



THE LONDON SCHOOL
OF ECONOMICS AND
POLITICAL SCIENCE ■

Department of Accounting

“Estimating the Amount of Estimation in Accruals”

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Abstract

This paper examines the link between the amount of estimation needed during the accrual generating process and the persistence of the accruals portion of earnings. We measure the amount of estimation needed during the accrual generating process using the number of linguistic cues in the notes to the financial statements that convey that estimation was needed. Consistent with the conjectures in Sloan [1996], we find that accruals which needed more estimation are less predictive of future earnings. We also find that greater estimation is associated with a lower mapping of accruals into the past, current, or future cash flows of the firm. Lastly, we find some evidence that the market reacts as if it does not incorporate the amount of estimation in accruals into its valuation of the firm in a timely manner. Overall, our results suggest that the estimation needed during the accrual generating process plays an important role in understanding the persistence of accrual earnings.