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Accrual reliability, earnings persistence and stock prices ☆

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Abstract

This paper extends the work of Sloan (1996. The Accounting Review 71, 289) by linking accrual reliability to earnings persistence. We construct a model showing that less reliable accruals lead to lower earnings persistence. We then develop a comprehensive balance sheet categorization of accruals and rate each category according to the reliability of the underlying accruals. Empirical tests generally confirm that less reliable accruals lead to lower earnings persistence and that investors do not fully anticipate the lower earnings persistence, leading to

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significant security mispricing. These results suggest that there are significant costs associated with incorporating less reliable accrual information in financial statements.

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1. Introduction

This paper investigates the relation between accrual reliability and earnings persistence. The paper builds on the work of Sloan (1996), who shows that the accrual component of earnings is less persistent than the cash flow component of earnings and attributes this difference to the greater subjectivity of accruals. We draw a natural link between Sloan's notion of subjectivity and the well-known accounting concept of reliability. We formally model the implications of reliability for earnings persistence, with our model predicting that less reliable accruals result in lower earnings persistence. Our empirical tests employ a comprehensive categorization of accounting accruals in which each accrual category is rated according to its reliability. Consistent with the predictions of our model, the empirical tests generally confirm that less reliable accruals lead to lower earnings persistence. We also show that stock prices act as if investors do not anticipate the lower persistence of less reliable accruals, leading to significant security mispricing.

Our paper makes three contributions to the existing literature. First, we directly link reliability to empirically observable properties of accounting numbers. Reliability, along with relevance, is considered to be one of the two primary qualities that make accounting information useful for decision-making.[1] While a large body of research examines the value relevance of accounting numbers, there is relatively little research on reliability. One consequence of the emphasis on relevance has been calls for the recognition of more relevant and less reliable information in accounting numbers (e.g., Lev and Sougiannis, 1996). However, as recently articulated by Watts (2003), allowing less verifiable and hence less reliable estimates into accounting numbers can seriously compromise their usefulness. Our research highlights the crucial trade-off between relevance and reliability. Our analysis suggests that the recognition of less reliable accrual estimates introduces measurement error that reduces earnings' persistence and leads to significant security mispricing.

The second major contribution of our work is to provide a comprehensive definition and categorization of accruals. Following Healy (1985), a large body of research has employed a narrow definition of accruals that focuses on working capital accruals. Non-current accruals, such as capitalized software development

[1]For example, see Fig. 1 in *Statement of Financial Accounting Concepts 2*, "Qualitative Characteristics of Accounting Information" (Financial Accounting Standards Board, 2002).