Year wise share price response to Annual Earnings Announcements

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Abstract

The information content of earnings is an issue of obvious importance for investors. Company earnings announcements are closely-watched events, being the main source of new information about company performance. The study investigated the impact of Earnings announcements on the stocks constituting the Sensex. The objective is to check the share price behavior to earnings announcements. The study includes Top 100 companies rated by Chartered Financial Analyst Survey 2008 and informational efficiency for last ten calendar periods- January. 2005 to December 2014 has been investigated. Data regarding share prices and Sensex has been taken from BSE and NSE websites. The data on daily closing values of market proxy is obtained from Capitaline Database. The results show that the Indian Capital Market is semi strong efficient as it is using the information relevant for security valuation and for investment decision making. However, the reaction after the announcement shows that the Indian Capital Market is not perfectly efficient as abnormal returns have been observed both prior to and after the announcement. The role of SEBI can be instrumental in preventing insider trading so that the confidence of the investors is maintained and the stock market can become more vibrant and dynamic.

Keywords: Capital Market, Security, Sensex and SEBI.

JEL Classification: G1, G10

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Introduction

In the light of media attention to corporate scandals and numerous restatements of financial statement one common demand on company chief executive officers and chief financial officers became evident; the need to beat earnings forecasts by the attainment of double-digit returns which subsequently drove up share prices of their respective companies. Financial analysts forecast earnings stream as one of their fundamental economic variables and often connect these forecasts into meaningful measures of security returns. Management decisions and their compensations are often stated in terms of earning objectives. Investors, bankers and creditors assess the prospects of enterprises' net cash flows through forecasts of the future earnings based on present and past earnings.

The information content of earnings is an issue of obvious importance for investors. Company earnings announcements are closely-watched events, being the main source of new information about company performance. However, when companies meet expectations, the price response is typically close to zero. The phenomenon is reflected in the abnormal stock return of the firm surrounding the announcement. The effect of the earnings announcement drift has been found to persist for a significant time, creating post earnings announcement drift. However, the magnitude of the effect and the time taken to incorporate the information content depend on characteristics of the firm under study. Thus, the effect of the earning announcements is an important empirical matter in the capital market, influencing the movement of the share prices.

REVIEW OF LITERATURE

A number of studies have documented the post-earnings announcement drift phenomenon where stock prices tend to drift upward or downward after the earnings announcement, if the earnings are unexpectedly positive or negative respectively. Thus, post-earnings announcement drift continues to pose a significant challenge to financial theorists **(Brennan, 1991; Fama, 1998).**

Reported earnings have been documented as an important determinant of stock prices in both accounting and finance literature. This study intends to fill the gap by conducting a comprehensive research on the issue of association between the stock price movements with earnings changes of firms listed on the Kuala Lumpur Stock Exchange, in an emerging market. In an emerging market, the availability and transmission of information have been found to be relatively inefficient compared to developed markets, making the surprise element even more relevant in this market **(Ajayi and Mehdian, 1994).**

Ball and Brown (1968), Rendeleman et al. (1982), Foster et al. (1984) as well as **Bernard and Thomas (1989, 1990)** proved the presence of abnormal returns during at least three months after the financial report publication date. On the basis of the research carried out by **Chan et al. (1996)** it can even be assumed that the delay of investors' reaction can reach as much as three quarters of a year.

Conventional wisdom suggests that bad earnings news is more likely to be released after the close of trading or on Friday. For example, prior research suggests that managers might release bad news when investors have limited opportunities to act on it, media coverage is light, or investors are focused on other news (**Patell and Wolfson, 1984; Damodaran, 1989; Vigna and Pollet, 2004**). In the U.S., **Aharony and Swary (1980),** on examination of quarterly earnings and dividend announcements at least 10 days apart, concluded that both earnings and dividends have information content. **Healy and Palepu (1988)** extended the work of **Asquith and Mullins (1983)** by looking at the nature of earning changes surrounding a dividend initiation or omission announcements. The results of the study showed a significant earning increase/decrease for at least one year prior to the dividend initiation/omission announcements.A study by **Gupta (2006b)** investigated the stock market reaction associated with earnings announcements in the Indian stock market, and to verify whether these announcements possess any informational value. An event study was conducted on 50 companies, comprising the CNX Nifty Index, which made earnings announcements in March 2004..**Das et al. (2007)** studied the effect of quarterly earnings announcements made by the large companies. However, this study was limited to a single quarter earning releases comprising only 30 announcements, and moreover the effect of clustering of multiple events in the overall return behaviour of the firms was not incorporated.

