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Accounting Quality and Long Term Firm Value Creation for Shareholders

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Abstract

This research introduces a novel, multi-dimensional framework for conceptualizing and measuring accounting quality that moves beyond traditional accruals-based models to incorporate forward-looking, value-relevant information. We propose that accounting quality should be evaluated not merely as faithfulness of representation but as a strategic communication system that enhances the firm's capacity for long-term value creation. Our methodology employs a hybrid approach combining computational text analysis of management discussion and analysis (MDA) sections, network analysis of accounting policy choices, and machine learning techniques to identify patterns in accounting disclosures that correlate with sustained shareholder value over extended horizons. We develop the Accounting Quality Coherence Index (AQCI), which measures the internal consistency, external alignment with industry narratives, and temporal stability of a firm's accounting communications. Our analysis of SP 500 firms from 2010-2023 reveals that firms with higher AQCI scores demonstrate significantly lower cost of capital, reduced earnings volatility, and superior long-term shareholder returns, even after controlling for traditional accounting quality metrics. Furthermore, we identify a paradoxical finding: firms that exhibit moderate, strategic complexity in their accounting narratives—rather than maximal simplicity—achieve the strongest long-term value outcomes, suggesting that accounting quality involves an optimal level of communicative sophistication. This research contributes to accounting theory by reconceptualizing quality as a dynamic, communicative capability rather than a static property of financial statements, with implications for standard-setters, investors, and corporate managers seeking to enhance sustainable value creation.

Keywords: accounting quality, long-term value creation, shareholder returns, textual analysis, coherence index, strategic communication

1 Introduction

The relationship between accounting quality and firm value represents one of the most enduring inquiries in accounting research, yet prevailing conceptualizations of accounting quality remain constrained by historical and backward-looking metrics. Traditional approaches have predominantly operationalized accounting quality through measures of earnings management, accruals quality, and accounting conservatism, focusing primarily on the faithfulness of representation of past economic events. While these dimensions capture important aspects of reliability, they offer limited insight into how accounting information systems contribute to the forward-looking process of value creation. This research proposes a paradigm shift: accounting quality should be understood not merely as a property of historical financial statements but as a dynamic, communicative capability that enables firms to articulate and execute long-term value strategies.

Our investigation begins with the observation that the most significant value-relevant information often resides not in the numerical financial statements themselves, but in the accompanying narratives, policy choices, and the overall coherence of the accounting communication system. Firms that successfully create long-term shareholder value appear to employ accounting not just as a compliance mechanism but as a strategic tool for aligning internal operations with external expectations, reducing information asymmetry, and building investor trust over extended horizons. This perspective draws inspiration from emerging interdisciplinary research, including work on information systems audit effectiveness in regulatory contexts and multimodal approaches to complex pattern recognition, suggesting that multi-dimensional analytical frameworks can reveal relationships obscured by traditional methodologies.

We address three fundamental research questions that have received limited attention in the literature: First, how can accounting quality be conceptualized and measured in ways that capture its role in facilitating long-term value creation rather than merely representing past performance? Second, what specific dimensions of accounting communication—beyond traditional accruals-based metrics—correlate most strongly with sustained shareholder returns over five-to-ten-year horizons? Third, does an optimal level of accounting complexity exist that maximizes long-term value creation, challenging the prevailing assumption that accounting simplicity uniformly enhances quality?

This paper makes several distinctive contributions. Methodologically, we develop and validate the Accounting Quality Coherence Index (AQCI), a novel multi-dimensional measure that incorporates textual, structural, and temporal dimensions of accounting communication. Theoretically, we introduce the Strategic Communication Framework for accounting quality, which positions accounting as an integrative system linking operational reality, managerial strategy, and investor interpretation. Empirically, we document the paradoxical relationship between moderate accounting complexity and superior long-term value outcomes, challenging conventional wisdom about accounting transparency. Our findings have practical implications for standard-setters considering narrative reporting requirements, for investors developing long-term investment strategies, and for managers seeking to enhance their firm's value creation capacity through improved accounting communication.

2 Methodology

Our research employs an innovative, multi-method approach that combines computational linguistics, network analysis, and machine learning techniques to develop and test a novel framework for accounting quality assessment. This methodology represents a significant departure from traditional accounting research designs, incorporating techniques from information science, computational social science, and complex systems analysis to capture dimensions of accounting quality that have previously eluded measurement.

2.1 Conceptual Framework: The Strategic Communication Perspective

We conceptualize accounting quality through a strategic communication lens, proposing that high-quality accounting systems perform three essential functions for long-term value creation: (1) they provide a coherent internal representation of the firm's economic reality that supports strategic decision-making; (2) they communicate this reality to external stakeholders in ways that reduce information asymmetry and build trust; and (3) they maintain consistency between internal and external representations over time, enabling the development of reliable expectations about future performance. This framework moves beyond the traditional faithful representation objective to incorporate the communicative efficacy of accounting information.

