STUDYING THE IMPACT OF QUALITATIVE CHARACTERISTICS STABILITY, PREDICTABILITY AND EARNINGS RESPONSE COEFFICIENT ON EXPECTED RETURN ON SHAREHOLDERS

*Keyhan Azadi¹ and Mohsen Noosh Azar²

¹Department of Accounting, Rasht Branch, Islamic Azad University, Rasht, Iran
²Department of Accounting, Kooshkyar Higher Education Institute, Rasht, Iran

*Author for Correspondence

ABSTRACT

Suitable occasions for manipulating profits arising from the conflicts of interest and some inherent limitations of accrual accounting make accounting profit different from the real benefit of economic units. Hence, so many accounting researches are about assessing the quality of reported earnings. Reduction of the quality of accounting information such as earnings quality, increases information risk, investment risk and finally return on demand. In this research, we study the impact of three qualitative features of earnings including persistence, predictability and earnings response coefficient on return on common stock by using financial information of the 91 accepted companies in the Tehran Stock Exchange during 2002 to 2012. According to the results, there is no significant relationship between qualitative characteristics of earnings and returns on equity.

Keywords: Expected Returns, Persistence of Earnings, Earnings Predictability, Earnings Response Coefficient

INTRODUCTION

Profit is one of the main items of financial statements and usually it is being used as a basis for investment, decision making and predicting. Inherent limitations of accounting such as various methods of accounting and deficiencies in estimation process made accounting profit different from actual earnings of a trade unit. Therefore, searchers and people who are involved in the accounting profession assess reported earnings by trade units. They use a concept called earnings quality for assessing.

Earnings quality is an important characteristic of accounting system. High quality financial information increases market efficiency. Therefore, we can say, investors and other users are interested in such information. Drafters of accounting standards are trying to expand standards to increase earnings quality. Assessing the impact of changes on the standards of accounting, auditing and corporate governance, and their relationship with cost of capital and earnings quality are subjects of different studies in several countries (Wagenhofer and Evert, 2011).

The high quality of reported earnings and the increase of the transparency of information and market efficiency make accounting profit more conformable with economic profit; it shows the earnings information are useful for decision making. The low quality of earnings causes risk in resource allocation, reduces economic growth through capital misallocation, deflects resources towards projects with unreal returns and increases risk information.

Return on equity is affected by the risk information. Risk information depends on the amount of confidential information and inaccurate general information that has been reported. When the amount of confidential information is high and the accurate of reported general information is less, the return on equity will be higher (Kordestani and Majadi, 2007)

Changes of earnings are the index of accounting information risk. Since, inaccurate information and disability of information in providing expected return cause information risk, we expect each inappropriate characteristic of earnings makes the returns ambiguous and affects them negatively (Kordestani and Majadi, 2007).
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Theoretical Foundations

Earnings quality is a multi-dimensional theoretical concept. Financial Accounting Standards Board believe predictability value, the value of feedback, being up-to-date, variability, neutrality and the ability to respond are the main indexes of earnings quality. The literature of earnings quality has a root in the depths of these fundamental features and usually related empirical studies are based on one or two of these indexes (Madhumathi and Ranganatham, 2011).

Financial experts have different approaches towards this subject. Schiper and Vincent defined earnings quality based on the ability of earnings in expressing Hicks’ economic benefit. Since, the economic benefit of Hicks is subjective Schiper and Vincent considered three constructs of earnings quality: persistence, predictability and time-series earnings variations (Saghafi, 2009). Schiveder et al., (1935) said in their theoretical accounting book that earnings quality is a correlation between accounting profit and economic profit of a company. Ball and Shivakumar (2005) believed high earnings quality means low-income management and it reflects bad news about the company’s stock price on time. According to Marinovic (2010) persistence, predictability and smoothing earnings are three features of earnings quality. Perotti and Wagenhofer (2011) used the mentioned features beside up-to-date information, conservatism, unusual accruals, earnings response coefficient, adjusted earnings response coefficients and earnings related to value of share (Ogeneva, 2008).

