The Pricing of Earnings

Essays on the Post-Earnings Announcement Drift and Earnings Quality Risk

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This dissertation is concerned with the relationship between accounting earnings and stock prices. It consists of three empirical papers, all using a sample of firms listed on the Stockholm Stock Exchange (1990-2008). The first paper documents the existence of a drift in stock prices subsequent to quarterly earnings announcements. Two interesting empirical observations are that the drift is only significant for longer holding periods and that the drift on the short position, i.e. after bad earnings news, is negligible. The lack of downward drift on the short position is interpreted as an indication of the post-earnings announcement drift, at least partly, being explained by investors demanding a compensation for a risk factor that is omitted in the test design.

The second paper illustrates under what conditions information risk in the earnings signal might explain a low announcement reaction and a price drift in the post-announcement period. It is hypothesized that two earnings signals – based either on GAAP earnings or core earnings – have different levels of information uncertainty with respect to how they depict the value creation of the firm. In the empirical sections, it is concluded that the low immediate announcement reaction and high post-announcement drift for the GAAP earnings signal is due to this signal being perceived by investors as containing more uncertainty than the core earnings signal. It is argued that this uncertainty might be due to GAAP earnings encompassing items that prior research has shown more likely to be manipulated and/or to contain estimation error.

The positive association between information risk and expected return is further investigated in the third paper, where information risk is measured by earnings quality metrics. Using a new approach to estimate the implied cost of capital, it is found that Swedish investors demand a higher expected return for firms with poor earnings quality, i.e. firms associated with higher information risk.

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