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Accounting Accruals and Stock Returns: Evidence from European Equity Markets

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Abstract

In this paper, I show a generalisation of the negative relation of traditional accruals and percent accruals with future returns in 11 of 16 European countries. Positive abnormal returns from hedge portfolios on both accrual measures summarise the economic significance of this generalisation. The magnitude of returns obtained from traditional accruals is higher than that obtained from percent accruals, contrary to existing evidence from the U.S. capital market. The magnitude of the accrual effect on stock returns based on both accrual measures is stronger in countries with higher individualism, lower uncertainty avoidance, higher equity-market development, higher equity-market liquidity, lower transaction costs, higher analyst coverage, lower analyst optimism, and lower ownership concentration. In markets where minorities have legal protection against expropriation by corporate insiders and where accrual accounting is permitted, the accrual effect based only on percent accruals is positive. Earnings

opacity does not appear to exhibit a significant influence. Overall, the evidence suggests that cross-country differences in culture, equity-market setting, analysts' research output, investor protection, and ownership structure play an important role in explaining variation on the magnitude of the accrual anomaly in Europe.

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The paper has benefited from helpful comments from the participants at the EFMA (2012) annual meeting, at the EAA (2013) annual congress and at the HFAA (2013) annual conference. Helpful comments have also been received from Gikas Hardouvelis, Dimitrios Thomakos and Emmanuel Tsiridakis. I am especially indebted to Guochang Zhang (the associate editor) and one anonymous reviewer for insightful comments and suggestions on several drafts of the paper. The usual disclaimer applies.

Notes

[†] The paper is dedicated to the memory of my father, Antonios Papanastasopoulos, who died unexpectedly on 14 October 2013. Paper accepted by Guochang Zhang.

¹The Pincus et al. (2007) sample consists of Australia, Canada, USA, eight Asian capital markets, and nine European capital markets.

²The legal system of the country (common law vs. code law) in which a firm operates can have significant effect on accounting structure, accounting quality, and investor protection (see Ball et al., 2000; Soderstrom & Sun, 2007).

³In a recent study, Leippold and Lohre (2012) show that hedge-trading portfolios on working capital accruals can generate significantly positive raw returns in Australia and the UK, but not in Canada, Indonesia, or Singapore. Among these countries, they document significantly positive risk-adjusted alphas from the Fama and French (1993) three-factor model on hedge portfolios only for Australia. Hedge raw and risk-adjusted alphas are both positive and statistically significant in Hong Kong, Denmark, Germany, Italy, Japan, and Switzerland. France exhibits significant raw returns and insignificant alphas, while South Korea and Thailand exhibit the opposite pattern.

⁴Pincus et al. ([2007](#)) use the anti-director index and the legal enforcement index as measures of shareholder protection and find conflicting results: investors overestimate the lower persistence of the accrual component of earnings in countries with weaker outside shareholder rights and stronger legal enforcement.

⁵I also perform initial data screenings for basic coding errors via the methods outlined in Ince and Porter ([2006](#)).

⁶All results remain qualitatively similar when I repeat the analysis using firm-level variables that are converted to local currency for all countries.

⁷Fama and French ([2008](#)) argue that size and book-to-market adjusted returns are almost similar to factor alphas from the Fama and French ([1993](#)) three-factor model.

⁸Hung's ([2001](#)) accrual intensity index is based on accounting standards associated with goodwill, equity method, depreciation, purchased intangibles, internally developed intangibles, research and development costs, interest capitalisation, lease capitalisation, allowance of the percentage of completion method, pension accounting, and accounting for other post-retirement benefits.

⁹Leippold and Lohre ([2012](#)) document that hedge quintile portfolios based on working capital accruals generate a country-average annualised alpha from the Fama-French three-factor model of about 0.048 in 13 out of 16 European equity markets of my sample (Austria, Finland, and Portugal that generate insignificant returns in my study are not included in their study) from 1994 to 2008. The respective country-average returns in my sample (i.e. when Austria, Finland, and Portugal are excluded) are an abnormal return of 0.075 based on traditional total accruals and an abnormal return of 0.065 based on percent accruals. Thus, my findings, consistent with existing evidence from the USA, indicate that the magnitude of the accrual effect on stock returns obtained from traditional and percent accruals is larger than that obtained from working capital accruals.

¹⁰Size and book-to-market ratio are mainly used as asset pricing control variables in regressions of stock returns on several accounting variables (e.g. accruals, cash flows, asset growth, net operating assets) at the firm level. In a similar vein, Titman et al. ([forthcoming](#)) use them at the country level to examine the asset growth anomaly in an international setting.

¹¹Results are qualitatively similar if I instead use the Petersen ([2008](#)) estimation procedure, clustered by country.

¹²I use the natural logarithm of LIQ and ACOV when I include them in the regressions as a result of the extreme variation of these characteristics (the standard deviations of LIQ and ACOV are about 436 and 453, respectively).

¹³Mandatory adoption of International Financial Reporting Standards on 1 January 2005 led to changes in the accounting regimes of European Union countries. Thus, I perform sub-period regression analyses (up to 2004) for both the accrual index and the earnings opacity index and find qualitatively similar results.

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