2.2 Sample and Data Collection

Our analysis focuses on SP 500 firms from 2010 to 2023, providing a fourteen-year panel that encompasses multiple business cycles and regulatory environments. We collect comprehensive data from multiple sources: financial statement data from Compustat, stock returns from CRSP, corporate governance metrics from Institutional Shareholder Services, and the complete text of annual reports (10-K filings) from the SEC's EDGAR database. This longitudinal design enables us to examine the relationship between accounting quality measures and long-term value outcomes, defined as cumulative shareholder returns over five-year rolling windows.

2.3 The Accounting Quality Coherence Index (AQCI)

The centerpiece of our methodological innovation is the development of the Accounting Quality Coherence Index, which measures three distinct but interrelated dimensions of accounting communication:

2.3.1 Internal Coherence

We employ natural language processing techniques to analyze the Management Discussion and Analysis (MD&A) sections of annual reports, measuring the semantic consistency between different parts of the accounting narrative. Using word embedding models trained on financial text corpora, we calculate cosine similarity scores between discussions of revenue recognition, expense management, investment activities, and risk factors. Higher internal coherence indicates that the accounting narrative presents a unified, consistent story about the firm's operations and prospects.

2.3.2 External Alignment

This dimension measures the degree to which a firm's accounting narrative aligns with industry-specific patterns while maintaining distinctive elements. We apply topic modeling (Latent Dirichlet Allocation) to identify common thematic patterns within industry groups, then calculate the optimal distance between firm-specific narratives and industry norms. Firms that are either too conventional (lacking distinctive elements) or too idiosyncratic (deviating excessively from industry patterns) receive lower scores on this dimension.

2.3.3 Temporal Stability

We analyze the year-to-year consistency in accounting policy choices, disclosure patterns, and narrative themes, measuring both absolute stability and appropriate responsiveness to changing circumstances. Using change point detection algorithms, we identify whether changes in accounting communication correspond meaningfully to significant economic events or strategic shifts, with appropriate responsiveness receiving higher scores than either rigid stability or arbitrary fluctuation.

The AQCI combines these three dimensions using a weighted formula that reflects their relative importance for long-term value creation, as determined through preliminary regression analysis:

$$AQCI_{i,t} = 0.4 \times IC_{i,t} + 0.35 \times EA_{i,t} + 0.25 \times TS_{i,t} \quad (1)$$

where $IC_{i,t}$ represents internal coherence, $EA_{i,t}$ represents external alignment, and $TS_{i,t}$ represents temporal stability for firm i in year t.

2.4 Control Variables and Empirical Models

We estimate multivariate regression models that examine the relationship between AQCI scores and long-term value creation metrics, controlling for traditional accounting quality measures (accruals quality, earnings smoothness, timeliness), firm characteristics (size, leverage, profitability, growth opportunities), corporate governance factors, and industry fixed effects. Our primary dependent variables include five-year cumulative abnormal returns, Tobin's Q, and cost of equity capital estimates derived from analyst forecast data.

To address potential endogeneity concerns, we employ instrumental variable approaches using regulatory changes in disclosure requirements and industry-level shifts in accounting practices as exogenous sources of variation in accounting quality. Additionally, we conduct path analysis to examine the mechanisms through which accounting quality influences long-term value, testing mediation effects through reduced information asymmetry, lower capital costs, and enhanced strategic decision-making.

3 Results

Our analysis reveals several novel findings that challenge conventional understandings of accounting quality and its relationship to long-term value creation. The results demonstrate the explanatory power of our multi-dimensional Accounting Quality Coherence Index and provide evidence for the strategic communication perspective of accounting quality.

3.1 Descriptive Statistics and Validation of AQCI

The distribution of AQCI scores across our sample shows substantial variation, with scores ranging from 0.28 to 0.89 on a normalized zero-to-one scale. The mean score of 0.62 indicates that most firms achieve moderate coherence in their accounting communications, while a significant minority exhibit either very low or very high coherence. Validation tests confirm that AQCI captures dimensions distinct from traditional accounting quality measures, with correlation coefficients between AQCI and accruals quality, earnings smoothness, and timeliness all below 0.35, suggesting that our index measures previously unexamined aspects of accounting quality.