Need for the study

There is need to study the significance of the emerging trend, its signalling effect on share price and its impact on the wealth of the shareholders. Further, it has been argued that if the capital markets are efficient then they would react immediately to various kinds of Earnings announcements. Since decisions regarding any Earning announcements are taken in the meetings of the Board of Directors, it is quite possible that there could be a leakage of information by employees who come to know of such information. The study aims to check whether efficient market hypothesis holds for Indian stock market or not i.e., whether there is any movement in share prices before or after the corporate announcements.

Objectives of the study

The study investigates the impact of Earnings announcements on the stocks constituting the Sensex. The study of the effect of clustering of event dates on the overall stock returns has been incorporated in the study. The objective is to check the share price behavior to earning announcements.

Research design

The present study is exploratory and empirical in nature. The study includes Top 100 companies rated by Chartered Financial Analyst Survey 2008 and informational efficiency for last ten calendar periods- January. 2005 to December 2014 has been investigated.

As many as 2502 companies listed on the Bombay Stock Exchange were considered for The Analyst 500 rankings. The data for financial years (April 1, 2007 to 31 March, 2008) was taken for the purpose of rankings. The Analyst 500 companies have been ranked on the basis of their Net Sales alone. Besides, Net Sales, other parameters, such as like Profit after tax (PAT), Operating profit or Profit before depreciation and tax (PBDIT), Operating Profit Margin and Market Capitalization have also been considered.

For the present study, secondary data has been used. For exploring the objectives of this study, the information disclosure concerning the earnings announcements have been collected from BSE (Bombay Stock Exchange) website. Data regarding share prices and Sensex has been taken from BSE (Bombay Stock Exchange) and NSE (National Stock Exchange) websites. Capitaline Database is maintained by Capital Market Publishers India Private Limited. In case of non-availability of data concerning the exact date, the nearest date (not varying more than a week) has been considered.

The event study methodology has been used to estimate Cumulative Abnormal Returns (CAR) for a 15 day window period. Market Model Method (Single factor Model) has been used. The study endeavours to find the Cumulative Abnormal Return (CAR).

The event study methodology has been extensively used to assess the impact of an announcement of a particular strategy of the firm's stock prices.

INTERPRETATION AND ANALYSIS

This study examines the relationship between share prices and earnings announcements. This study goes beyond previously documented market reactions to earnings announcements and presents a justification for management decisions.

Data regarding share prices and Sensex has been taken from BSE and NSE websites. The data on daily closing values of market proxy is obtained from Capitaline Database. This process revealed 927 observations. To be included in the sample, an earnings announcement must satisfy the following criteria:

- The earnings announcement date is to be reported in any of the leading financial dailies such as Economic Times, Business Line etc.
- At least 200 daily returns are available before and after the earnings announcement date. These returns are used to calculate pre-event and post-event beta.

Further, a comparison of Average abnormal returns (AARs) prior to the date of an announcement shows that the Average abnormal returns (AARs) is negative for majority of days. It has been noticed that the highest average abnormal returns (AARs) prior to the date of an announcement is 9.2581 in 2010 on day 9, whereas the highest average abnormal returns (AARs) after the date of an announcement is 7.1331 in 2014 on day 11.

The lowest average abnormal returns (AARs) prior to the date of an announcement is –7.9638 in 2013 on day 8, whereas the lowest average abnormal returns (AARs) after the date of an announcement is -–8.1234 in 2012 on day 1.The highest Cumulative Average abnormal returns (CAARs) on the announcement day were 25.3712 percent in 2012. It shows that market is recovering from the last two three years of sluggish growth.

