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Determinants and economic consequences of cash flow restatements[☆]Elio Alfonso^a, Andrew Christie^{b,1}, Dana Hollie^{c,*}, Shaokun (Carol) Yu^d^a Florida International University, 11200 SW 8th St., Miami, FL 33199, United States^b Virginia Beach, VA, United States^c E. J. Ourso College of Business, Louisiana State University, 2800 Business Education Complex, Baton Rouge, LA 70803, United States^d Northern Illinois University, 1425 W. Lincoln Hwy, DeKalb, IL 60115, United States

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ABSTRACT

The FASB, PCAOB, SEC, and AICPA have all acknowledged that the accounting field needs to revisit the statement of cash flows (SCF). While the overall number of restatements has held steady over the past five years, the percentage of cash flow restatements (CFRs) has risen from 8.7% of all restatements in 2009 to 20.2% of all restatements in 2014. We examine the determinants of CFRs, investors' differential beliefs about CFRs, and the information content of CFRs by focusing on abnormal trading volume and price reactions to CFRs. We then examine whether the guidance the SEC/AICPA published in early 2006 changed the information content of CFRs. Finally, since the proper classification within the SCF is a current regulatory issue, we examine whether classification shifting within the SCFs impacts the market. The market finds CFRs to be informative with some investor disagreement as shown by higher abnormal trading volume. We also find an incremental volume reaction to changes in operating cash flows after the SEC allowance period. While the market responds negatively to CFRs, we find that the market does not differentiate between whether classification shifting occurs or does not occur with the CFR. This study has implications for policymakers, auditors, and investors since it is one of the first to examine the capital market consequences of CFRs.

1. Introduction

The purpose of this study is to examine the determinants and information content of cash flow restatements (CFRs). This study is the first to examine the abnormal trading volume and market price reactions to CFRs using a comprehensive multivariate analysis. We contribute to the literature by analyzing a dataset of CFRs that has rarely been studied, despite regulators' recent interest in CFRs. We also analyze how investors perceive and react to this type of restatement. We contribute to literature on restatements by showing that the information content of CFRs is incrementally informative for investors and is incremental to the information contained in earnings restatements. While we provide evidence that the abnormal trading volume reaction to changes in operating cash flows increases after the SEC allowance period, we find that when classification shifting occurs within

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the statement of cash flows resulting from a CFR, there is no significant difference with abnormal trading volume or market returns reaction.²

The American Institute of Certified Public Accountants (AICPA), Financial Accounting Standards Board (FASB), [Public Company Accounting Oversight Board \(PCAOB\)](#), and the Securities and Exchange Commission (SEC) have all acknowledged that the accounting profession needs to revisit the statement of cash flows (SCF). While the overall number of restatements has held steady over the past five years, the percentage of CFRs has not. The SEC first dealt with the issue of misclassification of items in SCFs in 2005. The result was the SEC gave firms an allowance period to correct misclassified SCFs without penalty in 2006. The Center for Public Company Audit Firms (CPCAF) published Alerts #90 and then #98 to help firms determine whether or not to restate the SCFs. Most restatements at that time were related to the misclassification of items among the operating, investing, and financing categories within the SCFs. Following the SEC allowance period there was a decline in CFRs from 2006 to 2009. However, there has been a resurgence of cash flow restatements; the percentage of SCFs that were restated rose from 8.7% in 2009 to 20.2% in 2014.³ The reasons for restatements vary, but most do not involve complex determinations of underlying cash flow problems, and many of the issues with the original SCFs have been related to misclassifications.

As a result, in 2014, the FASB acknowledged that the SCFs have been neglected by the standard setting bodies (FASB, 2014). The following year, the FASB asked the Emerging Issues Task Force to consider nine issues related to the SCFs to address this problem. The SEC also noted an increase in the number of restatements related to errors in SCFs (Crews, 2014). They called for companies to tighten accounting procedures and controls pertaining to the SCFs. The PCAOB also noted the same issue and hired inspectors to evaluate auditors' testing of the SCFs (PCAOB, 2015). Consequently, the statement of cash flows continues to be a topic of interest for regulators.

