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## Firm strategy and market reaction to earnings

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### ABSTRACT

We examine whether a firm's strategy affects the information content of the firm's earnings announcement. A cost leadership strategy is characterized by low sales margins coupled with large sales volumes, economies of scale and major investments in plant and physical assets, whereas a differentiation strategy involves high sales margins achieved through product quality and branding realized by investments in intangibles such as R&D and advertising. These characteristics of the strategies result in differential impact on investor reactions to new information that is revealed about firms. Our results show that firms pursuing a cost leadership strategy have earnings announcements that are more commonly interpreted and result in a greater change in the average belief about stock price. On the other hand, earnings announcements of firms pursuing a differentiation strategy result in more heterogeneous interpretation accompanied by a smaller change in the average belief about stock price. This paper advances our understanding of the cross-sectional variation in the market's reaction to earnings announcements. In addition, the paper demonstrates a predictable instance of divergence in the price reaction and trading volume reaction to an earnings announcement.

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### 1. Introduction

In this study, we examine the differential impacts of accounting earnings announcements on average and differential investor belief revision by examining the impact of firm strategy on the way investors revise their beliefs in response to earnings announcements. We use the stock price response during the earnings release window to examine how the earnings announcement impacts the average belief of the market about that particular firm. We then use the trading volume reaction to examine the impact on individual<sup>4</sup> investors' beliefs about that firm. Overall, our results indicate that a firm's strategy is an important determinant of the impact of the earnings announcement on investors' beliefs.

Strategies are the investment and operating choices made by firms to achieve a competitive advantage. Business strategy is unique to individual firms and strongly influences firm performance and information environment. Business strategy is key to a firm being more than just the sum of its parts (Porter, 1980). A firm's strategy does not change much over time (Hambrick, 1983) and hence, becomes a significant factor of its information environment (Bentley, Omer, & Twedt, 2014). Therefore, it offers a useful framework for better understanding cross sectional

variation in the information environment of the firm and the consequent variation in the impact of earnings announcements.

Drawing on the concept of generic strategies (Porter, 1980), we conceptualize strategy as a two dimensional space (cost leadership and differentiation) and the particular strategy pursued by a firm is, thus, based on the extent to which it pursues each of these strategic dimensions. We argue that investment decisions made by the firm in the pursuit of a particular strategy, financial accounting rules, voluntary disclosure, and coverage by information intermediaries all have differential impacts on the information environment of firms based on the strategies they pursue. This may, in turn, cause predictable cross sectional variation in the market response to new information contained in earnings announcements.

Two papers, so far, have examined aspects of this issue: Bentley et al. (2014) find that firms that invest significantly in R&D and other intangible assets (similar to differentiation firms), demonstrate lower information asymmetry between the firm and investors, and that this appears to be accomplished by greater voluntary disclosure and greater analyst following. Asdemir, Fernando, Schneible, and Tripathy (2014) examine the relation between firm strategy and analyst information more closely and show that the lower average analyst error for differentiators is accomplished via greater private information acquisition on the part of individual analysts. To date, no study has directly examined the impact of firm strategy on the role of accounting earnings in revising investors' beliefs.

Prior literature shows that markets react to earnings (Beaver, 1968). However, this reaction to earnings is contingent on the information environment: the average quality of prior information (Kim &

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<sup>4</sup> Throughout the paper we use individual in the sense of unique and not in the sense of retail.

Verrecchia, 1991) and the idiosyncratic information gathered by individual market participants (Barron, Harris, & Stanford, 2005; Kandel & Pearson, 1995; Kim & Verrecchia, 1991). In this paper, we argue that firm strategy is a key construct which influences all of the other factors that make up a firms' information environment: the firms' investment decisions, financial reporting, voluntary disclosure, following by information intermediaries and efforts by investors to gather private information (Bentley et al., 2014). We expect that firm strategy will impact the role that earnings announcements play in revising investor beliefs both on average and individually.

To evaluate our hypothesis, we first examine the impact of firm strategy on the price response to earnings announcements (using both earnings response coefficients and absolute stock price movement), as measures of the average change in belief, in response to (a) earnings, per se, and (b) to all information contained in the earnings announcement. Then, using abnormal trading volume as a measure of the differential belief revision due to the news in the earnings announcements (Bamber, Barron, & Stevens, 2011; Bamber & Cheon, 1995), we examine the impact of firm strategy on the extent of the differential belief revision caused by earnings announcements. We find greater price responses (both absolute abnormal returns and ERCs) and smaller trading volume responses to earnings announcements to the extent that a firm follows cost leadership strategies, and smaller absolute price responses and greater trading volume responses to the extent that a firm follows differentiation strategies.

