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When Profits Rise but Cash Doesn't -
An Empirical Study of Earnings Quality and Retail Investors' Stock Selection Decisions

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Abstract - Earnings quality is an important consideration in evaluating a company's financial performance and making investment decisions. However, an increase in reported net profit does not necessarily indicate strong operating cash generation. This study examines the importance of the relationship between net profit and operating cash flow in retail investors' stock selection decisions. The research is based on primary data collected through a structured questionnaire, with 61 eligible responses from retail investors. The collected data were analysed using descriptive statistics and hypothesis testing. The findings indicate that although net profit remains a major consideration in stock selection, investors also recognise the importance of operating cash flow in assessing the sustainability of reported earnings. However, the hypothesis tests did not establish statistically significant associations between financial statement knowledge, investment experience and the identification of potential earnings quality concerns. The study highlights the importance of examining operating cash flow alongside reported profits to support more informed investment decisions.

Keywords: Earnings Quality, Net Profit, Operating Cash Flow, Retail Investors, Stock Selection, Financial Statement Analysis.

1. INTRODUCTION

Financial statements are an important source of information for evaluating the financial performance and position of a company. Investors rely on accounting information such as revenue, net profit, operating cash flow, and other financial indicators when making investment decisions. Among these indicators, net profit is commonly used to assess a company's profitability. However, reported profits alone may not provide a complete picture of the company's financial performance. A company may report increasing profits while generating relatively weak cash flows from its operating activities. Such differences raise questions about the quality and sustainability of the reported earnings.

Earnings quality refers to the extent to which reported earnings accurately reflect a company's underlying economic performance and provide useful information for decision-making. High-quality earnings are generally considered more sustainable and are supported by the company's actual operating performance and cash generation. In contrast, earnings that are heavily influenced by accounting estimates, accruals, or other non-cash adjustments may require closer examination. Dechow (1994) highlighted the role of accounting accruals in understanding the relationship between earnings and cash flows, demonstrating the importance of considering both measures when evaluating firm performance.

For retail investors, understanding earnings quality can be particularly important. Unlike institutional investors, retail investors may have varying levels of financial knowledge, investment experience, and ability to interpret financial statements. Some investors may primarily focus on reported net profit or earnings growth while overlooking the cash generated from operating activities. Others may consider operating cash flow as an additional indicator when assessing the financial strength and sustainability of a company's performance. The way investors interpret these financial indicators may therefore influence their stock selection decisions.

The Indian stock market has witnessed growing participation from individual investors, making it relevant to examine how retail investors use financial information in their investment decisions. Although profitability is an important consideration, the relationship between reported net profit and operating cash flow may provide additional insights into the quality of earnings. Understanding whether retail investors recognize this relationship can contribute to a better understanding of financial statement analysis and investment decision-making.

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Against this background, the present study examines the relationship between earnings quality and retail investors' stock selection decisions. It specifically investigates how investors interpret differences between reported net profit and operating cash flow, and whether their financial statement knowledge and investment experience are associated with their interpretation of such differences. The study uses primary data collected through a structured questionnaire from retail investors in India. By examining investors' responses to hypothetical company scenarios, the research seeks to understand whether earnings quality considerations influence their investment preferences.

2. REVIEW OF LITERATURE

2.1 Dechow (1994) – Accounting Earnings and Cash Flows as Measures of Firm Performance

Dechow (1994), in her study titled *"Accounting Earnings and Cash Flows as Measures of Firm Performance: The Role of Accounting Accruals,"* examined the usefulness of accounting earnings and cash flows in measuring a company's financial performance. The study explained that accounting accruals help address timing differences between cash receipts, cash payments, and the recognition of economic activities. It also found that the usefulness of accruals becomes more important when a company has longer operating cycles and greater fluctuations in its working capital requirements. This research highlights that neither reported earnings nor cash flows should always be considered in isolation. Both provide relevant information for evaluating business performance.

