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The Value Relevance of Changes in Financial Leverage

41 Pages

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Abstract

Economic performance (economic profits, economic income, or underlying operating performance) of a firm is not observable. Market participants use accounting earnings and other proxies to measure the otherwise unobservable economic performance. Ball and Brown (1968) show that accounting earnings capture the economic performance to some extent. In particular, they find that accounting earnings are correlated with stock returns (value relevant). We hypothesize and show that changes in financial leverage are also value relevant. We document a significantly negative association between changes in financial leverage and contemporaneous risk-adjusted stock returns. The information in changes in financial leverage is incremental to the information in earnings-based measures. Furthermore, we find that changes in financial leverage are also negatively associated with future risk-adjusted returns. This evidence suggests that the information in changes in financial leverage is not impounded in stock prices in a timely fashion.

Keywords: financial leverage, stock returns, operating performance, value relevance

JEL Classification: G14, G32, M41

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