The Implications of Accounting Distortions and Growth for Accruals and Profitability

May 1, 2006

This paper examines alternative explanations for the differential persistence of the accrual and cash flow components of earnings. Existing research proposes four (non-mutually exclusive) explanations for this phenomenon. These are (i) the existence of transitory estimation error in accruals; (ii) the use of conservative accounting principles; (iii) diminishing marginal returns to new investment; and (iv) the effect of managerial discretion on accruals.

Our results are most consistent with the existence of transitory estimation error in accruals, and also indicate that managerial discretion represents one source of estimation error.

Our findings reinforce the importance of accounting analysis in the evaluation of financial performance. Accrual accounting seeks to provide more relevant information to investors. Our results indicate the increase in relevance, however, comes at the cost of reduced reliability. Reduced reliability manifests itself in the form of transitory estimation error in accruals and increased opportunities for the opportunistic use of managerial accounting discretion.

Our evidence suggests that the lower persistence of the accrual component of earnings is a direct manifestation of this crucial trade-off between relevance and reliability.