2.2 Sloan (1996) – Do Stock Prices Fully Reflect Information in Accruals and Cash Flows?

Sloan (1996), in his research titled *"Do Stock Prices Fully Reflect Information in Accruals and Cash Flows About Future Earnings?"* investigated whether investors appropriately consider the accrual and cash flow components of reported earnings when evaluating companies. The study found that the cash flow component of earnings was more persistent than the accrual component. However, stock prices appeared to reflect an excessive focus on reported earnings, without fully incorporating the information contained in their individual components. This finding is particularly relevant to the present research because it suggests that investors may not always distinguish between earnings supported by operating cash flows and earnings substantially influenced by accruals.

2.3 Dechow and Dichev (2002) – The Quality of Accruals and Earnings

Dechow and Dichev (2002), in their study *"The Quality of Accruals and Earnings: The Role of Accrual Estimation Errors,"* examined how estimation errors in accounting accruals affect earnings quality. The authors explained that accruals involve estimates of future cash flows and therefore may contain measurement errors. Their research developed an approach to assessing accrual quality by examining the relationship between working capital accruals and past, present, and future operating cash flows. The study established that greater estimation errors are associated with lower accrual quality and that accrual quality is positively related to earnings persistence. This provides an important foundation for understanding why the relationship between reported profits and operating cash flows matters when assessing the reliability of earnings.

2.4 Richardson et al. (2005) – Accrual Reliability, Earnings Persistence and Stock Prices

Richardson, Sloan, Soliman and Tuna (2005), in their research titled *"Accrual Reliability, Earnings Persistence and Stock Prices,"* investigated how the reliability of different accrual components affects the sustainability of reported earnings. Their findings indicated that less reliable accruals are associated with lower earnings persistence. The study also suggested that investors do not always fully anticipate the reduced persistence of earnings arising from less reliable accruals, which can contribute to stock mispricing. This research strengthens the argument that investors should examine the quality and composition of reported profits rather than relying exclusively on the overall earnings figure.

2.5 Bhatia (2023) – Use of Information Sources, Annual Reports and Other Corporate Announcements

Bhatia (2023), in the study *"Use of Information Sources, Annual Reports and Other Corporate Announcements: The Case of Large and Small Investors of India,"* examined how individual investors in India use corporate information when making equity investment decisions. The research was based on responses from 276 investors and analysed their perceptions of annual reports, financial statements, and other information sources. The findings indicated that financial statements were among the most important and understandable sections of annual reports for investors. The study is relevant to the present research because it highlights the role of corporate financial information in the investment decisions of Indian retail investors.

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2.6 Shroff et al. (2024) – Financial Literacy and Investment Decisions in an Emerging Market

Shroff, Paliwal and Dewasiri (2024) examined the relationship between financial literacy and investment decisions using a sample of 384 investors from India. Their research found that financial literacy positively influences investment decisions and that investors with greater financial knowledge are more likely to make informed investment choices. The study provides useful evidence that differences in financial knowledge can influence how individuals evaluate investment opportunities. In the context of the present research, this supports examining whether investors with better financial statement knowledge are more capable of identifying differences between reported net profit and operating cash flow.

2.7 Research Gap

The reviewed studies establish the importance of accounting accruals, operating cash flows, earnings persistence, and financial literacy in understanding financial performance and investment decisions. Previous research has also examined whether investors appropriately interpret the information contained in different components of reported earnings.

However, the reviewed literature provides a basis for further examining how retail investors themselves interpret differences between reported net profit and operating cash flow when choosing between investment alternatives. In particular, there is scope to investigate whether financial statement knowledge and investment experience are associated with investors' ability to recognise such differences and how these interpretations influence their stock selection preferences.

Therefore, the present study attempts to address this area by collecting primary data from retail investors in India through a structured questionnaire. It uses hypothetical company scenarios to examine how investors respond to different combinations of reported profitability and operating cash flow.

