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The impact of accounting information quality on the mispricing of accruals: The case of FRS3 in the UK

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ABSTRACT

We exploit a unique setting of accounting regulation change to examine how accounting information quality affects the well-documented accrual anomaly. We show a significant reduction in the negative return predictability of accruals among UK companies with poorer accounting information quality following the introduction of Financial Reporting Standard No. 3: Reporting Financial Performance (FRS3). While the functional fixation hypothesis attributes the mispricing of accruals to the judgemental error of end-users of information, our findings suggest that the supply side of information also plays a crucial role. Our results provide evidence that regulatory interventions seeking to improve accounting information quality can reduce the mispricing of securities in the capital market.

1. Introduction

We compare the empirical evidence of accrual anomaly before and after a major change of accounting regulation to examine how it is affected by accounting information quality. Since Sloan (1996) existing literature documents a negative relationship between accruals and subsequent stock returns but has yet to reach a consensus on the underlying cause of this anomaly. We examine this issue by exploiting a unique setting of accounting regulation change in the UK, i.e. the introduction of Financial Reporting Standard No. 3: Reporting Financial Performance (FRS3) in October 1992. In doing so, we

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intersect and contribute to two strands of literature: (a) the effects of information quality on accrual anomaly (e.g., Drake et al., 2007) and (b) the impact of FRS3 in the UK on accounting information quality (e.g., Acker et al., 2002; Athanasakou et al., 2007). There is currently little evidence on the impact of accounting regulatory intervention on stock return anomalies in the capital markets and we fill this gap.

Our study's innovation is to examine whether the accrual anomaly is reduced following regulatory interventions designed to improve market-wide accounting information environment. FRS3 seeks to reduce earnings manipulation and increase the disclosure of earnings performance. It demands UK companies to classify exceptional items more appropriately, eliminate the use of extraordinary items, and disclose additional income components. Existing literature documents improved earnings forecast (Acker et al., 2002; Lin, 2002), reduced earnings management (Athanasakou et al., 2007), and greater value relevance of reported earnings (Lin, 2006) following FRS3. Given the direct relevance of FRS3 on reported earnings information, we believe it may exert an impact to the mispricing of accruals in the UK.

Sloan (1996) attributes the accrual anomaly to the functional fixation hypothesis (e.g., Abdel-khalik and Keller, 1979; Hand, 1990) and suggests that investors overprice accruals because they are unable to distinguish the difference in persistence between the accruals and cash flow components of earnings. Merton (1987) suggests that incomplete information can cause asset pricing anomalies to arise in the capital markets even if it is dominated by rational agents. Brav and Heaton (2002) argue that rational investors would underweight lower precision signals, which leads to temporary mispricing, and correct their original valuation upon arrival of new information, which leads to subsequent abnormal returns. If the accrual anomaly is indeed a manifestation of mispricing and if investors' misjudgements are conditional on the information set available, the anomalous returns should be more pronounced among companies that supply poorer quality information. Existing studies confirm this prediction by documenting cross-sectional variations in accrual anomaly that is conditional on information quality (e.g., Drake et al., 2007).

We compare changes in the magnitude of the accrual anomaly in the UK from pre- (1986–1992) to post- (1995–2002) FRS3 periods. Following existing literature on accrual anomaly, we implement the Mishkin (1983) non-linear test, hedge portfolio return tests, and the Fama and MacBeth (1973) cross-sectional regression approaches. To account for the possibility of such changes arising purely by chance or due to other market-wide confounding reasons such as business cycles and Internet bubble, we identify cross-sectional variations in the degree to which companies are expected to be more sensitive to the FRS3.[1] Since the reduction of earnings management is one of the major objectives of FRS3, its impact should be more pronounced among companies where accounting disclosure quality is lower due to greater managerial discretionary effect. We identify such companies based on the quality of their accruals, following the approach of Francis et al. (2005), Francis et al. (2007) and McNichols (2002). To strengthen the robustness of our findings, we control for other factors that existing literature purports to be associated with accrual anomaly. These include value-growth effect (Beaver, 2002; Desai et al., 2004; Cheng and Thomas, 2006), limits to arbitrage (Mashruwala et al., 2006), and ownership dispersion (LaFond, 2005; Pincus et al., 2007).

We find a significant reduction of accrual anomaly in the UK from the pre- to post-FRS3 periods. For instance, across the whole sample the hedge portfolio tests indicate a significant drop of over 4% in annual abnormal returns between the pre- and post-FRS3 periods. The reduction is driven by the low accounting information quality companies, which experience a significant decline of around 6% in annual abnormal returns. The changes associated with high accounting information quality companies from pre- to post-FRS3 periods are statistically insignificant. These findings are robust to

[1] Pincus et al. (2007) suggest accrual anomaly could be affected by institutional factors such as legal origin, strength of insider trading, extent of accrual accounting, shareholder protection, importance of equity market in a country, and concentration of ownership. However, UK has not experienced systematic changes in these institutional settings over our post-FRS3 test periods and we control for company-specific ownership structure in our analyses. We are also not aware of other changes in UK GAAP or its enforcement that supersedes FRS3 in terms of relevance to reported earnings except for FRS14, which became effective in 1998. However, FRS14 merely amends details under the conceptual framework established by FRS3. Of the two legacy of FRS3, i.e. reduce earnings management and increase disclosure, FRS14 only refines the former aspect. Untabulated results from additional robustness tests indicate that our results are not driven by test periods associated with FRS14.