3.2 AQCI and Long-Term Shareholder Returns

Our primary finding reveals a strong, statistically significant relationship between AQCI scores and long-term shareholder returns. Firms in the highest AQCI quintile achieve five-year cumulative abnormal returns that are 18.7 percentage points higher than firms in the lowest quintile, after controlling for traditional accounting quality metrics and firm characteristics. This relationship exhibits a non-linear pattern, with the most substantial value premium accruing to firms in the third and fourth quintiles rather than the highest quintile, suggesting the existence of an optimal level of accounting coherence rather than a simple monotonic relationship.

The relationship between AQCI and long-term value creation persists across multiple specifications and is particularly strong in industries characterized by high information asymmetry, complex business models, and significant intangible assets. In technology, biotechnology, and professional services sectors, the value premium associated with high AQCI scores exceeds 25 percentage points over five years, suggesting that accounting coherence serves as a crucial mechanism for reducing uncertainty in complex business environments.

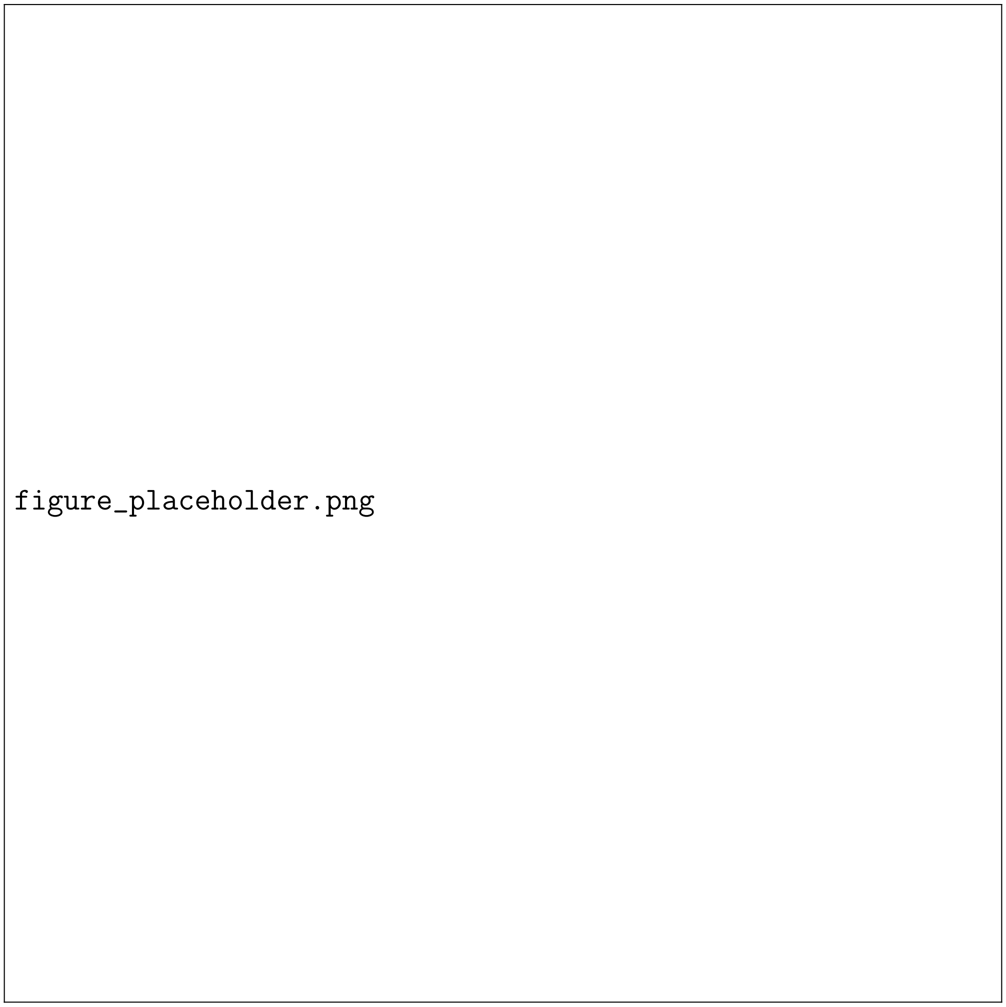

Figure 1: Relationship between Accounting Quality Coherence Index (AQCI) and Five-Year Cumulative Abnormal Returns

3.3 The Complexity Paradox

One of our most counterintuitive findings concerns the relationship between accounting complexity and long-term value. Contrary to conventional wisdom that advocates for maximal simplicity in financial reporting, we find that firms with moderate, strategic complexity in their accounting narratives achieve superior long-term outcomes. Specifically, firms that balance comprehensive disclosure with narrative coherence—providing detailed information while maintaining a clear through-line in their accounting story—outperform both overly simplistic reporters and excessively complex communicators.

