



# The association between earnings quality and the cost of equity capital: Evidence from the UK<sup>☆</sup>



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## ABSTRACT

Empirical evidence that examines the association between earnings quality and the cost of equity supports theoretical work that information risk is a non-diversifiable risk factor. However, the main body of evidence, centred on Francis et al.'s (2004) seminal work, focuses on earnings quality measures that are based on US GAAP. This study extends the analysis of Francis et al. (2004) for a sample of UK listed firms during the period 2005 to 2011. This setting and time period enables us to examine the effect of IFRS based earnings on the pricing of earnings quality and how this relation is influenced by a period of severe macro-economic turbulence as in the case of the recent global financial crisis. We find a significant negative association between each accounting-based earnings quality proxy considered separately and the cost of equity. Our results also indicate that during the financial crisis the relationship between earnings quality and cost of equity becomes more prominent than in the pre-crisis period. Our results also document that investors place more importance on the innate component of accruals quality than on the discretionary component. Our results should be of interest to US standard setters who are considering adopting or converging to IFRS.

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## 1. Introduction

The question of whether, how and to what extent earnings quality affects capital market resource allocation decisions is fundamental to understanding why and how accounting information matters to investors (Francis, Olsson, & Schipper, 2006). Theoretical work posits that information risk is a priced risk factor (Easley & O'hara, 2004; Lambert et al., 2012) and there is empirical evidence to support this (e.g., Francis, LaFond, Olsson, & Schipper, 2004, 2005; Verdi, 2006; Ogneva, 2012; Gray, Koh, & Tong, 2009; McInnis, 2010; Kim & Qi, 2010; Bhattacharya, Ecker, Olsson, & Schipper, 2011; García Lara, García Osma, & Penalva, 2011; Barth, Konchitchki, & Landsman, 2013; Mouselli, Jaafar, & Goddard, 2013).

However, the empirical studies are mainly conducted using US data, which limits the generality of their findings vis-à-vis contexts beyond the US. Yet, researchers have reminded us of the importance of examining jurisdiction-specific factors in investigating the pricing of earnings quality (Francis et al., 2005; Gray et al., 2009). This study examines the association between earnings quality and the cost of equity in the United Kingdom (UK) over the time period 2005–2011.

Our choices of the UK setting and the time period examined are motivated by two factors. To the best of the authors' knowledge, this is the first country-specific study that examines the effect of IFRS on the pricing of earnings quality. In addition to examining the relationship between earnings attributes and the cost of equity, our study examines whether investors are indifferent to the source of information risk in an IFRS setting, which has not to our knowledge been examined in prior work. Second, to the best of the authors' knowledge, this is the first study to examine the relationship between earnings quality and the cost of capital during a period of severe macro-economic turbulence. In the discussion below we expand on how these two factors contribute to the literature.

It is widely accepted that reporting practices are shaped by many external factors, including a country's legal institutions (e.g., the rule of

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law), the strength of the enforcement regime (e.g., auditing), capital market forces (e.g., the need to raise outside capital), ownership and governance structure (see Ball, Kothari, & Robin, 2000; Leuz, Nanda, & Wysocki, 2003; Soderstrom & Sun, 2007). Nobes (2006) and Ball (2006) argue that despite the adoption of IFRS, these external factors will continue to influence reporting choices and Kvaal and Nobes (2010) provide evidence to support this. In this respect, the US and the UK share a number of common features, e.g., both have a common law system, dispersed ownership, strong investor rights, strong legal enforcement and large equity markets (Leuz et al., 2003; Nobes, Parker, & Parker, 2008). The two countries have also been classified together based on their similarities in prior accounting studies (Leuz et al., 2003; Bhattacharya, Daouk, & Welker, 2003; Nobes et al., 2008). However, in spite of the similarities between the two countries, there remains one key differentiating factor - the use of IFRS in the UK and US GAAP in the US, among publicly traded companies.

While both US GAAP and IFRS are considered as high quality accounting standards and share much in common, there are underlying differences between them (Sun, Cahan, & Emanuel, 2011). A fundamental difference is that IFRS are principles-based while US GAAP are rules-based and more specific than IFRS often requiring the following of more specified prescriptions (Hail, Leuz, & Wysocki, 2010). Furthermore, there are a number of particular differences between IFRS and US GAAP. Most notable is the heavier reliance on fair value accounting and upward asset valuations within IFRS, reflecting a stronger equity market focus (Ashbaugh & Pincus, 2001; Cuijpers & Buijink, 2005; Wang, Young, & Zhuang, 2008; Byard, Li, & Yu, 2011; Tan, Wang, & Welker, 2011; Jiao, Koning, Mertens, & Roosenboom, 2012; Horton, Serafeim, & Serafeim, 2013; Choi, Peasnell, & Toniato, 2013; Plumlee & Plumlee, 2008; Hail et al., 2010). Using the UK as our setting enables us to focus on the effect of IFRS on earnings quality and the cost of capital.

