Discussion of "Pricing of Accounting Accruals Information and the Revisions of Analyst Earnings Forecasts: Evidence from Tokyo Stock Exchange Firms" by Professors Kubota, Suda, and Takehara

Douglas J. Skinner

University of Chicago

February 2006

Sloan

Skinner

Overview: Interesting setting

- We know a great deal about the accruals anomaly using US data. Very robust phenomenon.
- We know very little about the accruals anomaly in other countries.
- Advantages of looking at Japan:
  - One of the few countries where the economy is large enough to generate sample sizes that yield sufficient statistical power.
  - Good time-series and cross-sectional variation.
  - Different institutions than US.
  - Economically significant in its own right.

Overall Results

- Authors find evidence of accruals anomaly in Japan and that analysts fail to incorporate the information in accruals about future earnings. They also find the strongest evidence when accruals are measured as abnormal accruals.
- This is interesting given my previous remarks.
- In addition, I think the authors can also look at what they have done in a way that might make the study even *more* interesting to researchers in Japan and elsewhere.

Some More Ideas

- While the accrual anomaly is very robust, it is still not very well understood. Perhaps this study can help us understand it better.
- Studies are largely conducted in the US where there is little variation in institutional framework. Moreover, Pincus et al. (2005) report strongest evidence of accrual anomaly in other similar countries, like Australia, Canada, and the UK.
- But Japan is very different.
- Moreover, I think a different way of thinking about the author's evidence is that it is interesting because the results are actually quite different to those in other countries – magnitude of hedge portfolio returns seem quite a lot smaller.

Some More Ideas

- I would be interested to see the "first stage" Sloan-type regressions – that is, regressions of accruals and cash flows on future earnings. Is the differential persistence evident in the US also found in Japan? (Pincus et al. find no difference in the coefficients, but their sample size is small and Global Vantage data are not as good.)
- If this is not observed, then that is interesting in its own right.
- Pincus et al. find that Japanese firms have high BM, low ROA, low OCF but sample is only 1993-2001. Perhaps authors could provide more descriptive information about how their sample compares, say, to US firms?

7

Some More Ideas

- Perhaps the authors could exploit time-series and cross-sectional variation in factors likely to help explain efficiency:
  - Is result related to extent of foreign participation in Japanese equity markets?
  - Is result related to firm size, analyst following, or institutional ownership of different firms?
  - Is there more or less earnings management in Japan? Results show stronger correlation between accruals and cash flows in Japan than in other countries (annual correlations are -.9) – suggests greater income smoothing? (See Lang, Ready, Wilson JAE conference paper.)

8

Aside: The relation between income smoothing and the accruals anomaly

- If income smoothing is indeed much more prevalent in Japan, perhaps this reduces the likelihood of finding support for the accrual anomaly. Why?
- Under accruals anomaly, I think we expect earnings to be overstated by accruals management over a period of years. Because market focuses on the earnings increase (and does not understand that accruals are "low quality" earnings and will reverse) stock becomes overpriced.
- Subsequently, higher earnings cannot be sustained as accruals inevitably reverse. Stock prices then decline, causing the underperformance that forms the basis of the accruals anomaly.

9

Aside: The relation between income smoothing and the accruals anomaly

- But income smoothing is a different story (do not expect periods of consistently positive accruals, followed by periods of negative accruals, or vice versa), making it harder to predict time series pattern of accruals.

10

Some More Ideas

- Perhaps the authors could exploit time-series and cross-sectional variation in factors likely to help explain efficiency:
  - Japan's equity market performed very differently during 1980s and 1990s. Perhaps this variation can also be exploited to help explain the results.

11

More Generally

- My own research on Japanese banks as well as anecdotes from Japan (Livedoor being the most recent) suggest that even though accounting rules are ostensibly similar in Japan and US, the way rules are actually applied in practice may yield quite different results.
- Disclosure practices may also be quite different: do returns lead earnings to a greater or lesser extent in Japan than in the US?
- Perhaps there is something inherently different about the relation between earnings and returns in Japan, which is due to institutional differences.

12

In Conclusion

- Most interesting paper given how little we know about the accruals anomaly outside of the US.
- I think the authors could do some things that could help us better understand the accruals anomaly, by further exploiting the richness of their data.