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Extended Abstract

An Assessment of Accruals and its Components Ability in Forecasting Abnormal Earnings and Explaining Value of Company Considering the Sign of Abnormal Earnings

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Introduction

On the basis of theoretical principles of financial reporting, the primary goal of financial reporting is to assist the investors to make economic decisions. Economic decisions are related to optimal allocation of the resources. One of the most important decisions is related to investment in stocks which is itself considered as a function of the value of the investment seeking company. In its conceptual statement of financial accounting No .1, the Financial Accounting Standard Board (FASB) announced the presentation of useful information to the investors, creditors and other potential and present users for assessing the amounts, timing and uncertainty of cash flow as one of the goals of financial reporting. In spite of the knowledge of FASB about the importance of the amounts contained in financial reports, it has presented little guidance on the manner of using these amounts in its conceptual statement. Therefore, in order to fill out this gap, valuation models based on accounting have provided guidance in this area (Barth et al, 2005: 312). Accounting valuation models by information in financial statements evaluate a company. In the collection of the financial statements, the earnings enjoys special position and within the framework of the accepted accounting principles and in the accrual accounting system it includes two parts of cash flow and accrual. Regarding the ability of the management in the application of different methods of accounting for distortion and adjustment of the earnings through personal drive by accruals and with regard to the existing empirical evidence in this area based on the information content of these items, it is reasoned that accruals can be taken into consideration as an index for the determination of the improvement or the bankruptcy of the company (Palepu, 2000). Therefore, study of the effect of the accruals and its components on the value of the company seems necessary to assist the investors for investment decision making.

Research Questions or Hypothesis

In this paper the ability of aggregated accruals and its components in forecasting abnormal earnings and explaining value of companies have been evaluated. The main purpose of this paper is answering the question: "Does disaggregating accruals to its four main components and disaggregating abnormal earnings considering the sign of abnormal earnings improve forecasting abnormal earnings and explaining values of companies?" Four main components of accruals are change in receivables, change in payables, change in inventory and depreciation. For this purpose six hypotheses are compiled.

Methods

For testing the research hypothesis three linear information valuation models based on the framework of Ohlson Model are used. Then, for each linear information model distribution of prediction errors is constructed. For each distribution, absolute percentage error is calculated and to assess the statistical significance of differences in prediction errors, means for absolute percentage error are compared. To estimate the models, we use financial information of 70 sample companies for the period of 1995 to 2008 and pooled data method.

Results

The results indicate that the aggregated accruals have power for decreasing prediction errors of company value and abnormal earnings. Furthermore, four main components of accruals can decrease prediction errors of abnormal earnings but can not decrease prediction errors of company value. These results hold both the general model and the disaggregated sign model. Another result of this paper indicates that aggregating abnormal earnings by its sign does not decrease prediction errors of abnormal earnings and company value significantly.

Discussion and conclusion

In general, it is inferred from the findings of the present research that in spite of the aggregated accruals in the estimation of abnormal earnings and value of company that not significantly improve forecasting abnormal earnings and explaining value of company. These findings are also true for the four components of accruals to explaining value of company. Additionally, the sign of abnormal earnings has no significant effect on the improvement of the prediction of abnormal earnings.

Keywords: Value of Company, Abnormal Earnings, Accruals, Components of Accrual.