TABLE 1.1: Average abnormal returns (AARs) and cumulative average abnormal returns (CAARs) of Annual Earnings announcements.

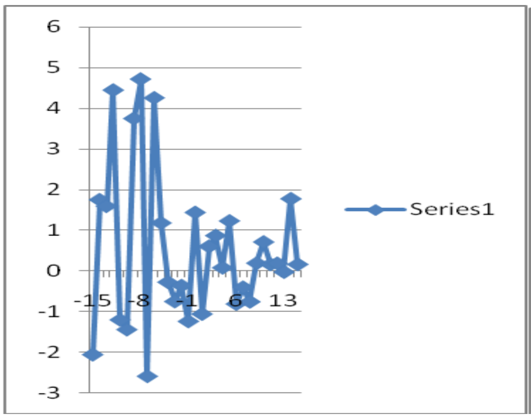
Year	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Days	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)	AAR (%)
-15	-2.0634	-0.1897	-0.4887	-2.6243	1.4695	1.0849	-1.6614	1.0021	0.4262	2.3117
-14	1.7508	-0.6023	-0.0776	0.0412	-1.3630	0.0166	0.5113	-1.6209	0.4827	-0.5974
-13	1.5925	-1.5885	1.7194	1.1501	0.1287	2.8361	-0.2366	0.1229	-0.7409	0.3218
-12	4.4513	1.5916	-4.2682	0.5956	0.0232	-0.6774	-0.5208	2.0919	1.1602	6.6984
-11	-1.2068	-0.5528	-0.3305	0.8186	0.0727	-2.6582	2.2522	5.3448	-2.4003	-3.0656
-10	-1.4474	-0.9087	2.5251	-0.3059	0.3792	-0.5548	-0.1234	1.8077	2.1068	-0.0010
-9	3.7522	0.7993	-0.3573	-0.2388	-0.2007	9.9450	-1.1516	3.8500	0.0065	0.8364
-8	4.7227	0.6366	1.8405	0.5486	-1.3553	-3.2937	3.5781	1.3939	-7.9638	-0.6508
-7	-2.5963	-0.2754	-1.0918	1.9839	1.3314	4.6199	1.9865	-0.5561	1.2784	-2.0644
-6	4.2601	0.4855	-	2.7134	-	0.2256	-	1.3456	-	-0.0068