This paper makes unique contributions to a well-established literature which uses market response to earnings announcements to understand the information environment of the firm, while providing additional insights on the news role played by earnings announcements. Whether and to what extent accounting earnings announcements provide new information to the market is an important and well-studied question (Bamber, Christensen, & Gaver, 2000; Beaver, 1968). New information contained in the earnings announcement leads individual investors to revise their beliefs about the value of the security. If these individual belief revisions change the average belief of the market, the average change is reflected in the price change. However, investors may differentially revise their beliefs (Kandel & Pearson, 1995; Kim & Verrecchia, 1991). In this case, price change might mask the full extent of individual investor belief revision because it measures only the average effect of those belief revisions. Thus, "trading in response to a financial disclosure arguably provides the most direct evidence that the disclosure has affected individual investors' expectations and investment decisions" (Bamber et al., 2011, 432).

Therefore, our first contribution is to highlight the differential reaction of price and trading volume to information contained in the same information event. Many papers have used price and trading volume response as different, but complementary measures of the information content of an earnings announcement (Beaver, 1968). Kim and Verrecchia (1991) theoretically show that trading volume and price reactions are correlated and this has been empirically confirmed by Atiase and Bamber (1994); Bailey, Li, Mao, and Zhong (2003) and Hope, Thomas, and Winterbotham (2009), among others. However, although prior research (Bamber & Cheon, 1995) shows that these two measures will capture different aspects of the news content, we believe ours is the first paper to demonstrate this predictable (opposing) cross sectional variation in the type of belief revision caused by the news content of earnings announcements. By highlighting the differential (and opposing) reactions of price and volume, we demonstrate the necessity of evaluating both price and trading volume reactions simultaneously to provide a more complete picture of how earnings announcements affect the beliefs of investors.

Second, we contribute to the recent discussion on the information content of earnings. Based primarily on tests of price response to earnings announcements, some recent research has cast doubt on the idea that earnings announcements provide significant new information to the market (Ball & Shivakumar, 2008; Ball 2013). Others, relying

primarily on trading volume tests, have argued that while it may have little effect on the market average, the importance of earnings announcements in bringing new information to individual investors and, thus, resolving investor disagreement is increasing over time (Barron, Schneible and Stevens 2015).

What has heretofore not been fully investigated is whether these two informational roles of accounting might vary cross-sectionally in a predictable manner. Relying on insights from the strategy literature, we are able to predict and present unique evidence that the informational role filled by accounting earnings announcements does vary cross-sectionally in a predictable manner. This result is useful in confirming our theoretical understanding that these two informational effects, average belief revision and differential belief revision, are distinct. Moreover, it suggests that averaging the market response, be it price change or trading volume, to accounting earnings announcements across firms is likely to understate the informational role of the announcements if the announcements are only fulfilling one of the two informational roles for some firms.

Our results also have practical implications. In making decisions about what accounting policies will lead to more useful accounting figures, policymakers may want to consider the different informational roles of accounting earnings announcements and the types of firms for which each is more important.

Finally, as in Balsam, Fernando, and Tripathy (2011), Asdemir, Fernando, and Tripathy (2013), and Schneible (in press), this paper also extends the strategy literature by demonstrating the usefulness of accounting measures for a descriptive evaluation of firm-level strategies.

The rest of the paper is organized as follows. Section 2 contains the literature review and hypotheses development and Section 3 contains the data description and methodology. Section 4 provides the empirical analysis and Section 5 contains a sensitivity analysis of our results. Finally, Section 6 discusses our findings and presents the conclusions.

## 2. Literature review and hypotheses development

### 2.1. Firm strategy

According to the framework presented in Porter (1980), a firm can achieve competitive advantage by following either of two generic strategies: differentiation or cost leadership. Based on this framework, a firm that successfully implements differentiation or cost leadership strategies will be able to effectively compete in the marketplace. Porter's framework is used extensively in academia and in practice to evaluate issues relating to strategic orientation in firms (see for example, Porter, 1985; Miller & Dess, 1993; Allen, 2007; Balsam et al., 2011).

Firms pursue a cost leadership strategy by producing goods or services at a lower cost compared to their competitors (Asdemir et al., 2013). The intuition is that price-conscious customers will prefer a low-cost product, enabling the lower cost producer to gain market share at the expense of competitors. Thus, the firm pursuing a cost leadership strategy will generate superior performance by achieving large sales volumes. Hence, a cost leadership strategy is a trade-off between low margins and high turnover. Some of the methods of achieving a cost leadership strategy are large production volumes to achieve economies of scale, continuous emphasis on process improvements and cost reduction (often through adherence to total quality management and 'kaizen' techniques) (Asdemir et al., 2013).

Cost leadership is reflected in the investments a firm makes. An efficient firm will keep capital expenditures and capital intensity relatively low (David, Hwang, Pei, & Reneau, 2002; Hambrick, 1983; Hambrick, MacMillan, & Day, 1982; Miller & Dess, 1993; Prescott, 1986) and work toward efficient utilization of the firm's resources by its employees (Nair & Filer, 2003).

A differentiation strategy involves making a strong distinction between a firm's products compared to its peers. The distinction may

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