

DISSERTATION DEFENSE

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Essays on Financial Reporting Quality

My first essay, joint work with Prof. Zhaoyang Gu, investigates whether recent results regarding the association of stock returns with accruals quality (e.g. Francis et al., 2005) can be generalized, or whether they are driven by some very specific factors. We find that the overall results are driven by a small subset of small and illiquid firms. We show that accruals quality is associated with future returns through two separate – and opposite – pricing effects, one indirect and one direct. First, we show that weak accruals quality firms have significantly higher exposure to liquidity risk, hence have higher future returns. Second, beyond that indirect effect, weak accruals quality firms have lower future returns and this direct effect is driven by firms with low institutional ownership, consistent with the Miller (1977) hypothesis of differences of opinion and short-sale constraints and other uncertainty studies (e.g. Berkman et al., 2009). For the largest 80% of firms, the direct effect dominates, but the liquidity risk effect is so strong for the very small firms that on average, weak accruals quality seems associated with higher cost of capital and realized returns. Finally, we show that earnings announcement returns follow the same pattern as the direct effect, again consistent with Miller (1977).

My second essay, again joint work with Prof. Gu, asks whether accounting conservatism, as measured in the Basu (1997) asymmetric timeliness framework, can vary with conditions consistent with earnings management, as opposed to outside demands for conservatism, and whether stronger corporate governance and the Sarbanes-Oxley Act of 2002 had any effect on this seemingly opportunistic behavior. Results suggest that firms are more conservative when they have incentives to understate earnings, that is, when they have both industry-wide and firm-specific bad news to report, consistent with firms taking “big baths” in order to inflate future earnings. We also find evidence that firms emphasize (distance themselves from) industry membership when their firm-specific news (industry-wide news) are bad. Additional tests reveal mixed evidence on the association between opportunistic reporting and strong corporate governance mechanisms or SOX, consistent with some of the prior literature on corporate governance.