Investors care about the earnings quality of companies. In the last months of 1999, some American companies saw a decrease in stock price after purposing non-operating profits in the quarterly reports. Apparently, the market believed the companies’ managers were trying to provide the needed earnings by those reports (Schiveder et al., 1935).

Each unit profit has its own risk and returns. Investors groups like holders of debt securities, preferred stock and common stock want an amount of returns rate that is appropriate for the risk (Novu, 1986).

Managers must try to take the expected returns to the level of cost of capital in order to maintain the value of trade unit. Reducing cost of capital is the only way to success. If managers reduce the cost of capital of the trade unit, the expected return arising from beneficial projects that are not affordable with higher cost of capital for rival trade units, will increase the economic value of the trade units (Kordestani and Majadi, 2007).

Companies must reduce investment risk in order to reduce their cost of capital and increase shareholders’ wealth. Information risk is a component of investment risk in a company. Investors believe when the accuracy and the quality of provided information are high, the information risk will lessen. Managers of companies must pay attention to the quality of the provided information.

Since, information about profit is more important than other information of accounting system, it is necessary for investors to pay attention to the reported qualitative characteristics of earnings (Kordestani and Majadi, 2007).

For this research, we assessed three features of earnings including persistence, predictability and the earnings response coefficient and we studied their relationship with the returns on equity

The Background

There have been many studies on earnings quality and stock returns so far. Penman and Zhang (2002) indicated that conservatism and having variations in investment costs could explain future stock prices (Penman and Zhang, 2002).

Francis et al., (2002) studied the relationship between eight indexes of earnings quality, cost of debt and cost of common equity. The results at a 99% confidence level indicated companies with low earnings quality have higher interest and common stocks costs compared to companies with high earnings quality. They concluded, when earnings quality reduces, the single-factor CAPM Beta will monotonically increase (Francis et al., 2002).

Francis et al., (2004) studied the impact of earnings quality on the cost of common stocks one more time. They were trying to answer a question: which one of these features has the greatest impact on the cost of common stocks and makes other features its subset? According to their results, features based on accounting information (the quality of accruals, persistence, predictability and the uniformity of profit)
have great impact on the cost of common stock and among them the quality of accruals has the greatest impact. 

Lara et al., (2006) concluded conservatism in accounting reduces risk and cost of capital in a company and previous measuring models of conservatism that have been used for checking their relationship with cost of capital are theoretically correct but have some errors. 

Ogneva (2008) studied the relationship between accruals and stock returns. He concluded there is an inverse relationship between accruals and future stock returns. 

Hirshleifer et al., (2009) studied the relationship between accruals and cash flows with the size of stock returns. According to their results, there is positive and significant relationship between the size of accruals and stock returns and there is a negative and significant relationship between the size of cash flows and stock returns. 

Artiach and Clakson (2010) studied the impact of conservatism and disclosure on cost of common equity separately and together. According to their research, there is an inverse relationship between the level of conservatism and cost of common equity. Interestingly, this relationship with high exposure level is weak. 

Perotti and Wagenhofer (2011) studied the relationship between qualitative features of earnings and excess returns. They concluded qualitative features of earnings have an impact on returns by affecting cost of capital. They also studied the effects of features including persistence, predictability, smoothing earnings, accruals quality, unusual accruals, earnings response coefficient, adjusted earnings response coefficient, the relationship between earnings and value of shares on excess returns. They selected many non-financial intermediary companies in USA from 1988 to 2007 for their study and they concluded features of market information (earnings response coefficient and earnings related to value of shares) are more trustworthy compared to most of features based on accounting information including accruals and unusual accruals. 

Ghaemi et al., (2003) studied the impact of smoothing earnings on stock returns of the accepted companies in the Stock Exchange. They concluded, smoothing does not affect unusual returns of companies but industry and smoothing affect unusual returns of companies. Smoothing and size do not affect unusual returns but smoothing and the increase of investment have an effective impact on unusual returns. The impact of smoothing earnings on unusual returns is weak. 