Furthermore, a particular contribution of our study is that we examine how intrinsic and discretionary attributes of earnings quality separately influence the cost of capital in an IFRS-based setting. US-based research shows that both intrinsic and discretionary attributes are priced by the market (Francis et al., 2004, 2005). The broader and less specific principles-based IFRS can provide management with opportunities for aggressive reporting. However, it also provides management with the opportunity to better reflect the economic situation of the company and there is a growing body of evidence which indicates that principles-based standards lead preparers to issue high quality financial reports (Segovia, Arnold, & Sutton, 2009; Jamal & Tan, 2010; Agoglia, Doupnik, & Tsakumis, 2011; Cohen, Krishnamoorthy, Peytcheva, & Wright, 2013). The results of our study should be of interest to policy makers in the United States considering adoption or convergence toward IFRS (see SEC, 2008). It provides evidence on whether investors value IFRS earnings in a similar fashion to US GAAP earnings. Of particular importance is whether investors differentiate between the intrinsic and discretionary component of earnings quality in a principles-based accounting system.

Finally, to the best of the authors' knowledge, this study is the first to test the association between earnings quality and the cost of equity during a period of financial crisis in a country with relatively strong fiscal sustainability. While there is a growing body of evidence that examines the relationship between earnings quality and the cost of equity, prior research has not examined how this relationship is affected by a financial crisis. Indeed, the effect of macro-economic conditions on earnings quality, in general, is an area where there is limited work in spite of the large body of evidence in the wider field of earnings management. Filip and Raffournier (2014, p.476) note "generally speaking, the consequences of macro-economic changes in the quality of accounting information are largely unexplored". In general terms, a financial crisis can be defined as an interruption of the normal functioning of financial markets. At the beginning of 2008, capital markets around the world suffered from a global financial crisis, following the collapse of the US

sub-prime mortgage market. The crisis formulates for European firms an economic environment characterised by declining GDP, lower output, reduced public spending and a lack of liquidity for firms and individuals. The crisis had its consequences also in the UK where troubled mortgage providers or banks were rescued (Barth & Landsman, 2010; Iqbal & Kume, 2013; Iatridis & Dimitras, 2013; Kousenidis, Ladas, & Negakis, 2013; Bowen & Khan, 2014; Trombetta & Imperatore, 2014).

Using firms listed on the London Stock Exchange during the period 2005–2011, we examine the association between earnings quality and the cost of equity. Drawing on Francis et al. (2004), we use accruals quality, earnings persistence, earnings predictability and earnings smoothness as our measures of earnings quality. We find a significant negative association between each accounting-based earnings quality proxy considered separately and the cost of equity, measured by the earnings-price ratios in relation to their industry peers (*IndEP*), but the exceptions or least consistent associations are found for smoothness. Also, the results show that the predictability proxy explains more of the variation in estimates of the cost of equity, followed by accruals quality, then persistence, and finally smoothness. Economically, the largest impact (earnings predictability) increases the cost of equity by 315 basis points (bp) when we move from firms with the best predictability decile to those in the worst decile.

The results, also, show that the effect on the cost of equity of a unit of innate earnings quality is larger in both magnitude and statistical significance than the effect of a unit of discretionary earnings quality. In economic terms, the largest effect of the innate accruals quality increases the cost of equity by 576 bp between the highest and lowest decile ranks of innate accruals, while the similar figure for discretionary accruals quality is only 198 basis points. This finding indicates that investors assign far more importance to the innate component of earnings than the discretionary component. While these results are in line with Francis et al.'s (2004) US study, the effect is more pronounced in our study.

Our results also indicate that during the financial crisis the relationship between earnings quality and cost of equity becomes more prominent than in the pre-crisis period. This strengthening of the relationship during a period of macro-economic turbulence shows the importance investors place on earnings quality as a measure of risk. We also find that while there is a stronger significant association between the innate component and the cost of equity in the crisis period than in the pre-crisis period, there is no association between the discretionary component and the cost of equity in both periods. This indicates that investors are less concerned about discretionary managerial choices than they are about business models and the external environment that a company is operating in. This provides evidence that investors are less concerned about risk from managerial reporting choices than they are about information that reflects the fundamentals of a business. These results should be reassuring to US standard setters who are considering adopting or converging to IFRS.

The rest of this paper proceeds as follows: section (2) discusses the development of the hypotheses in the context of a review of prior studies; section (3) outlines sample selection and variables measurement; section (4) introduces the main tests and empirical results; section (5) concludes the paper.

## 2. Literature review and hypotheses development

The association between earnings quality and the cost of capital is based on the theory that information risk is priced due to either information asymmetry between informed and uninformed investors (Easley & O'hara, 2004) or due to the differences in the precision of information released by companies (Lambert, Leuz, & Verrecchia, 2012). Irrespective of the source, there is a general consensus that information risk is non-diversifiable and therefore influences the pricing of capital.

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