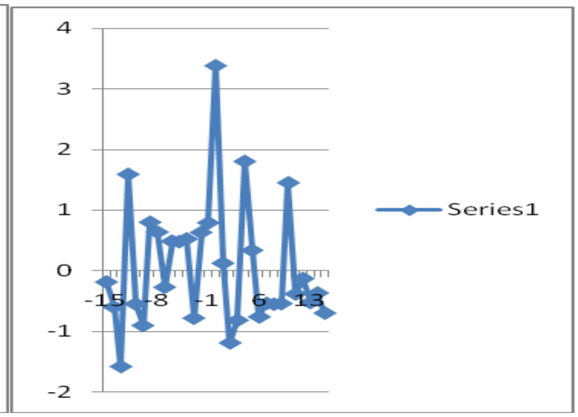
			0.2331		0.9144		0.0813		1.0956	
-5	1.1793	0.4781	-1.8000	2.1287	0.2046	2.6744	0.3235	-0.5561	3.0473	7.5945
-4	-0.2769	0.5230	-2.5907	0.4898	1.3930	0.9565	0.5352	1.3456	-2.3041	-0.2762
-3	-0.7549	-0.7869	3.0195	1.7687	-0.1575	-1.0206	-1.2625	8.2488	1.7703	-4.0623
-2	-0.3644	0.6309	0.4073	1.7272	0.1184	1.9258	-1.0354	1.4500	-0.2603	2.7328
-1	-1.2446	0.7901	2.7392	1.4843	-0.5114	-3.8734	-0.9280	-1.0112	2.0657	-0.0848
0	1.4381	3.3889	3.2017	4.5768	1.7413	1.9913	-0.3847	1.1122	0.9369	12.2500
1	-1.0627	0.1211	-0.1644	-0.7561	3.5876	-0.9649	0.7572	-8.1200	0.8322	1.3955
2	0.6019	-1.1964	-2.5594	-1.5332	1.4563	-0.2055	0.1586	1.2892	-1.7759	-2.8909
3	0.8696	-0.8232	4.2739	-1.8382	0.5765	-3.4946	1.8610	-0.2061	1.0654	2.6285
4	0.0769	1.8053	-0.0551	2.0781	-0.3311	-2.7980	2.1148	0.2667	0.0329	-0.9708
5	1.2286	0.3345	-0.7115	-0.0892	1.3160	0.0825	0.1699	-0.4544	-0.3507	1.2841
6	-0.8152	-0.7657	3.5723	1.1200	-0.7444	0.7378	0.1739	0.6105	-0.0991	0.2858
7	-0.4048	-0.5421	-2.6135	-1.9424	0.6480	-0.6415	-2.4474	-0.1084	-0.0991	1.5633
8	-0.7597	-0.5566	0.9159	-0.1224	-0.1621	-1.2294	-0.8227	0.7918	-0.4545	-1.1316
9	0.1894	-0.5468	-7.4784	1.4364	-0.0442	-0.2442	-0.5224	0.5208	1.3385	0.2090
10	0.7109	1.4523	1.6700	-1.7780	0.9454	-2.8446	-0.9472	0.4102	-0.9802	1.2311
11	0.1597	-0.3866	-0.0475	1.8339	-0.0786	-0.8144	-0.8911	-1.0882	-0.4265	7.1331
12	0.1843	-0.1336	-0.0681	1.2277	1.1851	0.6919	-2.6605	0.3234	0.4528	-3.7252
13	-0.0286	-0.5279	0.3063	-0.4119	-0.1192	0.1368	4.2676	-0.5500	-0.8092	-1.1499
14	1.7746	-0.3704	-0.8436	-0.4952	0.2720	-1.0415	-1.0929	-0.1427	0.0008	0.4958

15	0.1589	-0.7034	-1.7240	-1.4323	1.4925	4.2256	0.5169	-0.1940	-0.4689	0.6906

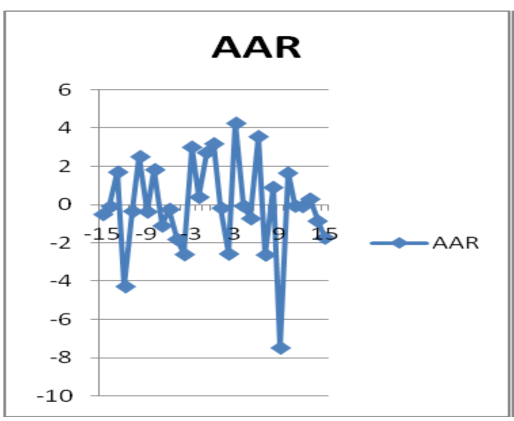
Figure 1.1: Year wise average abnormal returns of annual earnings announcements