Khajavi and Nazemi (2005) studied the impact of accruals on earnings quality of the accepted companies in the Tehran Stock Exchange. They indicated the mean of stock returns is not affected by the amount of accruals and their related components. In other words, we cannot say there is significant difference between the mean of returns of companies that have the least and the most reported accruals. 

Khoshtinat and Esmaeili (2006) studied the relationship between earnings quality and stock returns. Their criteria of earnings quality were the amount of accruals and voluntary and involuntary components of these accruals. They realized there is a weak relationship between earnings quality and stock returns. 

Kordestani and Majadi (2007) studied the relationship between qualitative features of earnings (explanatory variables) and cost of common stock (dependent variable). They calculated the cost of common stock by Gordon model and studied the impact of conservatism, persistence, predictability, up-to-date earnings information and earnings related to value of shares on cost of common stock. According to the results, being conservative does not affect the cost of common stock and other features have a significant impact on the dependent variable. 

Resaeiyan and Hosseini (2008) studied the relationship between accruals and cost of capital and debt. They indicated the quality of accruals does not affect cost of capital. 

Ahmadpoor and GhahremaniSaghir (2009) studied the reliability feature as a measure for assessing earnings quality of the accepted companies in the Tehran Stock Exchange. They had three hypotheses for studying the reaction of market to the reliability feature and they used quality criteria including accruals, conservatism and accruals of unusual progresses for operating the reliability feature. They studied the earnings response coefficient (ERC) in the first hypothesis, the explanatory power of earnings (R2) in two portfolios based on reliability feature in the second hypothesis and the relationship between cost of capital and reliability feature. According to the results, the ERC and R2 of the portfolio of companies with high...
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reliability are more than the portfolio of companies with low reliability; also, there is no relationship between cost of capital and the reliability feature.

Saghafi and Bolvou (2010) studied the relationship between cost of equity and four features of earnings including persistence, the quality of accruals, predictability and smoothing earnings from 2000 to 2005. They used Gordon model for calculating cost of equity. The results suggested only persistence affects cost of equity.

Rahmani and FalahNejad (2010) studied the relationship between accrual and cost of common stock. They used Gordon model for calculating cost of common stock as well and they realized there is a significant relationship between the quality of accruals and cost of common stock. Their results indicated there is a stronger relationship between the involuntary part of accruals and cost of common stock than the voluntary part of them.

Dastgir and Rastegar (2011) studied the relationship between earnings persistence and stock returns. They realized there is direct relationship between them; and when the quality of accruals decreases and the amount of accruals increases, stock returns will increase.

Our study is different from the previous studies. Firstly, we assessed features that have not been assessed before. Secondly, we used CAPM to estimate return on common stock. Thirdly, we have eleven-year information from 2002 to 2012.

The Hypotheses

We are trying to find a scientific answer for this question: does earnings quality has any impact on return on equity or not? Therefore, we have one main hypothesis and three secondary hypotheses as follows:

The Main Hypothesis: there is an inverse relationship between qualitative features of earnings and return on equity.

The Secondary Hypotheses:
1. There is an inverse relationship between earnings persistence and return on equity.
2. There is an inverse relationship between earnings predictability and return on equity.
3. There is an inverse relationship between earnings response coefficient and return on equity.

MATERIALS AND METHODS

Methodology

This is an empirical study and we used simple and multiple regression models. Since we used historical information for the hypotheses testing, it is a quasi-experimental study.

