

Earnings Volatility and Earnings Predictability

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Abstract : Most previous research that investigates the importance of earnings volatility for a firm's value has focused on the effects of earnings volatility on the cost of capital. Many study illustrate that earnings volatility can reduce the firm's value by enhancing the cost of capital. However, a few recent studies directly examine the relation between earnings volatility and subsequent earnings levels. In our study, we further explore the role of volatility in forecasting. Our study makes two primary contributions to the literature. First, taking into account the level of current firm's performance, we provide causal theory to the link between volatility and earnings predictability. Nevertheless, previous studies testing the linearity of this relationship have not mentioned any underlying theory. Secondly, our study contributes to the vast body of fundamental analysis research that identifies a set of variables that improve valuation, by showing that earnings volatility affects the estimation of future earnings. Projections of earnings are used by valuation research and practice to derive estimates of firm value. Since we want to examine the impact of volatility on earnings predictability, we sort the sample into three portfolios according to the level of their earnings volatility in ascending order. For each quintile, we present the predictability coefficient. In a second test, each of these portfolios is, then, sorted into three further quintiles based on their level of current earnings. These yield nine quintiles. So we can observe whether volatility strongly predicts decreases on earnings predictability only for highest quintile of earnings. In general, we find that earnings volatility has an inverse relationship with earnings predictability. Our results also show that the sensibility of earnings predictability to ex-ante volatility is more pronounced among profitability firms. The findings are most consistent with overinvestment and persistence explanations.

Keywords : earnings volatility, earnings predictability, earnings persistence, current profitability

Conference Title : ICAF 2015 : International Conference on Accounting and Finance

Conference Location : Amsterdam, Netherlands

Conference Dates : May 14-15, 2015