In this study, we first model the economic determinants for firms that overstate operating cash flows and compare them to a control group of non-restaters. Our analysis provides us with a deeper understanding of which factors may cause managers to intentionally (or unintentionally) misstate the statement of cash flows. Next, we examine whether CFRs impact the capital markets. Since financial disclosures result in investor reactions on two dimensions, we examine both returns and trading volume reactions. A growing body of literature asserts that the primary driver of trading volume reactions to public announcements is investor heterogeneity in the form of differential interpretation of the news (e.g., [Beaver, 1968](#); [Harris and Raviv, 1993](#); [Kandel and Pearson, 1995](#); [Bamber et al., 1997, 1999, 2011](#)). The lack of research focus on abnormal trading volume is a significant void because trading volume reactions are equally relevant in understanding investors' perceptions of public news (e.g., [Ross, 1989](#)). A growing body of literature asserts that the most dominant driver of trading volume reactions to earnings announcements are differences in interpretation of the earnings information (e.g., [Hong and Stein, 2007](#); [Bamber et al., 2011](#)). The sources of such differential interpretations are rooted in the presumption that market participants use different priors, likelihood functions, or models to interpret the earnings (i.e., cash flow is a component of earnings) news and determine a firm's value. For example, the cash flow restatement can be thought of as a public signal that reveals the intrinsic value of a firm plus a random error, but investors disagree about the mean of the error. This disagreement causes investors to have different interpretations of the cash flows news: one can interpret the financial disclosure more positively/negatively than the other, or treat the restatement news as a permanent or a temporary signal ([Israeli, 2015](#)). [Bamber et al. \(2011\)](#) state in a recent review of research on trading volume responses to earnings announcements and other financial disclosures that little is known about the information content of trading volume reactions to financial disclosures.

Following [Kim and Verrecchia \(1991\)](#), who demonstrate [Beaver's \(1968\)](#) hypothesis that the trading volume reaction reflects differences among individual investors that may be eliminated in the averaging process for determining stock prices, we investigate the effects of potential misperceptions among investors by focusing on disagreements between investors and measuring such disagreements by abnormal trading volume. [Kim and Verrecchia \(1991\)](#) propose that the trading volume reaction to a public announcement is an increasing function of both (1) the magnitude of the associated price reaction and (2) the level of predisclosure information asymmetry among investors. Additionally, [Cready and Hurr \(2002\)](#) provide simulation-based evidence suggesting that volume reactions are more powerful indicators of a market's response than price reactions. Their results suggest that using measures of volume reactions to complement measures of price reactions is especially important when returns-based analyses yield insignificant results and statistical power is a concern, which is partly the case in our study due to our small sample size.

Next, we investigate whether the market's price reaction differs for CFRs subsequent to the SEC allowance period and/or when classification shifting occurs. The market's reaction to a public announcement of a CFR is important because accounting policymakers such as the FASB and the SEC consider the magnitude of security price and abnormal trading volume reactions to determine whether such disclosure is useful for investors ([Atiase and Bamber, 1994](#); [Griffin, 1982](#); [Leisenring, 1983](#)). Consequently, we investigate both the abnormal trading volume and market price reactions to CFRs prior to and subsequent to the SEC published guidance regarding the classification of cash flows in order to examine the informativeness of CFRs resulting from SEC guidance.

Using a sample of 189 restatements (from 124 firms) announced from 2002 to 2014, we use abnormal trading volume reaction to assess how investors interpret CFRs. We first examine the determinants of CFRs and find that firms are more likely to issue a CFR when they have analysts' cash flow forecasts, discontinued operations, dividend issuances, more segments, are growth firms, and are larger in size. We also show that it is less likely that a firm reports a CFR if the firm has higher level of debt or return on assets, or has Big_N auditors. Following prior research (e.g., [Chen and Sami, 2008](#); [Bamber et al., 2011](#)), we examine the information content of

² A shift is a restatement with no change in total cash flows. When there is no change in total cash flows with a restatement, we assume that the restatement is the result of shifting within the statement of cash flows.

³ Data from [AuditAnalytics.com](#).

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