



## Quality of financial information and liquidity

Katsiaryna Salavei Bardos

Dolan School of Business, Fairfield University, United States

### ARTICLE INFO

#### Article history:

Received 29 August 2010  
Received in revised form 23 December 2010  
Accepted 4 January 2011  
Available online 31 January 2011

#### JEL classification:

G14  
G12  
M41

#### Keywords:

Liquidity  
Financial statement restatements  
Misreporting  
Earnings management  
Information asymmetry  
Quality of financial information  
Disclosure

### ABSTRACT

This paper examines the relationship between liquidity and quality of financial information by analyzing long-term trends in Amihud's (2002) illiquidity measure for firms that restate financial statements. I find that for most income decreasing restatements illiquidity increases several months before restatement announcement and remains at elevated levels one year after restatement. The result is most pronounced for firms listed on NASDAQ. Increase in illiquidity is greater upon restatements due to revenue recognition, those prompted by party other than auditor, those made by larger firms with high volatility of returns and low price levels. Income increasing restatements do not affect information asymmetry of the firm. Overall, my results indicate a positive relationship between quality of financial information and liquidity.

© 2011 Elsevier Inc. All rights reserved.

### 1. Introduction

In the aftermath of the corporate scandals of the Enron era and the recent financial crisis, policy makers and regulators have called for improved quality of financial reporting and greater transparency. However, the evidence regarding the costs and benefits of financial reporting and disclosure remains limited (Leuz & Wysocki, 2008).<sup>1</sup> The benefit of disclosure best supported by theory is the increase in liquidity of a firm's shares (Verrecchia, 2001). Liquidity is negatively related to the level of adverse selection in the market, which results from some traders having informational advantage over other traders (Glosten & Milgrom, 1985; Kyle, 1985). If better quality financial information reduces the level of adverse selection in the market, then liquidity will increase.

Empirical literature on the relation between the quality of financial information and liquidity is limited (Leuz & Verrecchia, 2000). Several papers examine the association between liquidity and analyst evaluations of disclosure quality (Healy, Hutton, & Palepu, 1999; Heflin, Shaw, & Wild, 2002; Welker, 1995).<sup>2</sup> They find that better

disclosure increases liquidity. For example, Welker (1995) documents that firms in the lowest third of the disclosure rankings have a 50% higher bid-ask spread. Leuz and Verrecchia (2000) use an event study framework and show that German firms that commit to higher levels of disclosure by switching to International Accounting Standards (IAS) or U.S. GAAP experience a 35% decrease in bid-ask spread and a 50% increase in share turnover.

Ng (2008) examines other measures of information quality and finds that management forecast frequency is negatively associated with a firm's liquidity, while relevance of earnings and accrual quality are not significantly associated with a firm's liquidity. Jayaraman (2008) finds that the bid-ask spreads and the probability of informed trading are higher when public information is less informative, e.g. when the difference between the volatility of earnings and the volatility of cash flows is high. This relation holds both when earnings are smoother than cash flows and when earnings are more volatile than cash flows. Bhattacharya, Desai, and Venkataraman (2010) find that accrual quality is positively associated with high frequency measure of the adverse selection component of the bid-ask spread, and that firms with poor earnings quality experience a greater increase in information asymmetry around earnings announcements. Asciglu, Hegde, and McDermott (2005) find that auditor compensation, which has been found to be associated with disclosure quality, decreases liquidity for firms with weak corporate governance.

This paper extends the literature on the relation between liquidity and quality of financial information by examining long-term trends in

E-mail address: [ksalavei@fairfield.edu](mailto:ksalavei@fairfield.edu).

<sup>1</sup> The terms "disclosure", "transparency" and "quality of information" are used interchangeably.

<sup>2</sup> These papers use CFA Institute (formerly Association for Investment and Management Research (AIMR)) score to measure quality of firm's disclosure. The score is composed by financial analysts and evaluates firm disclosure based on annual published information, quarterly and other published information, and communications with analysts.

liquidity for firms that make material mistakes in financial statements requiring a restatement. My research design has several advantages. As pointed out by [Leuz and Wysocki \(2008\)](#) “the existing literature shows that measuring firms’ financial reporting and disclosure activities is difficult and that commonly used proxies exhibit many problems.” Instead of using a proxy for the quality of financial information, for restating firms one observes the period during which financial statements of a firm were of poor quality and knows the date when the market learns for the first time of the reporting issues. Second, a restating firm can be used as its own control, therefore eliminating the need to account for potential endogeneity of the firm’s quality of financial information and liquidity.

I estimate [Amihud’s \(2002\)](#) measure of illiquidity for restating firms over three periods: 1) a one-year period prior to the 1st restated report (pre-error period); 2) the error period, which extends from the first misstated period to the date of restatement announcement; and 3) a three-year period after the restatement announcement (post-restatement period). To the best of my knowledge, this paper is the first to study changes in liquidity around restatement during these periods.