3. RESEARCH OBJECTIVES AND HYPOTHESES DEVELOPMENT

3.1 Research Objectives

The primary objective of this study is to examine how earnings quality influences the stock selection decisions of retail investors in India, particularly when reported net profit and operating cash flow present different financial signals.

The specific objectives are:

1. To examine the importance of earnings quality in the stock selection decisions of retail investors.
2. To analyse the extent to which retail investors consider operating cash flow alongside reported net profit while evaluating a company.
3. To assess whether differences between reported net profit and operating cash flow influence investors' stock selection preferences.
4. To examine the relationship between financial statement knowledge and investors' ability to interpret differences between reported net profit and operating cash flow.
5. To investigate whether investment experience is associated with investors' ability to identify potential concerns relating to earnings quality.

3.2 Research Questions

Based on the above objectives, the study seeks to answer the following research questions:

1. How important is earnings quality to retail investors when selecting stocks?
2. Do retail investors consider operating cash flow along with reported net profit when evaluating a company's financial performance?
3. Do differences between reported net profit and operating cash flow influence investors' stock selection decisions?
4. Does financial statement knowledge influence an investor's ability to interpret differences between reported net profit and operating cash flow?
5. Is investment experience associated with investors' ability to identify potential earnings quality concerns?

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3.3 Hypotheses Development

The study proposes the following hypotheses to examine the relationship between investors' financial knowledge, investment experience, and their interpretation of earnings quality.

Hypothesis 1: Financial Statement Knowledge

- **H_{01} (Null Hypothesis):** There is no significant association between the level of financial statement knowledge of retail investors and their ability to identify differences between reported net profit and operating cash flow.
- **H_{11} (Alternative Hypothesis):** There is a significant association between the level of financial statement knowledge of retail investors and their ability to identify differences between reported net profit and operating cash flow.

Hypothesis 2: Investment Experience

- **H_{02} (Null Hypothesis):** There is no significant association between investment experience and retail investors' ability to identify potential earnings quality concerns in different company scenarios.
- **H_{12} (Alternative Hypothesis):** There is a significant association between investment experience and retail investors' ability to identify potential earnings quality concerns in different company scenarios.

These hypotheses were tested using the primary data collected from respondents.

4. RESEARCH METHODOLOGY

4.1 Research Design

The present study adopted a quantitative research design to examine the relationship between earnings quality and the stock selection decisions of retail investors in India. A descriptive and analytical approach was used to understand investors' perceptions of reported net profit and operating cash flow and to examine whether financial statement knowledge and investment experience are associated with their interpretation of earnings quality.

4.2 Sources of Data

The study used both primary and secondary data.

Primary Data: Primary data were collected directly from retail investors through a structured questionnaire prepared using Google Forms. The questionnaire included questions relating to respondents' investment experience, educational qualifications, financial statement knowledge, use of accounting information, and preferences when evaluating hypothetical company scenarios.

Secondary Data: Secondary information was obtained from academic research papers, accounting journals, published literature, and other relevant sources dealing with earnings quality, accrual accounting, operating cash flows, and investor decision-making.

4.3 Population and Sample Size

The target population consisted of individual retail investors in India who currently invest or have previous experience investing in shares of listed companies. A total of 68 responses were received. However, seven respondents indicated that they had never invested in the Indian stock market and were excluded from the main analysis. Therefore, the final sample consisted of 61 eligible respondents.

4.4 Sampling Technique

A non-probability convenience sampling technique was used to collect responses. Participants were approached based on their accessibility and willingness to participate in the survey. This method was considered suitable for the present study because it enabled primary data to be collected from individual investors within the available time and resources.

4.5 Research Instrument and Questionnaire Design

A structured questionnaire was developed using Google Forms. It consisted of multiple-choice questions, financial knowledge questions, a perception-based question, and hypothetical investment scenarios.