The Statistical Community and Samples

The statistical community of this research includes the accepted companies in the Tehran Stock Exchange from 2002 to 2012. We removed investment and financial intermediation companies and selected the active companies in other industries of the Tehran Stock Exchange that their financial statements and explanatory notes were available and had the below criteria, as our samples:

• These companies must have been accepted in the Tehran Stock Exchange before 2002; because we wanted our samples during research period have an equal amount.
• In order to compare them, their fiscal year must have ended at the September of each year and they should not have any changes in their fiscal year from 2002 to 2012.
• Since we want to study the qualitative characteristics of earnings, they should not have been disadvantageous during the period.
• The stock of the accepted companies should not have had trading halt more than four months during the period.

Among all the active companies in the Stock Exchange, 91 companies had the mentioned features and we selected them as our sample. At first, we determined explanatory variables by using time-series regression models in order to analyze the data, and then, we tested the research hypotheses by using simple and multiple linear regression models. We put the required data in EXCEL to analyze them and we used SPSS software for final analysis and correlation analysis.
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The Variables

A. The Dependent Variable

The best-known and most widely used model for assessing return on equity is CAPM that introduced and proved by Sharpe (1964), Lintner (1965) and Mossin (1966). According to this model, there is a direct relationship between return on common stock and systematic risk. [14] Here, return on equity is the dependent variable and is being calculated by CAPM based on equation 1.

\[ \text{Equation 1} \]
\[
E(\text{Ret}_j) = R_f + \beta_j (R_m - R_f)
\]

In this equation:
- \( E(\text{Ret}_j) \) is the return on equity of company \( j \)
- \( R_f \) is cost of return without risk that is 16%
- \( \beta_j \) is the sensitivity of stock returns of company \( j \) than market stock returns
- \( R_m \) is market returns index

Beta and its Measuring Process

Beta is the severity of returns changes of an earnings then the market. When market is positive, we must invest in a stock with high Beta (or higher than one) and when the market is negative, we must invest in a stock with few Beta (or fewer than one). To calculate Beta, we compare the market returns process of the company to the market returns process and we will get Beta by the equation 2.

\[ \text{Equation 2} \]
\[
\beta_j = \frac{\text{Cov}(R_j, R_m)}{\text{Var}(R_m)}
\]

We used the 48-months period that started from January 2007 to calculate the variance and the covariance. In this equation, \( R_m \) is monthly returns of the overall market index and \( R_j \) is the returns of the company in the same month. Calculating process of monthly returns of the overall market index is as same as calculating process of annual returns of the overall market index. However, calculating monthly returns of the company is not that easy. We assume an investor was involved in all the increases of company’s capital in the place of cash and receivables and deposited underwriting fee of priority right. Hence, we can calculate the returns by the equation 3.

\[ \text{Equation 3} \]
\[
\text{Ret}_{j,n} = \frac{(P_{j,n} - P_{j,n-1} + \text{Div}_{j,n} + \text{SR}_{j,n} + \text{SD}_{j,n})}{(P_{j,n-1} + (C_j \times X_{j,n}))}
\]

In this equation:
- \( \text{Ret}_{j,n} \) is the returns of company \( j \) in month \( n \).
- \( P_{j,n} \) is the cost of stock of company \( j \) in month \( n \).
- \( P_{j,n-1} \) is the cost of stock of company \( j \) in month \( n-1 \).
- \( \text{Div}_{j,n} \) is the amount of divided earnings and belongs to each earnings of company \( j \) in month \( n \) after it has been adapted in public associations and it is \( \text{DPS}_{j,n} \) multiplies current capital divides into the first capital.
- \( \text{SR}_{j,n} \) is the amount of priority right that due to an increase in capital percentage form the place of cash and receivables of creditors in the month \( n \) belongs to the investor of company \( j \) and it is fee of priority right multiplies the increase of capital percentage from the place of cash and receivables of creditors.
- \( \text{SD}_{j,n} \) is an amount of bonus shares that due to increase of capital from storage in month \( n \) belongs to the investor of company \( j \) and it is the price of bonus shares multiplies an increase of capital from storage.
- \( C_j \) is nominal value of the shares of company \( j \).
- \( X_{j,n} \) is the increase percentage of the capital of company \( j \) in month \( n \) from the place of cash and receivables of creditors.