There are several reasons why examination of long-term liquidity around restatement announcement is important. First, studies of short-term changes in information asymmetry provide mixed results. [Anderson and Yohn \(2002\)](#) find that bid-ask spread increases surrounding restatements of revenue accounts. However, [Palmrose, Richardson, and Scholz \(2004\)](#) do not confirm this result. Second, in its report to the Securities and Exchange Commission (SEC), the Advisory Committee on Improvements to Financial Reporting (CIFR) expressed concern regarding the time it takes for restating firms to disclose full impact of a restatement.<sup>3</sup> For many firms the time between restatement announcement and the filing of restated financial statements can take as long as one year. According to CIFR, during this period the firms report little financial information. CIFR claims that “[l]imited information seriously undermines the quality of investor analysis” (CIFR, 2008, 79). Examination of long-term changes in liquidity after restatement announcement will provide evidence regarding CIFR’s concern. It will also provide empirical analysis of the belief of analysts and regulators that restatements cause long-term damage to credibility of firm’s financial information ([Wilson \(2008\)](#)). Third, restatements received considerable attention from law makers and affected such influential regulations as Sarbanes–Oxley Act of 2002 ([Palmrose et al., 2004](#)), making it important to know the full impact of a restatement, which is unlikely to be limited to the short-term window around its announcement.

Using [Fama and MacBeth \(1973\)](#) type regression that corrects for cross-sectional correlation of residuals, I find that firms restating net income downward (income decreasing restatements) that are listed on NASDAQ experience an increase in illiquidity four months before restatement announcement that continues one year after restatement. For income decreasing restating firms listed on NYSE or AMEX illiquidity increases one month after restatement and remains at elevated levels 12 months after restatement. An increase in illiquidity around restatement announcement for income decreasing restatements is economically important. For NASDAQ (NYSE/AMEX) firms, illiquidity three months before restatement increases 39% (55%), at restatement announcement – 43% (42%) and one year after restatement – 129% (80%) relative to pre-restatement level. I find no changes in illiquidity for firms that restate net income upward (income increasing restatements).

To summarize, this paper finds a substantial increase in information asymmetry in anticipation of income decreasing restatement announcement for firms listed on NASDAQ. For income decreasing restating firms listed on all exchanges information

asymmetry increases after restatement and remains at elevated levels for at least one year. Income increasing restatements do not affect information asymmetry of the firm. Overall, my results indicate a positive relation between quality of financial information and liquidity, supporting regulations that aim at improving the quality of financial information. This analysis is particularly timely given the focus of regulators on restatements and their concern that a firm’s information environment is adversely affected by a restatement ([Advisory Committee on Improvements to Financial Reporting, 2008](#)).

Cross-sectional analysis of the changes in illiquidity for income decreasing NASDAQ restatements reveals that restatements originated by an auditor result in lower changes in illiquidity both before and after a restatement.<sup>4</sup> Income decreasing NASDAQ restatements experience greater increase in illiquidity prior to restatement. Restatements that affect revenue recognition increase illiquidity more following restatement announcement for firms listed on all exchanges. Larger firms with higher volatility of returns have greater increase in illiquidity, while stocks with higher price experience smaller increase in illiquidity.

The paper contributes to several streams of literature. First, it extends prior research on the implications of the quality of financial information on liquidity. However, I use an event study framework to establish poor quality of financial information as opposed to an imperfect proxy for information quality. Second, the paper contributes to the literature on restatements. Restatements have increased in the past decade, motivating the Sarbanes–Oxley Act of 2002 and several SEC initiatives, which in turn lowered the threshold for errors that required restatements. The full impact of a restatement can be better understood by considering its liquidity effect. This paper is the first to document that income decreasing restatements increase information asymmetry several months before and one year after restatement announcement; and that income increasing restatements do not affect information asymmetry. This paper is also the first to document cross-sectional differences in the changes of liquidity around restatement announcement. My analysis complements that of [Palmrose et al. \(2004\)](#), [Anderson and Yohn \(2002\)](#) and [Badertscher and Burks \(2010\)](#) by focusing on much longer windows both before and after restatement, documenting trends in liquidity for different types of restatements and performing cross-sectional analysis of changes in liquidity.<sup>5</sup>

The paper is organized as follows. The next section outlines hypotheses and reviews related literature. My measure of liquidity is discussed in [Section 3](#). [Section 4](#) describes the data and sample selection. Results are presented in [Section 5](#). [Section 6](#) concludes the paper.

## 2. Hypotheses and literature review

Firms that restate financial statements experience large shareholder losses at restatement announcement ([Akhigbe, Kudla, & Madura, 2005](#); [Palmrose et al., 2004](#)). Large negative reaction to restatements is caused by the revelation that financial information of restating firms is worse than previously believed by the market. Poor quality of financial information can create information asymmetry between buyers and sellers of firm shares, which would result in reduced levels of liquidity of firm shares. This happens because market makers widen the bid-ask spread in order to protect themselves from better informed traders and to be compensated for bearing greater risk ([Amihud & Mendelson, 1988](#); [Diamond & Verrecchia, 1981](#); [Glosten & Milgrom, 1985](#); [Kyle, 1985](#); [Leuz & Verrecchia, 2000](#)).

<sup>3</sup> See [Badertscher and Burks \(2010\)](#) for detailed discussion of this issue.

<sup>4</sup> I use [GAO \(2002\)](#) for identification of the prompter of the restatement.

<sup>5</sup> Please see the next section for detailed literature review.

Download English Version:

<https://daneshyari.com/en/article/985960>

Download Persian Version:

<https://daneshyari.com/article/985960>

[Daneshyari.com](https://daneshyari.com)