The questionnaire was organised into the following areas:

1. **Respondent Profile:** Basic information about respondents, including age, educational qualification, and investment experience.

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2. **Investment Behaviour:** Investment preferences and the financial indicators considered while selecting stocks.
3. **Financial Statement Knowledge:** Questions assessing respondents' understanding of net profit, operating cash flow, and related financial information.
4. **Perceptions and Hypothetical Company Scenarios:** Questions examining respondents' views on earnings quality and their responses to different combinations of reported profitability and operating cash flow.

4.6 Tools and Techniques for Data Analysis

The collected responses were organised and analysed using Microsoft Excel. Descriptive statistical techniques, including frequencies, percentages, comparative tables, and graphical representations, were used to summarise the responses.

Fisher's Exact Test was applied to examine the association between financial statement knowledge and the identification of potential earnings quality concerns, as well as between investment experience and the identification of such concerns. This test was selected because of the small expected frequencies in the contingency tables.

4.7 Scope and Limitations of the Study

The study is limited to retail investors in India and focuses specifically on their interpretation of reported net profit and operating cash flow while evaluating hypothetical investment opportunities.

The findings are based on the responses received through the questionnaire and may not represent the views of the entire retail investor population. The use of convenience sampling and self-reported responses may also limit the generalisability of the findings.

5. DATA ANALYSIS AND INTERPRETATION

This section presents the analysis and interpretation of primary data collected through a structured questionnaire from retail investors in India. A total of 68 responses were received through Google Forms. However, seven respondents indicated that they had never invested in shares of companies listed on the Indian stock market. Therefore, these responses were excluded from the main analysis, resulting in a final sample of 61 eligible respondents.

The collected data were analysed using Microsoft Excel. Frequencies, percentages, comparative tables and appropriate statistical techniques were used to examine respondents' investment behaviour, financial statement knowledge and perceptions regarding earnings quality.

5.1 Demographic Profile of Respondents

Age Distribution

Age Group	Respondents	Percentage
20–25 years	29	47.5%
26–35 years	20	32.8%
36–45 years	8	13.1%
Above 45 years	4	6.6%
Total	**61**	**100%**

The age distribution indicates that 47.5% of respondents belong to the 20–25 years category, followed by 32.8% in the 26–35 years category. This indicates that the sample primarily consists of younger retail investors.

Educational Qualification

Qualification	Respondents	Percentage
Graduate	27	44.3%
Postgraduate	19	31.1%
Professional Qualification	11	18.0%

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Undergraduate	4	6.6%
Total	**61**	**100%**

The findings indicate that graduates form the largest group, representing 44.3% of the sample. Postgraduates account for 31.1%, while 18.0% possess professional qualifications such as CA, CMA or CFA. This reflects a sample with varied educational backgrounds.

Investment Experience

Investment Experience	Respondents	Percentage
Less than 1 year	10	16.4%
1–3 years	27	44.3%
4–6 years	14	23.0%
7–10 years	6	9.8%
More than 10 years	4	6.6%
Total	**61**	**100%**

The majority of respondents (44.3%) have investment experience ranging from one to three years. Overall, 60.7% have up to three years of experience, indicating that the sample is predominantly composed of relatively newer retail investors.

5.2 Factors Considered While Selecting Stocks

Respondents were asked to identify the factors they generally consider before selecting stocks. Multiple responses were permitted.

Factors	Respondents	Percentage
Net profit and earnings growth	54	88.5%
Revenue growth	45	73.8%
Valuation ratios	44	72.1%
Operating cash flow	39	63.9%
Debt and financial position	32	52.5%
Share price trends and technical indicators	30	49.2%
Company news and market sentiment	21	34.4%

The findings indicate that net profit and earnings growth are the most frequently considered factors, selected by 88.5% of respondents. Revenue growth and valuation ratios are also important considerations.

