Transformation Indicators, Earnings Persistence, Volatility and Forecast Errors

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Abstract

Transformational changes in an organization often require different stakeholders to perceive a sense of crisis to have them all agree on shared sacrifices to bring about change. We define transformation indicators to be financial measures such as loss, sales decline, earnings decline, and negative cash flow from operations that indicate unsatisfactory business performance, establish a perception of urgency, and thus trigger organizational changes such as abandoning underperforming businesses and modifying operating processes. In this study, we examine whether a firm's earnings generating process changes *following* the occurrence of transformation indicators. We hypothesize and find that earnings persistence decreases and earnings volatility increases in the year following the reporting of transformation indicators. We further study whether the changes in earnings generating process impact financial market participants' forecast and interpretation of future earnings. We find earnings response coefficient decreases in the year after the reporting of transformation indicators, which suggests that investors recognize the decrease in earnings persistence and hence react to earnings less aggressively. We also find that both analyst forecast errors and managerial forecast errors increase in the period after the reporting of transformation indicators, which suggests that the uncertainty in earnings generating process caused by organizational changes lead to additional difficulty in forecasting earnings.

Speaker Profile

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