Investor Sophistication, Arbitrage Risk, and the Mispricing of Accruals in Korean Listed Firms

By

Lee-Seok Hwang
College of Business Administration
Seoul National University
02-880-5075
lshwang@snu.ac.kr

Moon Hyun Kym
Department of International Business
College of Economics and Business
Hankuk University of Foreign Studies
011-208-3614
moon@korea.com

Woo Jong Lee
College of Business Administration
Seoul National University
019-698-6691
findes2@snu.ac.kr

and

Byung Chel Sohn
College of Business Administration
Seoul National University
016-785-3941
bcsohn@empal.com

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Abstract

This study examines whether investor sophistication and low arbitrage risk alleviate the mispricing of accruals in Korean listed firms. Using financial and price data from 1994 to 2002, this study finds that stock investors seem not to fully appreciate the value implications of either total accruals or abnormal accruals for future earnings. Future abnormal returns can be earned by exploiting the overestimation of accruals by investors. If investor naivety and limits to arbitrage underlie the mispricing of accruals, then firms with a high proportion of sophisticated investors and a low arbitrage risk will exhibit less of a tendency to misprice accruals. The results show that firms which are expected to show a reduced mispricing of accruals (large firms or firms with a large proportion of foreign ownership, institutional ownership, a low idiosyncratic return volatility, and a high share price) do not exhibit a decreased overreaction to accruals. Although this evidence is unexpected, it is consistent with previous findings for U.S. listed firms, and suggests that the mispricing of the accrual components of earnings is not entirely due to the inability of market participants to understand the value implications of accruals. A notable finding is the severity of performance-related bias in the estimates of accruals. Future studies should acknowledge this bias, and should attempt to remove it in drawing inferences on accruals as a proxy for earnings quality.

Key words: Mispricing, Abnormal accruals, Investor sophistication, Arbitrage risk, Performance-related bias.