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SHARE PRICE RESPONSE TO EARNINGS ANNOUNCEMENTS

The world economy before the 2007-2008 financial crisis was to a large extent characterized by enormously growing corporate activity: financial world saw numerous mergers and acquisitions, takeovers, divestitures, etc. (Frykman & Jakob, 2003). World's leading financial indexes showed upward trends. However, Figure 1 demonstrates that S&P 500 index was decreasing from Jan 2008, but further showed recovery from Jan 2009. The same pattern can be seen from plotting other financial indexes: Dow Jones industrial average, Amsterdam Exchange index, FTSE 100, etc.

Chordia, Roll and Subrahmanyam (2011) report increase of value-weighted average monthly share turnover and the rise of average number of daily transactions on NYSE from 1993 to 2008. Figure 2 supports the fact of enlarged number of share trading value for the period (with the downturn in year 2000), however revealing the abrupt decline of the value from 2008 with its clear reversion from 2009.

Such a situation, both with volatility of world financial markets and share trading activity, requires interested parties to be able to assess a value of a company, in order to determine, whether the company is possibly overvalued or undervalued by market. The current value of a company can be driven downwards by overall market perception, which is reflected in values of various financial indexes and the share trading activity of investors. In this case, if a company has strong internal financial indicators, it can possibly outperform the market, when its perception recovers. The valuation of a company can be done by getting insight of how much external and internal to a company economic events influence its value.

Private investors, valuating entity, can make justified decisions on investments on a stock market in order to be more profitable. Managers' purpose, in their turn, is to maximize shareholder's value. Thus, in order to understand how their decisions influence a company's value and hence a shareholder's value, managers first need to determine it, possessing information on what it depends on (Neale & McElroy, 2004).

Therefore, the obvious question occurs: how is it possible to assess a company, obtaining its share price response to diverse corporate events?

Copeland, Koller and Murrin (2000) state, that nowadays the most useful and widely accepted valuation model to assess a company is Discounted Cash Flow (DCF) model, which discounts expected future free cash flows to present time, taking into account the corresponding cost of capital of the company. Authors support the idea of using cash flows in corporate valuation, claiming that the value of a company directly depends on how well it generates cash flows. In their turn, Neale and McElroy (2004) consider cash flows valuation as a theoretical framework, converging to practice. At the same time, some researchers (e.g. Hecht and Vuolteenaho, 2006) claim the usefulness of accounting earnings as proxies for cash-flows. The advantage of using accruals is the timing, so cash flows even being the real underlying reason of returns variation, cannot be always reconciled with share price movements at the same period. Thus, by studying response of share prices to earnings, the one explores underlying relationship between a company's value variation and expected cash flows.

There are numerous papers providing research on share price response to earnings announcements.

Chari, Jagannathan and Ofer (1988) studied seasonal trends of stock returns as a result of response to quarterly earnings announcements. The data comprised 56147 quarterly announcements for 2527 firms during 1976-1984. The researchers found significant positive abnormal returns for small size firms.

The influence of quarterly earnings announcements to share returns in the Nigerian Stock Market was tested by Afego (2011). Using a sample of sixteen firms with quarterly earnings announcements during 2005-2008, listed on Nigerian Stock Exchange, the researcher found statistical significance of abnormal returns around earnings news release.

Apart from discussed papers, Su (2003) lists other studies, which found stock price response to earnings announcements in US and non-US markets: Ball and Brown (1968), Gennotte and Truemann (1996), Alford, Jones, Leftwish, and Zmijewski (1993), etc.

Reference:

1. Alford, A., Jones, J., Leftwish, R. & Zmijewski, M. (1993). The relative informativeness of accounting disclosures in different countries. Journal of Accounting Research, 31, 183-223.
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3. Ball, R. & Brown, P. (1968). Using daily stock returns: The case of event studies. . Journal of Accounting Research, 6, 159-178.