Operating cash flow was selected by 63.9% of respondents, suggesting that a considerable proportion of retail investors consider cash generation while evaluating stocks. However, the higher preference for reported profitability indicates that net profit remains a more prominent factor in stock selection.

5.3 Examination of Cash Flow Statements

Respondents were asked how frequently they examine a company's cash flow statement before investing in its shares.

Frequency	Respondents	Percentage
Always	22	36.1%
Often	27	44.3%

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Sometimes	9	14.8%
Rarely	3	4.9%
Total	**61**	**100%**

The results indicate that 80.3% of respondents always or often examine a company's cash flow statement before investing. This suggests that cash flow information is already an important part of the investment evaluation process for a substantial proportion of the sample.

5.4 Assessment of Financial Statement Knowledge

Respondents were asked three objective questions to assess their understanding of net profit, operating cash flow and the possible reasons for differences between these measures.

Knowledge Area	Correct Responses	Percentage
Meaning of net profit	58	95.1%
Meaning of operating cash flow	58	95.1%
Reasons for operating cash flow being lower than net profit	46	75.4%

The findings indicate that most respondents possess a basic understanding of financial statement concepts. While 95.1% correctly identified the meaning of net profit and operating cash flow, a comparatively lower proportion correctly identified the possible reasons for operating cash flow being lower than reported net profit.

For further analysis, one mark was awarded for each correct answer, resulting in a financial statement knowledge score ranging from zero to three.

Knowledge Score	Respondents	Percentage
1 correct answer	4	6.6%
2 correct answers	13	21.3%
3 correct answers	44	72.1%
Total	**61**	**100%**

A total of 72.1% of respondents answered all three knowledge questions correctly, indicating a generally good understanding of the financial concepts covered in the questionnaire.

5.5 Respondents' Perception of Earnings Quality

Respondents were asked to indicate their level of agreement with three statements relating to earnings quality and the importance of operating cash flow.

Statements	Agree / Strongly Agree	Percentage
Increasing net profit does not necessarily mean that operating cash flow is also improving	50	82.0%
Operating cash flow is important for evaluating the sustainability of reported profits	49	80.3%
A consistent difference between reported net profit and operating cash flow deserves further investigation	49	80.3%

The findings indicate that a significant majority of respondents recognise the importance of operating cash flow in evaluating reported profitability. Approximately 82.0% agreed that increasing net profit does not necessarily indicate improving operating cash flow.

Similarly, 80.3% agreed that operating cash flow is important for assessing the sustainability of reported profits and that consistent differences between these measures deserve further investigation. This indicates a considerable level of awareness regarding the concept of earnings quality among the respondents.

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5.6 Analysis of the Hypothetical Company Scenario

To understand how respondents interpret differences between reported profitability and operating cash flow, they were presented with two hypothetical companies operating in the same industry.

The financial information provided was as follows:

Financial Indicator	Company A	Company B
Net profit – Previous year	₹100 crore	₹100 crore
Net profit – Current year	₹140 crore	₹115 crore
Operating cash flow – Previous year	₹85 crore	₹90 crore
Operating cash flow – Current year	₹30 crore	₹105 crore

Question 1: Which company's financial performance would respondents consider more important to investigate further before investing?

Response	Respondents	Percentage
Company A – Profit increased while operating cash flow declined	15	24.6%
Company B – Net profit growth is lower	7	11.5%
Both companies equally	39	63.9%
Total	**61**	**100%**

The findings indicate that 63.9% of respondents considered both companies equally important to investigate, while 24.6% specifically selected Company A because of the decline in operating cash flow despite increasing net profit.

This suggests that although respondents generally recognise the importance of cash flow information, a relatively smaller proportion specifically identified the contrasting financial pattern presented by Company A as a reason for further investigation.

Question 2: Which company would respondents prefer if they had to select one based only on the information provided?

