Earnings properties

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Accounting information is used for various purposes and by various stakeholders. Where accounting was originally designed to hold a stewardship role to manage conflicts of interest in firms, its primary role has gradually shifted to being used in firm valuation. Capital market participants use accounting information to form expectations about a firm’s future performance and motivate subsequent investment decisions. The focus on this valuation role is also reflected in the objective of accounting standard setters, who require accounting information to accurately reflect firms’ underlying economics such that the information is relevant and has the ability to make a difference in users’ decisions. Yet, as outlined in Chapter 1, accounting information – and aggregate earnings in particular – is said to have decreased in relevance over time. At the same time, certain specific accounting figures seem to have gained in relevance to investors. Hence, given the purpose of reported earnings information as defined by accounting standard setters, and the limitations of aggregate earnings as single performance input for valuation purposes, it is important to more extensively examine the (quality of the) earnings generating process of firms. Specifically, there is need for a more detailed understanding of what determines future firm performance, and how current earnings information, including disaggregations of earnings, can be used to improve profitability forecasts and firm value estimates, as well as to identify potential market inefficiencies.

The social and economic relevance of this dissertation are reflected in its investigation of the role of industry and life cycle fundamentals in the firm’s earnings generating process, and their relevance in forecasting and valuation. The findings from this dissertation can inform, amongst others, auditors in forming their professional judgement, capital market participants in their valuations and investment decisions, and accounting standard setters in their standard setting process.

Specifically, the findings in Chapter 2 suggest that auditor industry specialization comes, on average, at the expense of accrual informativeness. This 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. This finding should be of interest to auditors, standard-setters, and capital market participants. First, auditors often organize themselves along industry lines by creating and applying industry-specific audit programs. The results in this study shed light on potential negative side effects of such industry-focused standardizations, by documenting the potential bias included in specialists’ judgements. This implication should also be of interest to standard-setters, as accounting standards require reported information to accurately reflect firms’ underlying economics. The results show that this may be less the case when firms are audited by industry specialists, especially in less homogeneous industries. These results also imply that auditor industry specialization may not always be associated with higher earnings quality. Consequently, the findings should be of interest to investors who wish to rely on accounting numbers to infer the future cash-generating ability of firms. When investing in firms operating in more uniform industries, investors may more heavily rely on accounting
information that is audited by industry specialists than when investing in firms that operate in less homogenous and less persistent industries.

The findings in Chapter 3, which examines the relevance of differential persistence of earnings components in the pricing of mergers and acquisitions, suggest that while acquirers are aware of fundamentals-driven variation in persistence, these persistence differences do not play a relevant role in target pricing. Acquirers seem to (rationally) make alternative valuation choices based on the components’ perceived informativeness and not general persistence levels. The findings should be of interest to accountants in academia and practice, as it broadens our understanding of the relevance of disaggregate accounting fundamentals in target valuation. The knowledge obtained from Chapter 3 can serve as a basis for further research on the economic consequences (e.g., post-deal performance) of acquirers’ focus on perceived informativeness instead of general persistence levels.

The findings in Chapter 4 show that commonalities shared by firms in the same life cycle stage are captured by a common earnings component that affects earnings persistence in a predictable way. These results are of interest to parties actively involved in forecasting and valuation. Specifically, the results inform investors, analysts, and other capital market participants about the persistence coefficients of life cycle-wide and firm-specific earnings components, which may serve as inputs in their valuation models. To the extent that a higher persistence improves the accuracy of valuation outcomes, incorporating life cycle information may improve capital market participants’ valuations and investment decisions. Yet, it should be stressed that incorporating life cycle information can only partly reduce the information asymmetry inherent in valuation tasks. The findings of Chapter 4 should be of particular interest to investors, as they show that investors currently misprice the disaggregated earnings components. While analysts already incorporate life cycle information, at least partially, the findings of this study may help them to further improve their forecasts of future firm performance.

Overall, the findings of this dissertation provide insights in the role of industry and life cycle fundamentals in the firm’s earnings generating process. More specifically, this dissertation enhances our understanding of how (specialist knowledge of) fundamental firm characteristics affect a firm’s (future) earnings, and how these earnings are currently used by various capital market participants including investors, analysts, and acquirers. Hence, this dissertation discusses and provides ways to increase the relevance of current earnings in forecasting and firm valuations, and as such adds to the ongoing debate about the value relevance of accounting information, and earnings information in particular, for capital market participants.