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Does the earnings quality matter? Evidence from a quasi-experimental setting

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ABSTRACT

Investor preference for local stocks provides a quasi-experimental setting to investigate whether the market rewards firms that comply with generally accepted accounting principles. We show firms with low earnings quality trade at a premium compared to firms in compliance with accounting principles; the difference in values is greater when the role of local investor over-trading is stronger in stock price-formation, in other words for the more isolated firms. The value of the information not conveyed to the market through accounting disclosure accounts for 30% of the market-to-book. Results are robust to earnings quality definition, and show while non-local investors are sensitive to the quality of accounting information, local and better-informed investors are not. Overall, accounting quality matters.

1. Introduction

The global financial crisis of 2007–2008 highlighted a fundamental need for transparency in corporate practices (e.g., Arnold, 2009; Barth and Landsman, 2011). For more than 40 years, the literature has been calling for more informative accounting disclosures and increased emphasis on detecting earnings management and fraudulent reporting (e.g., Chung et al., 2009; Dechow et al., 2010; Kothari, 2001; Lahr, 2014). Interestingly, research on compliance does not provide a clear picture on the relationship between firms' reporting quality and financial consequences, and whether the market rewards compliance with accounting principles is also unclear (e.g., Bhattacharya et al., 2003; Chan et al., 2006; Core et al., 2008; Francis et al., 2005; Morricone et al., 2009). Francis et al., (2005) show that reporting quality matters since investors price securities based on their awareness of accruals quality. On the other hand, Core et al., (2008) find no evidence that accruals quality is a priced risk factor and Lev (1989) suggests only a weak correlation between stock market returns and earnings disclosure, concluding that '*earnings manipulation is prevalent; but, except for egregious cases, it is hard to detect and prosecute*' (Lev, 2003, p. 48).

This paper exploits the quasi-experimental setting provided by investor tendency to overinvest in geographically proximate, or local stocks (the so-called Local Home Bias) (e.g., Coval and Moskowitz, 1999; Cumming and Johan, 2006) to investigate whether the market rewards firms that comply with accounting principles. The Local Home Bias is double-faced in

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nature. On one side, it stems from information advantages on local firms: proximity gives investors greater value-relevant information about the local firms, leading investors to prefer local firms over non-local firms (e.g., Coval and Moskowitz, 2001; Cumming and Dai, 2010; Ivković and Weisbenner, 2005). On the other hand, behavioural factors also come into play (e.g., Grinblatt and Keloharju, 2001; Levis et al., 2015; Shan and Gong, 2012). For instance, Grinblatt and Keloharju (2001) provide evidence that shareholders are more likely to trade in local stocks when the issuing firm CEO communicates in the same language as the investor or shares the same cultural background. This investor preference for local stocks even affects corporate market values (e.g., Baschieri et al., 2015; Hong et al., 2008; Korniotis and Kumar, 2013b). In fact, since a portion of local investor wealth will be invested in local equity, the lower the number of local firms, the higher the amount of local wealth invested in each local firm. As a result, isolated firms trade at a premium compared to non-isolated firms. In addition, as they are more informed, local investors ask for lower returns on local firms. Therefore, with respect to clustered firms the isolated firms benefit from a larger clientele of local investors asking for lower returns, and ultimately have higher market values.

The investor preference for local equity provides a quasi-experimental setting to test whether the market rewards compliance with accounting principles as the Local Home Bias disentangles the accounting information, or the information available to both local and non-local investors, from the local information, which is only available to local investors. Firms with full disclosure and high earnings quality, or firms that fully comply with accounting principles, are identical to both local and non-local investors, causing the information advantage for local investors to vanish. On the other hand, firms with partial disclosure and low earnings quality, or opaque firms, allow local investors to gain a valuable informational advantage as partial disclosure increases the information risk[1] for non-local investors. Therefore, they tend to shy away from opaque firms or, ask for higher returns in compensation for larger information asymmetries, while local investors move towards opaque local firms, trying to exploit their information advantage. This turn of events creates an apparent paradox, where firms with low earnings quality trade at a premium compared to firms with high earnings quality; the difference in firm values is greater when the role of local investor over-trading is stronger in stock price-formation, in other words for the more isolated firms. Therefore, we argue that the more a firm is isolated from other listed firms, the more a firm with low earnings quality trades at a premium compared with a firm with high earnings quality. The differential market value between low and high earnings quality firms is the value of the information that is not conveyed to the market through the accounting disclosure, or, in other words, it is the value of the accounting information.

Investment in local equity is not only driven by superior information on local firms (e.g., Coval and Moskowitz, 2001; Ivković and Weisbenner, 2005), but is also enhanced by the familiarity investors feel towards nearby companies (e.g., Grinblatt and Keloharju, 2001; Huberman, 2001), and our results might be affected by this behaviour. Within low and high earnings quality firms, we overcome this issue by further distinguishing under- from over-performing stocks (e.g., stocks with positive Jensen's alpha in the next 3 years). In line with the literature (e.g., Korniotis and Kumar, 2013a), we assume that investors with superior information are able to distinguish local under- from local over-performing stocks and pursue long positions only on local over-performing stocks (ignoring local under-performing stocks). On the other hand, when investors show a preference for local stocks based on feelings of familiarity with nearby firms, they are expected to be equally attracted to both under- and over-performing local stocks. In this case, over-performing firms are predicted to trade at a premium compared with under-performing firms and the difference in market values tells us to what extent the investor preference for local stocks is indeed driven by superior information. To the extent that the empirical patterns of high and low earning quality firms are unchanged across under- and over-performing stocks, our results are not affected.

To test our conjectures we analysed the Italian firms listed on the Milan Stock Exchange (MSE) over the period 1999–2011. The MSE ranks at the top among informationally opaque financial markets (e.g., Bhattacharya et al., 2003; Leuz et al., 2003) and uncertain legality in Italy is widely recognised (e.g. Cumming and Zambelli, 2013; Bigelli and Mengoli, 2011) with Leuz et al., (2003) classifying Italy fourth out of 31 countries for earnings management. Although Consob (the Italian equivalent of US SEC) has improved disclosure requirements for firms listed on the MSE (e.g., segment information disclosure in compliance to IAS 14) with legislative decree 58/1998 (Consolidated Law on Finance), the regulations give no details about how or what quantity of information should be disclosed. There is no clear sanction for companies that do not comply and as a result, disclosure by Italian firms is limited due to disclosure-related costs and the risk of providing useful information to competitors (Prencipe, 2004). Therefore, Italy represents an ideal research setting for investigating value implications of firm compliance with accounting principles (Mengoli et al., 2009; Pazzaglia et al., 2013).

In line with the literature (e.g. Hong et al., 2008), we find that corporate market values increase the more the issuing firm is isolated from the other listed firms. Furthermore, we find over-performing firms trade at a premium compared with under-performing firms, and the wedge between the market values increases with the extra-performance period. Overall this evidence is consistent with local investor superior information on local stocks. When low vs. high earnings quality firms are investigated, results are as expected. We use a wide range of market- and accounting-based measures to proxy for firm earnings quality: in all cases the more the firm is isolated from the other listed firms, the more the firm with low earnings quality trades at a premium compared to the firm with high earnings quality. In addition, the market value of low earnings quality firms is larger for over-performing than for under-performing firms, and increases with the extra-

[1] For instance, in Bertinetti and Mantovani (2012) the information risk originates from the timing of the information spreading in the market, the errors in the information, and the ways the information is transmitted to the market. Huang and Cheng (2013) define the information risk as the ambiguity of the information possessed by market participants.

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