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journal homepage: [www.elsevier.com/locate/jae](http://www.elsevier.com/locate/jae)Accrual reversals, earnings and stock returns <sup>☆</sup>Eric J. Allen <sup>a</sup>, Chad R. Larson <sup>b</sup>, Richard G. Sloan <sup>c,\*</sup><sup>a</sup> Marshall School of Business, University of Southern California, USA<sup>b</sup> C.T. Bauer College of Business, University of Houston, USA<sup>c</sup> Haas School of Business, University of California at Berkeley, Berkeley, CA 94720, USA

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## ABSTRACT

We show that accruals consist of at least two distinct underlying processes, one with positive serial correlation and the other with negative serial correlation. We also find that the accrual reversals characterizing the negatively serially correlated process are predominantly good accruals that correctly anticipate fluctuations in working capital. Accrual estimation error is the least persistent component of earnings, while accruals relating to firm growth are less persistent than cash flows. Finally, the mispricing of accruals appears to be driven by a combination of accrual estimation error and firm growth.

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## 1. Introduction

A growing body of literature employs accrual reversals in tests of earnings management and accrual mispricing.<sup>1</sup> The key idea underlying this research is that ‘errors’ in accruals must ultimately reverse. Subsequent accrual reversals, however, are not a distinguishing feature of errors in accruals. In fact, all accruals must ultimately reverse. The unique characteristic of errors in accruals is that the estimated future benefits represented by the accruals are not subsequently realized.

In this paper, we conduct a comprehensive examination of accrual reversals and their impact on earnings and stock returns. Accruals represent managers’ forecasts of future benefits and reverse when either (i) the anticipated future benefits are realized or (ii) new evidence indicates that the anticipated future benefits are unlikely to be realized. Accordingly, we decompose accruals into (i) accruals that correctly anticipate future benefits and (ii) accrual estimation errors. We refer to the former category as ‘good accruals’ and the latter category as ‘accrual estimation error’. We develop and test predictions concerning the properties of accruals in each of these categories.

Our empirical tests proceed in four stages. We first examine the extent to which firm-level working capital accruals exhibit reversals over adjacent fiscal years. While all accruals must reverse at the individual transaction level, accruals need not reverse at the firm level, because new originating accruals can offset old reversing accruals. Thus, the extent to which

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<sup>1</sup> The literature on accrual reversals includes Defond and Park (2001), Moehrl (2002), Zach (2006), Baber et al. (2011), Fedyk et al. (2013) and Dechow et al. (2012).

accrual reversals are observed at the firm level is an empirical question. Our study is the first study to document pervasive evidence of reversals in firm-level accruals over adjacent fiscal years.

In the second stage, we examine the relative importance of good accruals versus accrual estimation error in driving firm-level accrual reversals over adjacent fiscal years. Using a modified version of the accrual model in Dechow and Dichev (2002), we decompose accruals into three components: (i) good accruals relating to firm growth; (ii) good accruals relating to temporary fluctuations in working capital; and (iii) accrual estimation error. We find that evidence of firm-level accrual reversals is limited to good accruals relating to temporary fluctuations in working capital. Surprisingly, we find no systematic evidence of reversals in firm-level accrual estimation error. Since accrual estimation error must reverse at the level of individual event/transaction, this result suggests that (i) reversing estimation errors are often offset by new originating estimation errors; and/or (ii) estimation errors often take longer than one year to reverse.<sup>2</sup>

Our third stage examines how each accrual component relates to earnings persistence and future stock returns. Previous research by Sloan (1996) shows that the accrual component of earnings is less persistent than the cash flow component of earnings, and that stock prices act as if investors do not fully anticipate this differential persistence. We show that the lower persistence of the accrual component of earnings and associated mispricing are attributable to a combination of accruals relating to firm growth and accrual estimation error. Importantly, the lower earnings persistence is not attributable to accruals relating to temporary fluctuations in working capital. While such accruals exhibit strong reversals, these reversals offset temporary fluctuations in cash flows, and so they do not result in lower earnings persistence.

Finally, our fourth stage corroborates the results in the first three stages using a hand-collected sample of inventory write-downs. Since inventory write-downs represent reversals of accrual estimation error, we use them to corroborate our model for decomposing accruals into good accruals and accrual estimation error. The results indicate that the model we use to decompose accruals into good accruals and accrual estimation error is effective in extracting accrual estimation error.

Our paper makes several contributions to the existing literature. First, our paper contributes to research on the time series properties of accruals. Dechow et al. (1998) model working capital as a linear function of sales and assume that sales follow a random walk, implying that accruals follow a white noise process. In contrast, we show that accruals consist of two distinct processes. The first process represents accruals supporting firm growth. Since firm growth is positively serially correlated, the associated accruals are also positively serially correlated. The second process represents accruals relating to temporary fluctuations in working capital. For example, a firm may temporarily accelerate normal inventory purchases, resulting in temporarily higher inventory. Since temporary fluctuations in working capital subsequently revert to normal levels, the associated accruals will be negatively serially correlated. These two processes combine to create the initial impression that accruals follow a white noise process.

Second, our paper has implications for research that associates accrual reversals with opportunistic earnings management (e.g., Defond and Park, 2001; Moehrl, 2002; Baber et al., 2011; Dechow et al., 2012). Our results indicate that accrual reversals are primarily associated with 'good' accruals related to temporary fluctuations in working capital. As such, it is important that studies using accrual reversals to detect earnings management rule out the possibility that the reversals are attributable to 'good' accruals. Failure to do so could result in misspecified tests that falsely reject the null hypothesis of no earnings management. Moreover, our findings also indicate that firm-level accrual estimation errors often take longer than one year to reverse, contradicting Dechow et al.'s (2012, p. 287) claim that "the assumption that earnings management reverses within one year is reasonable for working capital accruals".

Third, our paper contributes to research attempting to explain the lower persistence of the accrual component of earnings and associated mispricing documented in Sloan (1996).<sup>3</sup> Sloan attributes the lower persistence of the accrual component of earnings to the lower reliability of accruals. Consistent with Sloan's hypothesis, we find that accrual estimation error is the least persistent component of earnings. We also find that 'good' accruals related to firm growth are less persistent than cash flows. In contrast, we find no evidence that 'good' accruals relating to temporary fluctuations in working capital are less persistent than cash flows. Meanwhile, we find that the mispricing of accruals is attributable to a combination of 'good' accruals relating to firm growth and accrual estimation error. Thus, Sloan's results appear to be driven by a combination of accrual estimation error and firm growth.

The paper is organized as follows. Section 2 provides an overview of previous research and develops our empirical predictions. Section 3 describes our data and 'good' accrual model, Section 4 presents our empirical analysis and Section 5 concludes.

## 2. Literature review and hypothesis development

### 2.1. Summary of previous literature on accrual reversals

Dechow et al. (1998) provide the first comprehensive examination of the time-series properties of accruals. They model working capital accruals as a linear function of the change in sales. They also assume that the change in sales is serially

<sup>2</sup> Consistent with these explanations, an analysis of the Accounting and Auditing Enforcement Releases issued by the SEC for alleged earnings overstatements indicates that over 50% of the cases involve more than one adjacent fiscal year of earnings management.

<sup>3</sup> This research is voluminous and summarized in the next section.

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