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# The relationship between returns and unexpected earnings: A global analysis by accounting regimes

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**Abstract**

Numerous studies have documented a long-term association between earnings and returns. Surprisingly, few attempts have been made to internationally examine market reactions to earnings releases over return windows less than 12 months. This paper globally explores the market reaction to unexpected earnings defined by both the change in earnings per share (EPS) and analyst forecast errors (AFE) using a 1-month return window. First, the existence of the earnings–returns relationship is examined using a sample of firms from 32 countries grouped into accounting regimes. Accounting regimes represent groups of countries that exhibit similarities in accounting standards, stock market characteristics, corporate governance mechanisms, and economic conditions. Thus, similar reactions to earnings are expected within regimes. Next, the incremental information content of analyst forecasts, a proxy for investors' earnings expectations, is examined. Finally, changes in the structure of the earnings–returns relationship over time are investigated. Results support the existence of a relationship between earnings and returns in all accounting regimes. In addition, analyst forecast errors appear to be incorporated into earnings expectations in most developed countries. Finally, evidence suggests that the significance and explanatory power in the earnings–returns relationship has increased in recent years.


*Keywords:* Capital markets; Earnings–returns relationship; International accounting

## 1. Introduction

Assessing the usefulness of financial information has become a primary goal of accounting research. In this study, I use the earnings–returns relationship to examine the usefulness of earnings in an international setting. Specifically, this paper globally examines the monthly market reaction to unexpected earnings defined by both change in earnings per share (CEPS) and analyst forecast

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errors (AFE). It adds to prior literature in two ways. First, the incremental explanatory power of AFE versus the change in EPS is internationally explored. Given the documented superiority of analyst earnings forecasts over other earnings estimates, efficient investors will likely incorporate analyst forecasts into earnings expectations.[1] The degree that analyst forecasts are incorporated into earnings expectations is measured by the strength of the relationship between analyst forecast errors and returns around the earnings announcement. The use of analyst forecasts as proxies for earnings expectations provides some insight into the process investors use in forming earnings expectations.

The next contribution of this paper is the international examination of the stability of the earnings–returns relationship over time. Though research in the U.S. has examined changes in the earnings–returns relationship across time to determine if there have been variations in the value relevance of accounting information (e.g., Francis & Schipper, 1999), little international research addresses this issue. This is an interesting issue because there have arguably been greater changes in factors that may impact the earnings–returns relationship outside the U.S. (e.g., quality of accounting information, characteristics of capital markets, access to financial and non-financial information) as compared to the changes that have occurred within the U.S. I extend this research to an international setting to determine if there have been changes in the value-relevance of earnings and the information content of analyst forecast errors.[2]

The results of analyses using data from the entire time period pooled by accounting regimes reveal a significant market reaction to the announcement of earnings (either AFE or CEPS) in all regimes. This indicates that investors view accounting information as value relevant and react when earnings do not meet expectations. In addition, analyst forecast errors appear to have incremental explanatory power over the change in EPS in most regimes. This suggests that investors around the world act efficiently to incorporate analyst earnings forecasts into earnings expectations. Results of the multi-period analysis reveal a trend toward increased significance of the reaction to the earnings release. This implies that in recent years, investors are more likely to react to the release of earnings. In addition, the results suggest that investors are more likely to incorporate analyst forecasts into earnings estimates in recent years.

The results of this study are likely to be of interest to researchers, investors, and educators. The analysis suggests that there has been an increase in the market reaction to the release of earnings. New research aimed at identifying factors which have driven this change would contribute to the literature. Investors can use the understanding of how market earnings expectations are formed to improve investment decisions. The increase in significance of earnings and/or analyst forecasts in recent time periods may be partially caused by improvements in accounting standards. If so, such standards improvements may provide guidance to less developed countries attempting to develop accounting standards. Educators could integrate the results of this paper in upper level or graduate accounting classes.

[1] Analyst forecasts of earnings have been shown to be more accurate than time-series estimates of earnings (Brown, Hagerman, Griffin, & Zmijewski, 1987a). In addition, analyst forecasts of earnings explain greater abnormal returns around earnings announcements in the U.S. than other proxies for market expectations of earnings (Brown, Hagerman, Griffin, & Zmijewski, 1987b). Analytical research shows that analyst forecasts serve as a reasonable proxy for investor beliefs with error (Abarbanell, Lanen, & Verrecchia, 1995).

[2] Prior literature has not used analyst earnings forecasts because it has not been widely available until recent years (see Meek & Thomas, 2004 for a discussion of this issue).