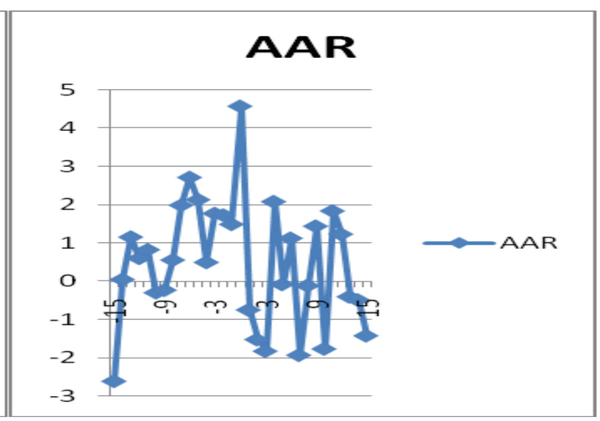
2004 **2006**



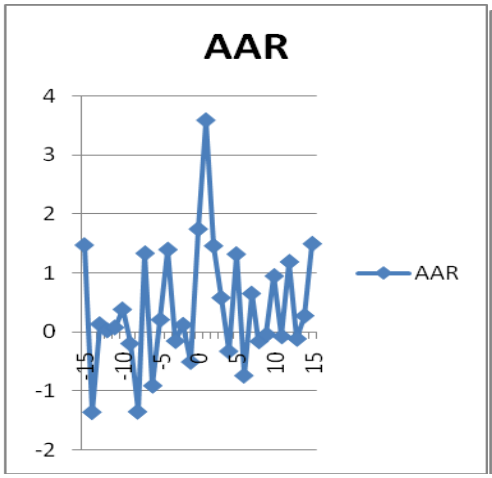


2007 **2008**

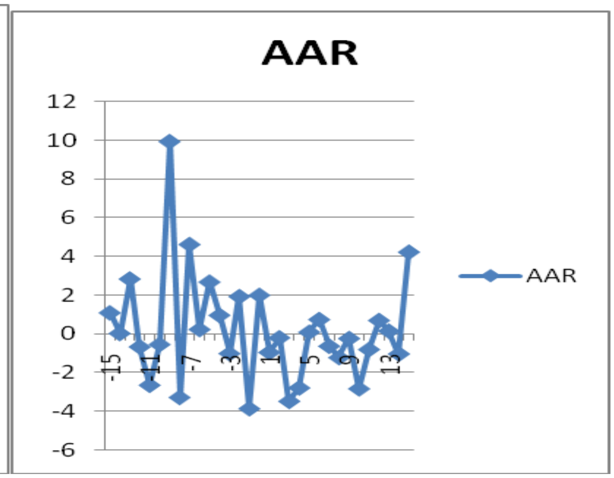




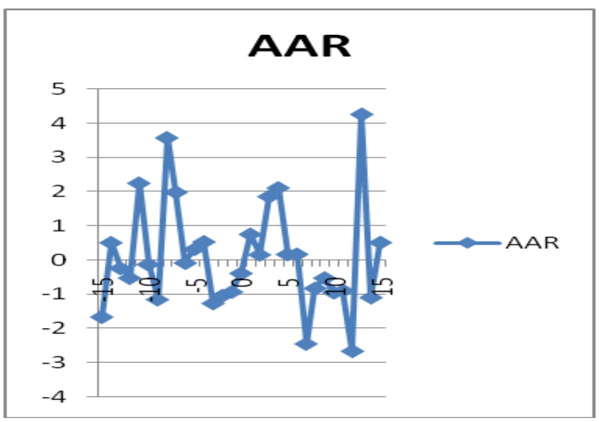
2009 **2010**



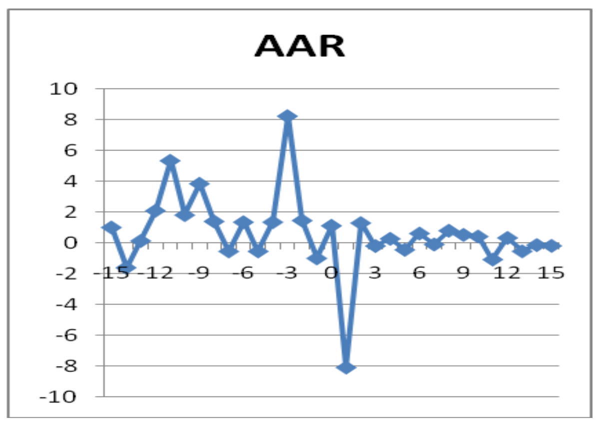
2011



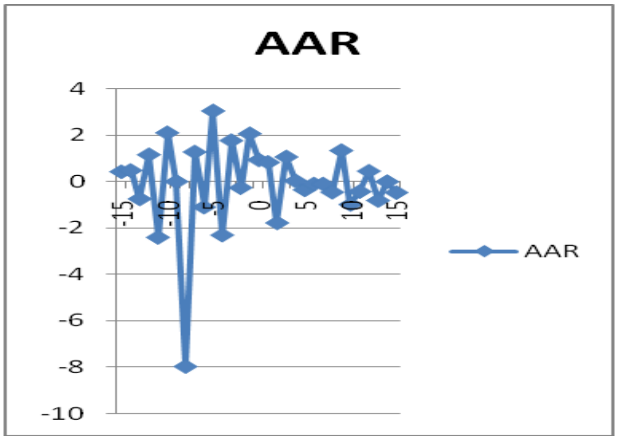
2012



2013



2014



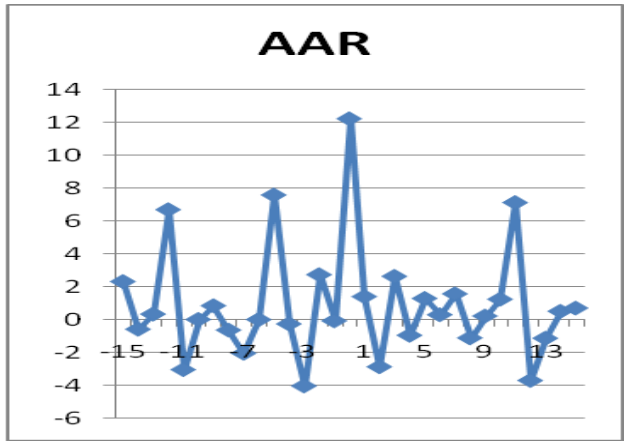


Figure 1.1 shows the graphical representation of year wise average abnormal returns of annual earnings announcements It has been seen that Average abnormal return (AARs) is fluctuating randomly prior to and post-announcement event period. Thus, inference can be made that the abnormal returns are showing an irregular trend due to earnings announcement. The figure indicates that for the 15 days before the announcement date, there is no consistent pattern of abnormal returns of companies engaging in quarterly earnings announcement in all of the years. It depicts that the maximum average abnormal return (AARs) is 12.2513 percent in 2014.

CONCLUSION

The stock price movements are attributed to various factors related to the economy, industry, company etc. It is impossible to forecast the share prices on the basis of economy-wise and industry-wise factors as it is quite difficult to obtain the quantitative data on these factors. Therefore, the various company performance variables have been considered to determine the equity price behavior. Management decisions and their compensations are often stated in terms of earning objectives. Investors, bankers and creditors assess the prospects of enterprises' net cash flows through forecasts of the future earnings based on present and past earnings. An evidence of significant abnormal returns has been found in these samples. This implies that the annual Earnings announcements have pre-return or post-return effects on the firms included in the Sensex. It may also be inferred that these announcements carry information value for investors. The index also reflects higher