INCREASING EARNINGS FIRMS AND THEIR CHARACTERISTICS: EVIDENCE FROM THE TAIWAN STOCK MARKET

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ABSTRACT

Barth et al. (1999) show that increasing earnings firms in the U.S. have higher price-earnings multiple. This study investigates the applicability of their results to Taiwan's stock market, which has different institutional and investor characteristics. Results consistently show that earnings of increasing earnings firms have higher persistence than those of other firms. Forward stepwise discriminant analysis is also performed to examine the differences in firm characteristics. Increasing earnings firms tend to have higher market value of equity to book value of debt, and sales to total assets ratios.

INTRODUCTION

The goals of U.S. corporations are usually articulated by their CEOs in the management discussion section of their annual reports. The most common one is annual growth in earnings per share (Loomis, 2001).[1] Empirical evidence also shows that, in examining the cross-sectional distributions of corporate

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earnings changes, there are unusually high frequencies of small increases in earnings (Burgstahler & Dichev, 1997).

Reasons for maintaining steady increase in annual earnings are conjectured both in the financial press and by academicians. Wall Street portfolio managers and analysts generally believe that there is a persistent linkage between increasing earnings expectations and increasing stock prices, i.e. increasing stock prices are driven by increasing earnings (Garcia, 1986; Picker, 1994; Weil, 1999; Zweig, 1995).[2] Academicians have two different interpretations of the increasing earnings phenomenon (Burgstahler & Dichev, 1997). The first is based on the theory of human information processing heuristics: CEOs want to avoid the costs imposed in transactions with stakeholders, assuming the stakeholders' decisions are based on a heuristic of non-decrease in earnings. The second is based on prospect theory: CEOs achieve the highest gains in utility when moving from a loss to a gain in earnings changes (see Kahneman & Tversky, 1979).

To date, no empirical studies have been done to validate Burgstahler and Dichev's (1997) explanations, and very limited evidence has been provided to validate Wall Street's conjecture. DeAngelo et al. (1996) show that their sample firms experience an average of 14% negative abnormal return in the year when the pattern of consistent earnings growth is broken. Thus, their results indirectly support the notion that increasing stock prices are driven by increasing earnings. Erickson and Wang (1999) show that acquiring firms in their sample attempt and are successful to increase stock prices by increasing earnings prior to stock merger. Thus, their results indicate that increase in earnings can lead to increase in stock prices.

Barth et al. (1999) is the first empirical study to directly examine the association between stock prices and a pattern of increasing earnings. They study the difference in market rewards toward firms with patterns of increasing earnings, relative to firms without such a pattern of increasing earnings in the U.S.. They have found that firms with patterns of increasing earnings do have a significantly higher price-earnings multiple, i.e. a higher regression coefficient when regressing prices on earnings. Their result seems to confirm Wall Street's belief in the significance of increasing earnings.

The results presented in Barth et al. (1999) show that earnings and increasing earnings are important for investors in the U.S.. The importance of earnings and increasing earnings, however, may be varied in other stock markets that possess different institutional and investor characteristics such as Taiwan's stock market (Chu, 1997; Flannery, 1991). Previous empirical studies on the association between stock prices and accounting information in the Taiwan Stock Exchange do present results that are similar to and different from those of the

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