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〈ABSTRACT〉

This study examines the value relevance of earnings news, accruals news, and cash flows news in driving the stock returns of the firms listed in Korea Stock Exchange (KRX) for the period 1994 through 2010. Using the variance decomposition (VD) framework (Vuolteenaho 2002), this study addresses the bias arising from constant discount rate assumption, which is unavoidable in the standard regression model used by most value relevance studies since Ball and Brown (1968) and Beaver (1968). Consistent with Vuolteenaho (2002), we find that earnings news explains the variance of stock returns better than the expected return news. Following Callen and Segal (2004), we further disaggregate earnings news into cash flows news and accruals news. We discover that cash flows news dominates accrual news in explaining the variability of excess stock return. Interestingly, our finding is the opposite of the results from the US stock market in Callen and Segal (2004). This finding suggests that cash flows are more value-relevant than accruals in countries where accounting...
transparency is low, the result possibly contributing to international value relevance literature. Our results are robust to various firm characteristics such as the level of stock returns, firm size, operating cycle, and industry classification.

Key Words: Accruals, Cash flows, Discount rate, Earnings, Variance decomposition, Value relevance

I. Introduction

What moves a firm’s stock prices? The answer to this question is in valuation equation. The accounting and finance literature show that the firm’s stock prices are a sum of discounted future cash flows. Based on the valuation equation, finance studies show that a firm’s stock returns is driven by shocks to future cash flows, shocks to discount rate, or both (Campbell and Shiller 1988; Campbell 1991). In line with the finance studies that examine the stock price’s movement, the seminal work in the accounting studies by Ball and Brown (1968) and Beaver (1968) finds the value relevance of the accounting earnings by showing the positive associations between earnings and stock returns. Since then, many studies using Ball and Brown (1968)’s and Beaver (1968)’s methodology have built on their findings and provided evidence that corroborates the value relevance of accounting numbers. Despite several advantages of using Ball-Brown (1968)’s and Beaver (1968)’s regression approach in the value-relevance research, there are following limitations (Callen 2009). First, while their regression approach assumes a constant discount rate, discount rates change over time in reality. As a result, bias is inherent in the estimation based on the regression approach. In the long-window association studies, such bias cumulates over time and is magnified, thereby distorting the

1) In this context, the word “cash flow” is generic. Depending on valuation models, “cash flow” are meant to be dividend, free cash flows, or abnormal earnings.
2) We use the terms “news”, “shocks”, “unexpected changes”, and “revisions” interchangeably. For instance, cash flows news, shocks to cash flows, unexpected changes in future cash flows, and revisions in cash flow expectation are all equivalent.
3) Callen (2009) mathematically shows that variance decomposition method is superior to regression in value relevance study. Callen and Segal (2010) also provides SAS/STATA code and detailed explanations for how to implement variance decomposition in accounting research.