Response	Respondents	Percentage
Company A	6	9.8%
Company B	13	21.3%
Neither – Additional financial information required	41	67.2%
Not sure	1	1.6%
Total	**61**	**100%**

The results indicate that 67.2% of respondents preferred obtaining additional financial information rather than immediately selecting either company. Company B was preferred by 21.3% of respondents, while only 9.8% selected Company A.

This finding reflects a cautious approach towards stock selection when the available financial information may not be sufficient to make a confident investment decision. It also highlights the importance of examining financial information beyond reported net profit before selecting an investment.

5.7 Overall Importance of the Relationship Between Net Profit and Operating Cash Flow

Respondents were asked to rate the importance of the relationship between reported net profit and operating cash flow when evaluating a company's financial performance.

Response	Respondents	Percentage
Extremely important	41	67.2%

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Very important	16	26.2%
Moderately important	3	4.9%
Slightly important	1	1.6%
Total	**61**	**100%**

The findings indicate that 93.4% of respondents consider the relationship between reported net profit and operating cash flow either very important or extremely important. This demonstrates strong recognition of the relevance of cash flow information while evaluating a company's financial performance.

Respondents were also asked whether they would examine a company's cash flow statement more carefully if its reported profits increased while operating cash flow declined.

Response	**Respondents**	**Percentage**
Definitely yes	47	77.0%
Probably yes	8	13.1%
Not sure	6	9.8%
Probably no	0	0.0%
Definitely no	0	0.0%
Total	**61**	**100%**

A combined 90.2% of respondents indicated that they would definitely or probably examine the cash flow statement more carefully in such a situation. This suggests that most respondents are willing to investigate further when reported profitability and operating cash flow present contrasting trends.

5.8 Hypothesis Testing

The study proposed two hypotheses to examine whether financial statement knowledge and investment experience are associated with investors' ability to identify potential earnings quality concerns.

For the purpose of statistical testing, selecting Company A in the hypothetical scenario was treated as explicit identification of the particular situation in which net profit increased while operating cash flow declined. Other responses were grouped together. This provides a conservative measure of specific identification.

Hypothesis 1: Financial Statement Knowledge

H_{01}: There is no significant association between the level of financial statement knowledge of retail investors and their ability to identify differences between reported net profit and operating cash flow.

H_{11}: There is a significant association between the level of financial statement knowledge of retail investors and their ability to identify differences between reported net profit and operating cash flow.

For analysis, respondents were classified into two groups: those who answered all three financial knowledge questions correctly and those who answered one or two correctly.

Financial Knowledge Group	**Specifically Identified Company A**	**Other Responses**	**Total**
All 3 answers correct	8	36	44
1–2 answers correct	7	10	17
Total	**15**	**46**	**61**

Fisher's Exact Test was applied because of the small expected frequencies in the contingency table.

Test Result:

- Significance level: 5% (0.05)
- Fisher's Exact Test p-value: 0.096

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Since the p-value of 0.096 is greater than 0.05, the null hypothesis is not rejected. Although the proportion of respondents specifically identifying Company A differed between the two knowledge groups, the results do not provide sufficient statistical evidence of a significant association between financial statement knowledge and the identification of the particular earnings quality concern.

Hypothesis 2: Investment Experience

H_{02}: There is no significant association between investment experience and retail investors' ability to identify potential earnings quality concerns in different company scenarios.

H_{12}: There is a significant association between investment experience and retail investors' ability to identify potential earnings quality concerns in different company scenarios.

For analysis, respondents were classified into two groups: those with up to three years of investment experience and those with four or more years of investment experience.

Investment Experience	Specifically Identified Company A	Other Responses	Total
Up to 3 years	11	26	37
4 years or more	4	20	24
Total	**15**	**46**	**61**

Fisher's Exact Test was applied to examine the association between investment experience and the identification of the earnings quality concern.