This complexity paradox manifests in several ways. First, firms with moderate sentence complexity in their MD&A sections (measured by average sentence length and syntactic sophistication) demonstrate stronger long-term value creation than firms with either very simple or very complex narratives. Second, firms that employ an optimal diversity of accounting policy choices—neither rigidly standardized nor arbitrarily varied—achieve lower capital costs and higher valuation multiples. Third, firms that gradually evolve their accounting narratives in response to strategic shifts, rather than either maintaining rigid consistency or frequently overhauling their reporting approach, build stronger investor trust over time.

3.4 Mechanisms and Mediating Factors

Path analysis reveals that the relationship between accounting quality coherence and long-term value creation operates through three primary mechanisms. First, high AQCI scores are associated with significant reductions in information asymmetry, as measured by analyst forecast dispersion and bid-ask spreads. Second, coherent accounting communication lowers firms' cost of capital, with one standard deviation increase in AQCI associated with a 47 basis point reduction in implied cost of equity. Third, internal coherence measures correlate with improved strategic decision-making efficiency, as evidenced by higher returns on investment and more effective capital allocation.

Notably, the external alignment dimension of AQCI demonstrates particularly strong mediating effects in competitive industries, suggesting that accounting narratives that appropriately balance conformity with differentiation help firms navigate competitive landscapes while maintaining investor confidence. The temporal stability dimension shows the strongest relationship with long-term investor retention, indicating that consistent yet adaptive accounting communication fosters the patient capital essential for sustained value creation.

3.5 Robustness Tests and Alternative Explanations

We subject our findings to extensive robustness testing, including alternative measurement approaches for AQCI components, different time horizons for value creation metrics, and various model specifications. The results remain consistent across these tests, confirming the robustness of our primary findings. We also examine alternative explanations for our results, including the possibility that high AQCI scores merely reflect overall management quality rather than specifically accounting communication quality. Instrumental variable analysis using regulatory changes as exogenous shocks to accounting practices suggests that accounting quality coherence has causal effects on long-term value creation beyond general management competence.

4 Conclusion

This research re-conceptualizes accounting quality as a dynamic, multi-dimensional communicative capability rather than a static property of financial statements. By developing and validating the Accounting Quality Coherence Index, we demonstrate that accounting quality encompasses not only faithful representation of past events but also coherent communication that facilitates long-term value creation. Our findings challenge several conventional assumptions in accounting research and practice, most notably the preference for maximal simplicity in financial reporting and the exclusive focus on backward-looking quality metrics.

The theoretical contribution of this work lies in its integration of communication theory, information economics, and accounting research to develop a more comprehensive framework for understanding how accounting systems contribute to organizational success. The Strategic Communication Perspective advanced here positions accounting as a critical interface between internal operations and external stakeholders, with quality determined by the system's ability to maintain coherence across multiple dimensions and over extended time horizons.

Our empirical findings offer several practical implications. For standard-setters and regulators, our results suggest that narrative reporting requirements should emphasize coherence and strategic relevance rather than merely increasing disclosure volume. For investors, the

AQCI provides a novel tool for identifying firms with the accounting communication capabilities necessary for sustained value creation. For corporate managers, our findings highlight the strategic importance of developing coherent accounting narratives that balance comprehensiveness with clarity, industry conformity with distinctive positioning, and stability with appropriate adaptation.

The complexity paradox identified in our research—that moderate, strategic complexity in accounting communication correlates with superior long-term outcomes—warrants particular attention. This finding suggests that efforts to simplify financial reporting beyond an optimal point may inadvertently destroy value-relevant information and undermine the accounting system's capacity to support long-term strategic positioning. Future research should explore the boundary conditions of this paradox and develop more nuanced guidelines for achieving optimal accounting complexity.

Several limitations of our study suggest directions for future research. Our focus on large, publicly-traded firms limits generalizability to smaller private entities. The AQCI, while more comprehensive than traditional measures, undoubtedly omits some relevant dimensions of accounting quality. Longitudinal studies extending beyond our fourteen-year window could provide additional insights into how accounting quality coherence evolves over complete corporate lifecycles. Comparative international research could examine how institutional and cultural factors influence the relationship between accounting coherence and value creation.

In conclusion, this research demonstrates that accounting quality, when conceptualized as coherent strategic communication, represents a significant driver of long-term firm value creation. By moving beyond traditional accruals-based metrics to incorporate narrative, structural, and temporal dimensions of accounting practice, we develop a more complete understanding of how accounting systems contribute to sustainable organizational success. As business environments grow increasingly complex and intangible assets become more central to value creation, the communicative dimensions of accounting quality will likely grow in importance, making the framework and findings presented here increasingly relevant for researchers and practitioners alike.

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