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Accounting quality, information risk and the term structure of implied volatility around earnings announcements

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Abstract

We examine the association between accounting quality, which is used as a proxy for firm information risk, and the behavior of the term structure of implied option volatility around earnings announcements. By employing a large sample of US firms having options traded on their equity during 1996-2010, we find that lower (higher) accounting quality is significantly associated with stronger (weaker) changes in the steepness of the term structure of implied volatility curve around quarterly earnings announcements. This finding (which is robust to controls for business-stemming uncertainty regarding future firm performance) is consistent with a stronger differential of short vs. long-term uncertainty for higher information risk firms, indicating greater uncertainty on the future economic performance of poorer vs. stronger accounting quality firms. We also establish the trading implications of these findings by demonstrating a (profitable in-sample) self-financed option trading strategy that is based on the quality of the accounting information released on earnings announcement days.

Keywords: Accounting quality, information risk, term structure of implied volatility, earnings announcements

JEL classification: G13, G14, M41

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