq 0$
According to the following table the value of F Limer statistics probability is 0.000 that shows the use of panel data method. In addition, the value of Hasman test statistics probability is 0.4775 that confirms the use of fixed effects method.

Table 6: The results of F Limer and Hasman tests

$EP_{i,t} = \beta_0 + \beta_1 LTT_{i,t} + \beta_2 ROA_{i,t} + \beta_3 SIZE_{i,t} + \epsilon_{i,t}$

The kind of test	value	The meaningfulness level of statistics	Conclusion
F Limer test	2.793783	0.000	Panel data method
Hasman test	2.487532	0.4775	Fixed effects method

According to the calculated F statistics probability in the following table at error level of 5 percent H$_0$ is rejected (0.05>0.000), this means that the model is meaningful and at least one of the coefficients of regression model is opposite Zero. In addition, according to the following table the value of estimate determination coefficient shows that about 65 percent of dependent variable changes are explained by control and independent variables. This represents the high relation of control and independent variables with dependent variable.
According to the extent of presented Durbin- Watson statistics in the following table, we can find that in the presented model there is not first type self- regression. Consequently, model is suitable in terms of meaningfulness and the power of fitness. In addition, self- regression is not seen in the model.
Finally, according to the presented results in the following table third subordinate hypothesis of research is accepted.

Table 7: The results of model estimation

$EP_{i,t} = 0.131493 - 0.007214 LTT_{i,t} - 0.209010 ROA_{i,t} + 0.023584 SIZE_{i,t} + \epsilon_{i,t}$

Explanatory variable	Coefficient	Standard deviation	t statistics	The probability of t statistics (meaningfulness level)
constant	0.131493	0.619360	0.212305	0.8319
LTT$_{i,t}$	-0.007214	0.002277	3.167663	0.0016
ROA$_{i,t}$	-0.213708	0.136727	-1.563027	0.1186
SIZE$_{i,t}$	0.023445	0.045876	0.511056	0.6095
Determination coefficient	0.647199	F-Statistics		8.968461
		The probability of F statistics		0.0000
Adjusted determination coefficient	0.575035	Durbin- Watson statistics		1.654278

Fourth subordinate hypothesis of research states that there is a meaningful relationship between the ratio of optional reserve and earnings stability.
In order to study the meaningfulness of independent variable of the ratio of optional reserve, we can state H$_0$ and H$_1$ at error level of 5 percent as follows:
H$_0$: there is not a meaningful relationship between the ratio of optional reserve and earnings stability.
H$_0$:β_1=0
H$_1$: there is a meaningful relationship between the ratio of optional reserve and earnings stability.
H$_1$:$\beta_1 \neq 0$

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According to the following table the value of F Limer statistics probability is 0.000 that shows the use of panel data method. In addition, the value of Hasman test statistics probability is 0.5893 that confirms the use of fixed effects method.

Table 8: The results of F Limer and Hasman tests

$EP_{i,t} = \beta_0 + \beta_1 OTT_{i,t} + \beta_2 ROA_{i,t} + \beta_3 SIZE_{i,t} + \epsilon_{i,t}$

The kind of test	Value	The meaningfulness level of statistics	Conclusion
F Limer test	2.824580	0.000	Panel data method
Hasman test	1.919604	0.5893	Fixed effects method

According to the calculated F statistics probability in the following table at error level of 5 percent H_0 is rejected (0.05>0.000), this means that the model is meaningful and at least one of the coefficients of regression model is opposite Zero. In addition, according to the following table the value of estimate determination coefficient shows that about 65 percent of dependent variable changes are explained by control and independent variables. This represents the high relation of control and independent variables with dependent variable.

According to the extent of presented Durbin- Watson statistics in the following table, we can find that in the presented model there is not first type self- regression. Consequently, model is suitable in terms of meaningfulness and the power of fitness. In addition, self- regression is not seen in the model.

Finally, according to the presented results in the following table fourth subordinate hypothesis of research is accepted.

Table 9: The results of model estimation

$EP_{i,t} = 0.075013 + 2.402635 OTT_{i,t} - 0.209010 ROA_{i,t} + 0.023584 SIZE_{i,t} + \epsilon_{i,t}$

Explanatory variable	Coefficient	Standard deviation	t statistics	The probability of t statistics (meaningfulness level)
constant	0.075013	0.612203	0.122530	0.9025
$OTT_{i,t}$	2.402635	0.575893	4.172018	0.0000
$ROA_{i,t}$	-0.133310	0.124812	-1.068084	0.2859
$SIZE_{i,t}$	0.025902	0.045016	0.575397	0.5652
Determination coefficient	0.643896	F-Statistics		8.839843
		The probability of F statistics		0.0000
Adjusted determination coefficient	0.571054	Durbin- Watson statistics		1.651956

According to the obtained results from testing subordinate hypotheses we can state that when the variable of the ratio of stock capital is used instead of equity composition variable, main hypothesis of research is rejected.

This implies that there is not a meaningful relationship between equity composition and earnings stability of firms in Tehran securities exchange, and when one of the variables of the ratio of aggregated gain (Loss), the ratio of legal reserve and the ratio of optional variable is used instead of equity composition variable, the main hypothesis of research is accepted i.e. there is a meaningful relationship between equity composition and earnings stability of firms in Tehran securities exchange.

Conclusion

In order to study main hypothesis, four subordinate hypotheses have been defined.

First we tested these four hypotheses. Then based on obtained results from testing these four subordinate hypotheses we concluded regarding rejection or acceptance of main hypothesis. According to the results

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of first subordinate hypothesis there is not a meaningful relationship between the ratio of stock capital and earnings stability. In addition, based on the results obtained from second, third and fourth subordinate hypotheses it is seen that there is a meaningful relationship between the ratios of aggregated gain (Loss), legal reserve and optional reserve variables and earnings stability.

According to the obtained results from testing first to fourth subordinate hypotheses it can be noted when the variable of the ratio of stock capital is used instead of equity composition variable main hypothesis of research is rejected.

This implies that there is not a meaningful relationship between equity composition and earnings stability of firms in Tehran securities exchange. When the variables of the ratio of aggregated gain (Loss), the ratio of legal reserve and the ratio of optional reserve are used instead of equity composition variable, main hypothesis of research is not rejected. This implies that there is a meaningful relationship between equity composition and earnings stability of firms in Tehran securities exchange.

According to the obtained results it is suggested that users of financial statements analyze the equity composition of firm before making any decision regarding investment. In addition, it is recommended to evaluate the managers of stock companies measures and variables other than reported earnings and stability are considered by general assemblies of stock holders, because one of the main motivations of managers for reporting stable earnings is that it is a basis for efficiency assessment and consequently rewards payment and other fringe benefits. It is important to use qualitative measures for evaluating the efficiency of managers.

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