The market pricing of accruals quality

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Received 29 October 2002; received in revised form 30 April 2004; accepted 28 June 2004
Available online 2 March 2005

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 $AQ$).

\textsuperscript{*}This research was supported by the Fuqua School of Business, Duke University and the University of Wisconsin. The views expressed in the paper are those of the authors’ and do not represent positions of the Financial Accounting Standards Board. Positions of the Financial Accounting Standards Board are arrived at only after extensive due process and deliberation. We appreciate comments from Ross Watts (the editor) and Charles Wasley (the referee); from workshop participants at the Boston Area Research Colloquium, Duke, Missouri, Northwestern, Rochester, University of Southern California, the Southeast Accounting Research Conference 2002 and the Stockholm Institute for Financial Research Conference; and from Jan Barton, Sudipta Basu, George Benston, Larry Brown, Stephen Brown, Marty Butler, Qi Chen, John Graham, John Hand, Grace Pownall, Eddie Riedl, Michael Smith, Greg Waymire, Joanna Wu and Jerry Zimmerman.

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doi:10.1016/j.jacceco.2004.06.003
Both components have significant cost of capital effects, but innate $AQ$ effects are significantly larger than discretionary $AQ$ effects.

JEL classification: D80; G12; G14; M41; M43

Keywords: Capital markets; Accruals quality; Information risk

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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