level of market efficiency where the influence of non-fundamental factors, which are largely behavioural, is the least. The annual Earnings announcements do have information relevant for the security valuation and market uses the information in general. The Indian capital market is able to capture the information contained in the annual Earnings announcements. Hence, it is efficient in the semi-strong form of Efficient Market Hypothesis. The pre-announcement reaction shows that market is able to capture the earnings information before its announcements.

The results show that the Indian Capital Market is semi strong efficient as it is using the information relevant for security valuation and for investment decision making. However, the reaction after the announcement shows that the Indian Capital Market is not perfectly efficient as abnormal returns have been observed both prior to and after the announcement. The role of SEBI can be instrumental in preventing insider trading so that the confidence of the investors is maintained and the stock market can become more vibrant and dynamic.

Recommendations and suggestions

From the foregoing analysis, the following suggestions have been made to make Indian capital market more efficient. It is a known fact that reliability of accounting information is important. The regulation of accounting norms and audit practices will improve the reliability of accounting information.. The larger the number of analysts, the more efficient will be the market. Thus, market efficiency depends upon the number of investors in the market, particularly the institutional investors and number of analysts. The existence of insider trading or information leakage can erode the confidence of investors in the instrument and may be viewed by them more as a tool to deceive than to benefit them. SEBI should mull over the listing rules, and suitable amendments are the need of the hour to prevent such practices.

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