Test Result:

- Significance level: 5% (0.05)
- Fisher's Exact Test p-value: 0.363

Since the p-value of 0.363 is greater than 0.05, the null hypothesis is not rejected. The results do not provide sufficient statistical evidence of a significant association between investment experience and the specific identification of the earnings quality concern.

Summary of Hypothesis Testing

Hypothesis	p-value	Decision
H_{01} – Financial statement knowledge	0.096	Do not reject H_{01}
H_{02} – Investment experience	0.363	Do not reject H_{02}

The results indicate that neither of the proposed relationships was statistically significant at the 5% level. However, this does not establish that the relationships do not exist; it indicates that the available sample does not provide sufficient evidence to establish them.

5.9 Overall Findings

Based on the analysis of 61 eligible responses, the following major findings emerged:

1. Net profit and earnings growth were the most frequently considered factors in stock selection, selected by 88.5% of respondents.
2. Operating cash flow was considered by 63.9% of respondents, indicating its relevance in investment evaluation.
3. Approximately 80.3% of respondents always or often examine a company's cash flow statement before investing.
4. A majority of respondents demonstrated a good understanding of basic financial statement concepts, with 72.1% answering all three knowledge questions correctly.
5. More than 80% of respondents recognised that increasing net profit does not necessarily indicate improving operating cash flow.

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6. In the hypothetical company scenario, 63.9% considered both companies equally important to investigate, while 24.6% specifically identified Company A because of its declining operating cash flow.
7. Approximately 67.2% preferred obtaining additional financial information rather than immediately selecting either company.
8. A combined 93.4% considered the relationship between net profit and operating cash flow very or extremely important.
9. Approximately 90.2% indicated that they would examine the cash flow statement more carefully if reported profits increased while operating cash flow declined.
10. Neither financial statement knowledge nor investment experience showed a statistically significant association with the specific identification of the earnings quality concern at the 5% significance level.

Overall, the findings indicate that respondents recognise the importance of operating cash flow in evaluating reported profitability. However, the hypothetical scenario suggests that general awareness of earnings quality does not necessarily translate into consistently identifying a particular financial warning sign when evaluating investment alternatives.

6. CONCLUSION, IMPLICATIONS AND LIMITATIONS

6.1 Major Findings

The study indicates that retail investors recognise the importance of cash flow information, although net profit remains a major factor in stock selection. Out of 61 eligible respondents, 54 (88.5%) considered net profit and earnings growth while selecting stocks, compared with 39 (63.9%) who considered operating cash flow. Further, 49 respondents (80.3%) agreed or strongly agreed that operating cash flow is important for evaluating the sustainability of reported profits.

The hypothetical company scenario revealed that 39 respondents (63.9%) considered both companies equally important to investigate, while 15 (24.6%) specifically identified Company A, where net profit increased but operating cash flow declined. Additionally, 57 respondents (93.4%) considered the relationship between net profit and operating cash flow very or extremely important. A total of 55 respondents (90.2%) indicated that they would examine cash flow statements more carefully if profits increased while operating cash flow declined.

The hypothesis tests did not establish statistically significant associations at the 5% significance level. The association between financial statement knowledge and identifying Company A as requiring further investigation was not significant ($p = 0.096$). Similarly, the association between investment experience and this identification was not significant ($p = 0.363$). Therefore, the null hypotheses were not rejected.

6.2 Suggestions and Implications

Retail investors should evaluate operating cash flow alongside net profit rather than relying solely on reported earnings. They should examine whether profits are supported by cash generated from business operations and investigate persistent differences between the two figures. Companies should also maintain transparent financial reporting to help investors assess the quality and sustainability of earnings.

6.3 Limitations and Conclusion

The study is based on 61 eligible responses collected through convenience sampling; therefore, the findings may not represent all Indian retail investors. The analysis also relies on questionnaire responses and a hypothetical company scenario rather than actual investment decisions.

Overall, the study highlights that rising profits do not necessarily indicate strong earnings quality. Considering operating cash flow alongside net profit can help retail investors make more informed stock selection decisions.

