What happens when companies announce an earnings delay?

Several securities class actions over the past decade have featured announcements of earnings delays as alleged corrective disclosures. Figure 1 shows a selection of securities class actions involving earnings delay announcements associated with significant stock price reactions. Despite their potential relevance to securities litigation, earnings delay announcements have not been studied empirically. Our research fills this research void. We document a significant negative stock price reaction, on average, to companies that announce an earnings delay. In addition, we show that this reaction is likely due to an expectation on the part of investors of deteriorating future financial performance.

Figure 1: Selected securities class actions involving earnings delay announcements

<table>
<thead>
<tr>
<th>Company</th>
<th>Stock return on delay announcement date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interpublic</td>
<td>-24%</td>
</tr>
<tr>
<td>Nortel Networks</td>
<td>-28%</td>
</tr>
<tr>
<td>Peregrine Systems</td>
<td>-50%</td>
</tr>
<tr>
<td>Refco</td>
<td>-45%</td>
</tr>
<tr>
<td>Reliant Resources</td>
<td>-14%</td>
</tr>
<tr>
<td>Sonus Networks</td>
<td>-10%</td>
</tr>
</tbody>
</table>

Searching electronic databases of press releases and newswires, we identified a sample of 449 earnings delay announcements over the 12-year period between 1995 and 2006 made by companies trading on a US stock exchange. Given the number of US public companies, each making four quarterly earnings announcements per year, our first observation is that earnings delay announcements occur relatively infrequently. Even for companies in our sample, the average number of earnings delay announcements is only one.
Although fairly uncommon, earnings delay announcements have become more frequent over time. As Figure 2 shows, 49% of the delay announcements we identify occur between 2004 and 2006. In terms of their occurrence throughout the year, earnings delay announcements tend to be concentrated in the months of January to March, with the majority of these delays relating to the reporting of fourth-quarter earnings. As Figure 3 shows, 47% of the delay announcements we identify occur during this three-month period.

In approximately 60% of our sample where a delay is related to an incomplete accounting process (e.g., audit not yet completed) or specific accounting issue (e.g., revenue recognition, inventory accounting, impairment testing), the average stock market reaction ranges between -7.5% and -9.0%. In roughly 25% of our sample where a delay is attributed to a business event (e.g., merger), the stock market reaction averages only -3.9%. An accounting rule change or other relatively innocuous reason for delay, such as bad weather, is offered in approximately 10% of our sample. These reasons do produce statistically significant average announcement stock returns. In roughly 5% of our sample where companies do not provide a reason for delay, the stock market reaction averages -10.3%. This last finding is consistent with investors assuming the worst in the absence of any specific information to the contrary.

Consistent with investors’ negative reaction to earnings delay announcements, we also find that companies making such announcements tend to experience subsequent earnings declines. Figure 5 shows that when our sample companies eventually announced the delayed quarter’s earnings per share (EPS), the results were 2.8% lower, on average, than EPS in the same quarter of the prior year. Annual results

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1 All earnings per share figures are presented as a percentage of stock price on the day before the earnings delay announcement.
post an even steeper average decline: 5.5% lower EPS in the year of the delay versus the prior year. This decline also persists into the next year with annual EPS in the year after the delay 4.0% lower, on average, than the year before the delay. Lastly, our research shows that worse stock price reactions at the time of the earnings delay announcement in Figure 4 are generally associated with worse future financial performance in Figure 5. This last finding suggests that investors, unless told otherwise, interpret earnings delay announcements as having negative consequences for earnings and that investors’ expectations are generally realized.

Figure 5: Changes in EPS around earnings delay announcements

Where securities class actions involve earnings delay announcements, our research suggests evaluation of the facts and circumstances on a case-by-case basis will be required to assess the effect of a particular earnings delay announcement with respect to the issues of loss causation or damages.

This research was conducted in collaboration with Huijing Fu at Texas Christian University and K. Ramesh at Rice University.

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