Earnings properties

5. CONCLUSION

5.1. Summary

In this dissertation, I examine the role of industry and life cycle fundamentals in the firm's earnings generating process and their relevance in forecasting and valuation. Earnings information is expected to be useful in decision making for a wide variety of stakeholders. Whereas multiple studies have examined earnings properties by solely focusing on earnings components as defined by the accounting measurement system (i.e., accrual- and cash flow-based disaggregations), we know relatively little about the effect that (knowledge of) fundamental firm characteristics have (has) on the earnings generating process of firms, and thus, on future firm performance. The studies in this dissertation shed more light on how earnings properties are affected by (knowledge of) firm underlying economics, i.e., industry and life cycle fundamentals, and on how these fundamentals-driven earnings are used by various market participants.

In the first study (chapter two), I examine the relation between auditor industry specialists and accrual informativeness. An important part of the literature on auditor industry specialization has focused on the reliability of its clients' accounting figures, generally providing support that financial statements audited by industry specialists contain more reliable accounting information. In this study, I focus on an alternative quality dimension of accounting information, the relevance of accounting information, which is a critical quality attribute that determines whether the reported financial information is useful to investors. Specifically, I examine how industry specialists' superior knowledge of industry fundamentals affects the informativeness of accruals. Since I can provide arguments in various directions, it is ex ante unclear whether this relation is positive or negative.

Results from a cash flow prediction model show that, on average, accruals of clients audited by an industry specialist auditor are *less* informative about future cash flows. This holds under various specifications, including a firm-fixed effects analysis and analyses using propensity score matching and entropy balancing. This finding is consistent with industry specialist auditors requiring greater comparability and standardization across clients in the same industry, thereby restricting managers' ability to signal firm-specific private information. Furthermore, results of cross-sectional tests show that this finding is concentrated in industries that are less homogeneous, in firms that are less comparable to industry peers, and in firms that operate in more uncertain environments with more information asymmetry. In more similar industries, superior knowledge of industry fundamentals is particularly useful and relevant, and auditors can easily apply standardized industry procedures. In industries where firms are less similar, however, it is more difficult to transfer knowledge about audit processes and audit risks across clients (Bills et al. 2015). If specialist auditors try to minimize costs and apply standard industry procedures in such industries, this can come at a cost in the form of a loss of accrual relevance. Overall, the results of the first study provide novel evidence on the effects of auditor industry specialization by documenting that auditor industry specialization comes, on average, at the expense of accrual informativeness.

In the second study (chapter three), I examine the relevance of differences in the persistence of earnings components in target pricing. Research has shown that not all mergers are successful and that mispricing of targets (overpayment) is one reason why mergers can be value-destructive to acquirer shareholders (e.g., Moeller et al. 2005). To lower the investment risk typically associated with significant corporate investments such as mergers and acquisitions, acquirers are incentivized to incorporate all decision-useful information into bid prices. Given that persistence of earnings is often perceived as a positive indicator for earnings relevance or decision-usefulness, it is interesting to examine whether acquirers incorporate within-earnings variation in persistence into their bid prices. Prior literature has concluded that capital market investors fail to incorporate such variation into stock prices, as they fixate on aggregate earnings numbers (e.g., Hui et al. 2016; Sloan 1996). It is not yet clear whether and how these findings transfer to the merger market.

The results show that relative to market pricing, accruals receive significantly greater weights than cash flows in the merger market. This suggests that acquirers perceive (the less persistent) accruals as relatively more informative than (the more persistent) cash flows for estimating future firm performance. Additionally, acquirers 'underreact' to industry-wide cash flows – the most persistent component – and 'overreact' to (the less persistent) firm-specific accruals components. Cross-sectional tests show that the relatively greater weights on accruals are concentrated in various subsets of deals. The perceived superior informativeness of accruals is mainly driven by deals in which the acquirer and the target do not share the same auditor, which is consistent with acquirers obtaining more forward-looking information from accruals when the informational advantage associated with common auditors is absent. Accruals also receive relatively greater weights in subsets of deals with high accounting quality target firms, diversifying transactions, and targets that operate in relatively stable industries as indicated by highly persistent industry earnings. I also observe variation in the overall importance of earnings as a determinant of bid prices. Except for diversifying transactions, earnings have a higher overall importance in deals with non-common auditors, high accounting quality targets, and targets benefiting from a high industry earnings persistence. Collectively, the cross-sectional results show that the importance of earnings components in M&A pricing varies with information asymmetry. With respect to the hypothesis, the results suggest that acquirers are aware of certain persistence differences in earnings, but do not price all (fundamentals-driven) earnings components according to their persistence levels. More specifically, the significantly greater weights placed on accruals in comparison to cash flows suggest that the components' perceived informativeness about future firm value is not in line with their general persistence levels. While acquiring firms at least partially consider the impact of industry fundamentals on earnings persistence, as shown in the cross-sectional test on industry earnings persistence, they nonetheless seem to perceive less persistent (both industry-wide and firm-specific) accruals as relatively more informative. I therefore conclude that while acquirers are aware of fundamentals-driven variation in persistence, persistence differences in disaggregate earnings components do not play a relevant role in target pricing.

In the third study (chapter four), I investigate the existence and informational value of life cycle-wide and firm-specific earnings, and examine the extent to which these components are reflected in share prices. Recent studies have shown that life cycle stage commonalities affect earnings dynamics (Dickinson 2011; Vorst and Yohn 2018) and their findings suggest that a common, life cycle-wide earnings component exists. Given the relatively sticky nature of the fundamentals underlying these life cycle-wide earnings, I expect this component to be more persistent than firm-specific deviations from the life cycle-wide average. Furthermore, I expect investors to misprice these components, as prior literature has documented that they fail to incorporate persistence differences into stock prices (e.g., Hui et al. 2016; Sloan 1996).

Consistent with my expectations, I find that life cycle-wide earnings are significantly more persistent than firm-specific earnings and thus enjoy a higher informational value. Implicit weights impounded in stock prices show that capital market investors underreact to the common component and overreact to the firm-specific component. By showing that life cycle-wide earnings significantly predict future abnormal stock returns, I confirm that my results are reflective of investor mispricing. Additionally, I test whether life cycle-wide earnings add incremental value over industry-wide earnings, as industry and firm life cycle may share some underlying fundamentals such as a firm's competitive environment. Results reveal that the effect of firm life cycle on the earnings generating process is not driven by industry dynamics, indicating that life cycle fundamentals are incrementally informative about future firm performance. Furthermore, results are different for more sophisticated market participants such as analysts. I find that analysts, at least partially, incorporate life cycle information in their earnings forecasts and as such perform better than the average market participant. Finally, I show that life cycle information remains relevant in various subsets of firms and that results are robust to alternative specifications of my life cycle and earnings measure. Overall, this study adds to the understanding of a firm's earnings generating process and provides additional evidence on the relevance of life cycle information in forecasting and valuation.