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ScienceDirect
Journal of Accounting and Economics 42 (2006) 87–105
JOURNAL OF Accounting & Economics
www.elsevier.com/locate/jae

Weighing the evidence on the relation between external corporate financing activities, accruals and stock returns ☆

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Available online 12 July 2006

Abstract

Bradshaw, Richardson, and Sloan (BRS) find a negative relation between their comprehensive measure of corporate financing activities and future stock returns and future profitability. Noticing that accounting accruals are increases in net operating assets on a company's balance sheet, we question whether it is possible to distinguish between the 'external financing anomaly' documented by BRS and the 'accrual anomaly' first documented by Sloan [1996. Do stock prices fully reflect information in accruals and cash flows about future earnings? The Accounting Review 71, 289–315]. We show that once controlling for total accruals, the relation between external financing activities and future stock returns is attenuated and not statistically significant. These findings are consistent with Richardson and Sloan [2003. External financing, capital investment and future stock returns. Working Paper, University of Pennsylvania and University of Michigan].

JEL classification: G10; M4

Keywords: External financing; Sell-side analysts; Capital markets; Market efficiency

☆We would like to thank Jieying Zhang for helpful comments. All remaining errors are our own responsibility.
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0165-4101/$ - see front matter
doi:10.1016/j.jacceco.2006.04.006

1. Introduction

Bradshaw et al. (2006, hereafter BRS) examine the relation between firms' external financing activities, future stock returns, future profitability and analysts' forecasts. BRS summarize that, "The key innovation of our research design is the use of statement of cash flows data to construct a comprehensive and parsimonious measure of the net amount of cash generated by corporate financing activities" (p. 1). In other words, BRS' major contribution is their focus on net external financing activities rather than individual components of corporate financing activities (e.g., debt versus equity) chosen by firms. In addition to investigating future stock returns and profitability following firms' corporate financing activities, BRS analyze analysts' short- and long-term earnings forecasts, growth forecasts, stock recommendations, and target prices. Overall, BRS ask an interesting and intriguing question that goes beyond the traditional pecking-order theory.

Their primary findings are that there exists a negative and statistically significant relation between net external financing and future stock returns, and future profitability, and a positive relation with optimism in analysts' forecasts. These results, in turn, imply that the relevant information in financing activities is that the firm raised (or repaid) funds, rather than the specific means by which the firm raised (e.g., debt versus equity) or repaid (dividends and stock repurchases versus interest and repayment of debt) funds.

Using a trading strategy based on the overall measure of net external financing, BRS document that such a hedge portfolio generates an annual return of 15.5%. This return exceeds the hedge portfolio returns based on the individual components of net external financing. The overall results on the relation between external financing and future stock returns and future profitability imply that investors do not correctly infer the negative relation between financing activities and future performance.

BRS investigate both investors' and analysts' responses to firms' financing activities. Their research is designed to distinguish between risk and misvaluations as potential explanations for the association between future stock returns and firms' corporate financing activities. They find a systematic positive relation between net external financing and optimism in analysts' forecasts. Furthermore, the results suggest that analysts' optimism is related to the type of security issued: over-optimism for debt issuance is restricted to short-term earnings forecasts, while over-optimism for equity issuance is also related to long-term earnings forecasts, growth, stock recommendations and target prices. The above findings lead BRS to conclude that analysts play a 'central role' in the overpricing of security issuances.

Based on their findings, BRS offer the following interpretations and implications:

(i) "…consistent with the misvaluation hypothesis, the predictable stock returns are directly related to predictable errors in analysts' earnings forecasts…. Overall, the results are consistent with the hypothesis that firms time their corporate financing activities to exploit the temporary misvaluation of their securities in capital markets."

(ii) "…our results suggest that the negative stock returns following new security issuances are primarily attributable to firm misvaluations rather than wealth transfers between stockholders and bondholders… we show that changes in debt are negatively related to future returns. This evidence is consistent with the firm misvaluation hypothesis, but inconsistent with the wealth transfer hypothesis."