Financial Statement Comparability and Analysts’ Over-optimism for Accruals

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ABSTRACT

This study investigates the association between financial statement comparability and analysts’ over-optimism for accruals. Prior research has shown that sell-side analysts do not fully incorporate accrual information in anticipating future earnings and thus tend to issue optimistic forecasts for firms with high accruals. Using various financial statement comparability measures, we find that analysts’ accrual-related over-optimism is substantially moderated for firms with a high level of financial statement comparability at both the consensus forecast level and the individual forecast level. More importantly, we find that the inverse relation between financial statement comparability and analysts’ over-optimism for accruals arises from comparability of accruals rather than that of operating cash flows. We further show that the positive effect of accrual comparability on analysts’ forecast accuracy for high accrual firms is more pronounced for analysts with less firm-specific experience and for those with less accurate prior forecasts, implying that comparability is more effective in helping analysts with less expertise better incorporate accrual information in forecasting future earnings. This study contributes to the literature by highlighting the substantial benefits of comparability to less sophisticated analysts and revealing an important channel through which comparability improves analysts’ forecast accuracy.

Keywords: Financial statement comparability, Accrual comparability, Analysts’ forecast errors, Accruals, Accrual-related over-optimism

JEL Classification: G14, M41

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I. INTRODUCTION

In a seminal paper, Bradshaw et al. (2001) show that sell-side equity analysts do not fully incorporate accrual information in forecasting future earnings and thus tend to react to accruals optimistically. Specifically, they find that analysts’ forecast errors (actual earnings minus forecasted earnings) are large and negative for firms with high accruals and provide an interpretation that analysts may lack the sophistication to anticipate the future earnings declines associated with high current accruals. Consistent with this interpretation, subsequent research finds that more sophisticated information users appear to better understand the negative implication of high accruals than less sophisticated counterparts (Elgers et al. 2003; Drake and Myers 2011). For example, Drake and Myers (2011) show that more experienced analysts issue less optimistic forecasts for high accrual firms compared to less experienced analysts. However, previous studies pay relatively little attention to whether and how a high quality of financial reporting moderates analysts’ accrual-related over-optimism. To fill this void, our study investigates the relation between financial statement comparability and analysts’ over-optimism for accruals.

We focus on comparability as a key quality of financial reporting because high comparability is expected to moderate analysts’ over-optimism for high accrual firms. Comparability has been regarded as an important qualitative characteristic that enhances the usefulness of accounting information. A primary benefit of comparability is to allow analysts and investors to reduce their cost to process and interpret publicly available information (Bae et al. 2008; Bradshaw et al. 2009; De Franco

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1 Prior literature also reports empirical evidence indicating that sophisticated investors take advantage of the negative association between current accruals and future stock returns (Collins et al. 2003; Mashruwala et al. 2006; Ali et al. 2008; Green et al. 2011).
2 Previous studies document that the ability of accruals to anticipate future returns is associated with the quality of accruals (Xie 2001; Richardson et al. 2005) and the quality of voluntary disclosure (Levi 2008; Louis et al. 2008; Drake et al. 2009; Xu 2010), but provide little evidence on the relationship between the accrual anomaly and the overall quality of financial statements.