The market pricing of accruals quality

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Abstract

We investigate whether investors price accruals quality, our proxy for the information risk associated with earnings. Measuring accruals quality (AQ) as the standard deviation of residuals from regressions relating current accruals to cash flows, we find that poorer AQ is associated with larger costs of debt and equity. This result is consistent across several alternative specifications of the AQ metric. We also distinguish between accruals quality driven by economic fundamentals (innate AQ) versus management choices (discretionary AQ).
Both components have significant cost of capital effects, but innate \( AQ \) effects are significantly larger than discretionary \( AQ \) effects.

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1. **Introduction**

This study investigates the relation between accruals quality and the costs of debt and equity capital for a large sample of firms over the period 1970–2001. Our study is motivated by recent theoretical research that shows that information risk is a non-diversifiable risk factor (e.g., Easley and O’Hara, 2004; O’Hara, 2003; Leuz and Verrecchia, 2004). By information risk, we mean the likelihood that firm-specific information that is pertinent to investor pricing decisions is of poor quality. We assume that cash flow is the primitive element that investors price and identify accruals quality as the measure of information risk associated with a key accounting number—earnings. That is, accruals quality tells investors about the mapping of accounting earnings into cash flows. Relatively poor accruals quality weakens this mapping and, therefore, increases information risk.

Our paper makes two contributions. First, consistent with theories that demonstrate a role for information risk in asset pricing, we show that firms with poor accruals quality have higher costs of capital than do firms with good accruals quality. This result is consistent with the view that information risk (as proxied by accruals quality) is a priced risk factor. Second, we attempt to disentangle whether the components of accruals quality—accruals that reflect economic fundamentals (innate factors) and accruals that represent managerial choices (discretionary factors)—have different cost of capital effects. While theory does not distinguish among the sources of information risk, prior research on discretionary accruals (e.g., Guay et al., 1996; Subramanyam, 1996) provides a framework in which discretionary accruals quality and innate accruals quality will have distinct cost of capital effects. Briefly, this body of work suggests that, in broad samples, discretionary accrual choices are likely to reflect both opportunism (which exacerbates information risk) and performance measurement (which mitigates information risk); these conflicting effects will yield average cost of capital effects for discretionary accruals quality that are likely lower than the cost of capital effects for innate accruals quality. Consistent with this view, we find that innate accruals quality has larger cost of capital effects than does discretionary accruals quality.

The accruals quality \( (AQ) \) metric we use is based on Dechow and Dichev’s (2002) model which posits a relation between current period working capital accruals and operating cash flows in the prior, current and future periods. Following McNichols (2002) discussion of this model, we also include the change in revenues and property, plant and equipment (PPE) as additional explanatory variables. In this framework,
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