Available online at www.sciencedirect.com

SciVerse ScienceDirect

Procedia Economics and Finance 2 (2012) 91 – 100

Procedia Economics and Finance

www.elsevier.com/locate/procedia

2nd Annual International Conference on Accounting and Finance (AF 2012)

Overvalued equity and the accruals anomaly: Evidence from insider trades

Julia Sawicki[a] and Keshab Shrestha[b]

[a] Dalhousie University, 6100 University Ave, Halifax B3H 3J5, Canada
[b] NUS Risk Management Institute, 21 Heng Mui Keng Terrace, 119613 Singapore

Abstract

This paper examines the accruals anomaly in an agency context where managers of overvalued firms have incentives to sustain overvaluation. We hypothesize that mangers anticipate the ultimate share price reversals and use high accruals to temporarily sustain overvaluation, while at the same time sell their shares. There is no incentive to deflate earnings of undervalued firms, leading to the prediction of an asymmetric relationship between trading and accruals. Our results support an agency explanation. Quadratic and binary regressions confirm that relationship between trades and accruals is concentrated on the selling side. The relationship between accruals and trading is only significant within the overvalued, low book-to-market (BM) firms. There is also evidence that low BM firms manage their earnings upward compared to high BM firms.

Keywords: Overvalued equity; Earnings management; Agency theory; Accruals Anomaly; Misvaluation; Insider Trading

1. Introduction

The accruals anomaly is one of many well-documented apparent contradictions of the efficient market hypothesis. First reported by Sloan (1996), a strategy of buying low accrual firms and selling high accrual firms yields significant returns. In his seminal paper and others, Sloan attributes misvaluation to investor fixation on earnings. The over- (under-) valuation of high (low) accrual firms subsequently adjusts resulting in a predictable negative relationship between accruals and returns.

The abundant literature investigating the anomaly documents an important empirical regularity: mispricing related to positive accruals is not matched by mispricing related to negative accruals (Beneish and Vargus, 2002; Barth and Hutton, 2004). Rather than being naïve and indiscriminate, investors' fixation is one-sided, suggesting a need to refine our understanding of the anomaly. Kothari et al. (2006) advance an alternative

 doi:10.1016/S2212-5671(12)00068-8

explanation for the accruals anomaly, citing a large body of literature articulating the agency theory of overvalued equity. Jensen (2005) defines and analyzes the agency costs of overvalued equity where firms become overvalued for various reasons, and managers get caught up in a game of meeting expectations.[1] Actions include using overvalued equity to make acquisitions (Moeller et al., 2005; Shleifer and Vishny, 2003) delaying the release of bad news (Kothari et al., 2006) and income increasing earnings management (Jensen, 2005; Kothari et al., 2006). Specifically considering accruals as an earnings management tool, the ultimate price reversal for high accrual firms leads to the prediction of a negative relationship between high accruals and subsequent returns.

Investor errors in interpreting accruals are at play in both explanations of the accruals anomaly, however there are important distinctions regarding motivation, mechanisms and implications. In the agency scenario, managers play a direct role, reporting inflated earnings to help sustain overvaluation. In order for the high accrual component of earnings to be an effective mechanism of manipulation, investors must misinterpret the elements of reported earnings. In contrast to the agency theory's intent and action to mislead, the fixation hypothesis is silent regarding explicit managerial motivation and acts. Also, the agency theory of overvalued equity does not require investor fixation for firms to become overvalued. Accruals are part of the arsenal for sustaining overvaluation. Under the fixation hypothesis, cognitive errors are a direct *cause* of mispricing. Investors do not properly distinguish between the cash flow (permanent) and accrual (reversing) components of earnings in forecasting future performance. Firms with a high (low) component of accruals in earnings thus become over- (under-) valued. The mis-valuation adjusts quickly (as accruals reverse within the next few quarters) leading to low returns for high accrual firms, and high returns for low accrual firms.

On the other hand, the agency theory is restricted to the relationship between high accruals and overvaluation. If the agency explanation is behind the accruals anomaly, the relationship between accruals and returns will be non-linear (asymmetric): mispricing is only related to high accruals which are part of the process of sustaining overvaluation that eventually corrects. Kothari et al. (2006) provide supporting evidence of asymmetry on the relation between accruals and returns (past, current and future), and other variables related to overvaluation (investment/financing, insider trading and analyst optimism) concentrated in the high accrual deciles.

A key empirical distinction between the naïve fixation and overvalued equity explanations is the symmetry of the relation between the level of accruals and returns. Under the fixation hypothesis, investors are focusing on the earnings number, and errors are expected in both extreme levels of accruals. The predicted relationship between accruals and future returns will be linear (symmetric).

Our investigation into the accruals anomaly focuses on the relationship between accruals and one variable: insider trading. This is a particularly interesting variable to use in exploring the accruals anomaly in the context of overvalued equity for several reasons. Jensen (2005) describes a distorted path taken by managers to validate market (and perhaps their own) growth expectations (e.g. acquisitions, excessive internal spending and risky investments) which eventually turns to accounting manipulation as challenges to meet the expectations mount. Accruals, one of many tools available for earnings management, are not particularly effective for sustaining valuation over a long time frame due to their short term, reversing nature. This is precisely the strength of the using insider trading an empirical test of the accruals anomaly in the agency context. At some point along the distorted path, the illusion of growth becomes increasingly difficult to maintain. We hypothesize that managers anticipating a share price correction use accruals to temporarily sustain overvaluation while at the same time sell their shares. Another advantage of using insider trading to understand the accruals anomaly is that gives rise to a clear empirical distinction of asymmetry versus linearity in the trading accruals relationship. The agency incentive for upwards earnings management and selling of overvalued firms is not matched by an incentive to manage earnings downwards and buy for

[1] Kothari et al. (2006) discuss the incentives managers have to sustain overvaluation such as equity-linked compensation, and reputation.