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APPENDIX

QUESTIONNAIRE

Title: When Profits Rise but Cash Doesn't: An Empirical Study of Earnings Quality and Retail Investors' Stock Selection Decisions

SECTION A: RESPONDENT PROFILE AND INVESTMENT BEHAVIOUR

Q1. Do you currently invest in or have previous experience investing in shares of companies listed on the Indian stock market?

- Yes, I currently invest.
- Yes, I have invested previously.
- No, I have never invested.

Q2. What is your age group?

- Below 20 years
- 20–25 years
- 26–35 years
- 36–45 years
- Above 45 years

Q3. What is your highest educational qualification?

- Higher Secondary
- Undergraduate
- Graduate
- Postgraduate
- Professional qualification (CA, CMA, CFA, etc.)
- Other

Q4. How long have you been investing in the stock market?

- Less than 1 year
- 1–3 years
- 4–6 years
- 7–10 years
- More than 10 years

Q5. Which factors do you generally consider before selecting a stock?
(Select all that apply.)

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- Company's net profit and earnings growth
- Revenue growth
- Operating cash flow
- Debt and financial position
- Share price trends and technical indicators
- Company news and market sentiment
- Valuation ratios (P/E, P/B, etc.)
- Other

Q6. How frequently do you examine a company's cash flow statement before investing in its shares?

- Always
- Often
- Sometimes
- Rarely
- Never

SECTION B: UNDERSTANDING OF FINANCIAL STATEMENTS

Q7. What does net profit primarily indicate?

- Revenue remaining after expenses and applicable taxes are deducted.
- Total cash received by a company.
- The total value of a company's assets.
- Cash generated only from operating activities.

Q8. What does cash flow from operating activities primarily represent?

- Profit earned after deducting all expenses.
- Cash generated or used by a company's main business operations.
- Total cash spent on purchasing fixed assets.
- Cash received from issuing shares.

Q9. What could cause a company's operating cash flow to be lower than its reported net profit?

- Increase in receivables due to credit sales.
- Increase in inventory.
- Timing differences and non-cash accounting adjustments.
- All of the above.

SECTION C: PERCEPTION OF EARNINGS QUALITY

Q10. To what extent do you agree with the following statements?

Select one response for each statement.

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Statement	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Increasing net profit does not necessarily mean that a company's operating cash flow is also improving.	○	○	○	○	○
Operating cash flow is important for evaluating the sustainability of reported profits.	○	○	○	○	○
A consistent difference between reported net profit and operating cash flow deserves further investigation.	○	○	○	○	○

SECTION D: HYPOTHETICAL INVESTMENT SCENARIO

Consider the following financial information of two hypothetical companies:

Particulars	Company A	Company B
Previous Year Net Profit	₹100 crore	₹100 crore
Current Year Net Profit	₹140 crore	₹115 crore
Previous Year Operating Cash Flow	₹85 crore	₹90 crore
Current Year Operating Cash Flow	₹30 crore	₹105 crore

Q11. Based on the above information, which company's financial performance would you consider more important to investigate further before investing?

- Company A, because net profit has increased while operating cash flow has declined.
- Company B, because its net profit growth is lower.
- Both companies equally.
- Neither; both companies appear satisfactory based on the information provided.

Q12. If you had to select one company based only on the information provided, which would you prefer?

- Company A
- Company B
- Neither; I would require additional financial information.
- I am not sure.

SECTION E: INVESTOR AWARENESS AND DECISION-MAKING

Q13. How important is the relationship between reported net profit and operating cash flow when evaluating a company's financial performance?

- Extremely important
- Very important
- Moderately important
- Slightly important
- Not important

Q14. Would you examine a company's cash flow statement more carefully if its reported profits increased but its operating cash flow declined?

- Definitely yes
- Probably yes

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- Not sure
- Probably no
- Definitely no

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