B. The Explanatory Variables

In this research, qualitative characteristics of earnings are the explanatory variables. We used the models in the research of Peroti and Wigenhafer (2011) to calculate persistence, predictability and earnings response coefficient. All models have estimated by 11-year information of companies from 2002 to 2012.

1. Persistence of Earnings: persistence of earnings is the sustainability and reproducibility of current earnings for future. The persistence of earnings indicates its high quality. [21] Earnings is more
sustainable when it not because of some unusual and unexpected activities. [3] The explanatory variable coefficient of NIBEj,t that is β in model 1, indicates this feature.

\[ \text{Model 1} \]
\[ \text{NIBE}_{j,t} = \alpha + \beta \text{NIBE}_{j,t-1} + \varepsilon_{j,t} \]

When the Beta is closer to one, the persistence of earnings is higher and vice versa.

2. Predictability of Earnings: it is the ability of earnings to predict its own earnings [9] and indicates higher quality earnings are more useful for predicting future earnings. Just like the persistence feature, the high predictability feature indicates the high quality of earnings. [21] R2 of model 2 indicates this feature. According to the definition of determination coefficient and since this coefficient is always between zero and one, when R2 is closer to one, it means the regression model was able to relate changes of earnings in year t to the changes of its previous year and the predictability characteristic of earnings is higher.

3. Earnings Response Coefficient: ERC indicates the reaction of market to the changes of each earnings and it is one of the best methods for assessing earnings quality. [15] The Beta of model 2 indicates earnings response coefficient.

\[ \text{Model 2} \]
\[ \text{Ret}_{j,t} = \alpha + \beta (\text{NIBE}_{j,t}) + \varepsilon_{j,t} \]

Higher Beta magnitude (lower) implies the higher sensitivity (lower) of stock returns than earnings

The variables of the model 1 and 2 have been defined as follows:

• NIBE_{j,t} is the earnings before unexpected activities of company j in year t that has been divided for standardizing into the value of stock market in the beginning of the period of the same company.
• NIBE_{j,t} is the earnings before unexpected activities of company j in year t-1 that has been divided for standardizing into the value of stock market in the beginning of the period of the same company.
• Ret_{j,t} is annual return of company j in year t.
• ERC_{j} is the returns response coefficient of company j.
• Neg_{j,t} is the negative returns of company j in year t. When annual return is negative, this index equals one otherwise it is zero.

C. The Control Variables
The impact of qualitative characteristics of returns on return on common stock might being influenced by information environment and specific characteristics of any company. In order to increase the accuracy and reliability of the results, we controlled three variables including the size of firm, book value than the stock market value and earnings variation coefficient (the operational risk of company).

1. Size_{j} = \text{Ln (AssetBV}_{j}) is the size of firm
2. BM_{j} = \text{StockBV}_{j}/\text{Stock MV}_{j} is the book value than the stock market value
3. CV_{j} = \delta(\text{NIBE}_{j}) / \chi(\text{NIBE}_{j}) is earnings variation coefficient from t-10 to t

The Model for Hypotheses-Testing
The overall equation for studying the relationship between the explanatory and dependent variables of this research is model 3.

\[ \text{Model 3} \]
\[ \text{RET}_{j} = \beta_0 + \beta_1 \text{Attribute}_{j,k} + \beta_2 \text{Size}_{j} + \beta_3 \text{BM}_{j} + \beta_4 \text{CV}_{j} + \varepsilon \]

RET_{j} is return on common stock and Attribute_{jk} in hypothesis k (one to three) is respectively the persistence of earnings, the predictability of earnings, and the earnings response coefficient of company j. Hence, H0 and H1 are as follows:

H0: \beta_1 = 0
H1: \beta_1 \neq 0

RESULTS AND DISCUSSION

Results
In the first step, we calculated the return on common stock by CAPM. In the second step, we used models 1 and 2 and financial information from 2002 to 2012 to make qualitative characteristics of earnings...
quantitative and we considered them as a basis of the hypotheses testing. Chart 1 is a summary of statistical parameters of the research variables.

In order to increase the reliability of the results, we checked if the dependent variable is normal or not. The significance level of the Kolmogorov–Smirnov test is 0.828 and it indicates the null-hypothesis that proves the normality of the dependent variable at a 5% error level is accepted; hence, the dependent variable has normal distribution.

**Chart 1: Descriptive statistics of the data**

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<th>The upper limit</th>
<th>Kurtosis</th>
<th>Skewness</th>
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<th>Median</th>
<th>Mean</th>
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<td>1/46</td>
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<td>0/54</td>
<td>CV</td>
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**The Results of the First Hypothesis Testing**

The results of the first hypothesis are in chart 2. According to this information, t-statistic of the persistence of earnings is not in critical area. Hence, H0 at a 5% error level is accepted and we realize there is no significant relationship between the persistence of earnings and return on common stock. Regarding the control variables, there is a direct relationship between earnings variation coefficient and the size of firm and the dependent variable. However, this relationship is only significant for the size of firm. There is a weak inverse relationship between the book value and the market value of the company and it is not significant at a 95% confidence level. Durbin-Watson statistic shows there is no correlation between the components of the model error.

**Chart 2: The test of the persistence of earnings and return on common stock**

[Model 3-1]

\[
\text{RET}_j = \beta_0 + \beta_1 \text{Persist}_j + \beta_4 \text{CV}_j + \varepsilon + \beta_3 \text{BM}_j \beta_2 \text{Size}_j
\]

<table>
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<td>Durbin-Watson statistic</td>
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</table>

**The Results of the Second Hypothesis Testing**

The results of this hypothesis are in chart 3. According to the results, there is no significant relationship between the predictability of earnings and return on common stock and the second hypothesis at a 5% error level is not accepted.

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Among all the control variables, only the size of firm has a significant direct relationship with return on common stock. Durbin-Watson statistic indicates there is no correlation between the components of the model error.

**The Results of the Third Hypothesis Testing**
The results of the third hypothesis are in chart 4. According to the results, at a 95% confidence level, H0 is accepted and we realize there is a significant relationship between the earnings response coefficient and return on common stock. In addition, there is a significant relationship between the control variables of the earnings variation coefficient and book value than market value. However, there is no direct significant relationship between the size of firm and return on common stock. The Durbin-Watson statistic is 1.644 and shows there is no correlation between the components of the error model.

**Conclusion**
When profit is stable, it has lesser risk and since Investors often are inherently risk averse, they look for a stable profit. However, if investors could not predict future earnings, they will have a risky investment. Shareholders believe a company that has higher earnings predictability, has a better stock. On the other hand, when a company has a good function, its value and return on stock will increase, in other words, returns react to earnings. Generally, a high quality profit is beneficial and when it decreases information risk, the expected return will decrease as well. In this research, the main hypothesis that is about the relationship between qualitative characteristics of earnings and returns on common stock is not accepted. According to the results, shareholders of stock market do not pay attention to earnings quality and probably, affecting factors on the return on equity include political factors and macroeconomic issues.
The results of the impact of the persistence and predictability characteristics of earnings on returns on common stock do not have any conformity with the results of Francis et al., (2004) and Kordestani and Majadi (2007).

**Limitations**

Return on stock market in 2012 was greater than other years (almost 83%) and it made the returns on stock of some companies with Beta lesser than zero, negative. Hence, these companies have been removed from the samples. Return on stock is an index of cost of stock. Severe variations of cost of stock and trading halt during the research period may affect the results.

**A Suggestion for Future Studies**

Since the research hypotheses have not been accepted, we suggest enthusiasts instead of using regression model compare the mean of returns on stock of companies with high earnings quality to the mean of returns on stock of companies with low earnings quality.

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