Study finds when companies announce earnings surprises, locals reach for their pocketbooks

June 19 2024

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Corporate earnings announcements are more than just powerful signals to those in the know. After all, it might be expected that sophisticated investors and employees of public companies closely watch news that directly affects their personal wealth. But surprising news about corporate earnings also affects the communities that surround a company, three Stanford Graduate School of Business accounting professors find in a new paper.

"When ordinary people see a local firm performing well, they infer that there's going to be more local investment," says Suzie Noh, an assistant professor of accounting at Stanford Graduate School of Business, who coauthored the paper with her Stanford colleagues Brandon Gipper and Jinhwan Kim, along with Laura Lingyu Gu, a a former research fellow at Stanford GSB and a Ph.D. student at the University of Chicago Booth School of Business. "In other words, local people believe they could also grow wealthier."

The paper is published in the *SSRN Electronic Journal*.

People see local news of a company's higher-than-expected profits and talk about it with family members and neighbors. Word quickly gets around that a company may be hiring more people or investing more in local businesses than expected. Conversely, bad news suggests that it may be planning layoffs and cost-cutting measures.

"Earnings news could be like a proxy for other types of relevant news, like people's employment prospects or policies that might be implemented in a local area that could affect people's pocketbooks," says Kim, an associate professor of accounting. When that news is surprising, the effect is even more salient to people's decision-making.

The upside of surprise

The information from an unexpectedly positive or negative earnings announcement causes people to spend significantly more or less, the researchers found. And that matters a great deal in a country like the United States, where consumer spending accounts for 68% of all economic activity.

The authors looked at multiple sources of proprietary local consumption data, including transaction-level data from a financial software supplier to five of the top 10 banks in the U.S. They checked that data against anonymized Mastercard credit card data from hundreds of millions of accounts. They were able to discern changes in spending in the area surrounding a company's headquarters after an earnings surprise.

The researchers found that the cumulative effects of changes in spending were long-lasting, extending up to 15 months or more after an announcement.

When people see external signals that things are going well, they tend to splurge on the little things, like eating out and entertainment. Likewise, when things are going worse than expected, they tighten their belts. However, they don't rush out and buy a car or cash in their retirement portfolios based on a single earnings announcement.

Strong earnings surprises have the biggest impact on communities where a single employer dominates the local economy, such as "company towns" like Benton Harbor, Michigan, where Whirlpool is headquartered.

To corroborate their findings, the researchers conducted a nationwide survey of 500 households. Most survey respondents reported getting news about companies through online outlets, social media, or word of mouth.

Nearly 50% said that financial news about local firms influenced their spending decisions because they expected greater job or investment opportunities. On average, people said they spent 3% more after hearing exceptionally good news and spent 7% less after hearing exceptionally bad news.

Compared to those with higher incomes, increases in spending were 60% larger among people with lower incomes following unexpectedly good earnings news, and drops in spending were 85% larger after surprisingly bad news. Low-income people typically spend a larger share of what they make on daily living expenses than people with high incomes, who save more.

The downside of fraud

The researchers discovered that consumers also react quickly following the revelation of fraudulent earnings. "After a fraud is announced, all of a sudden people start to pull back quite a bit," says Gipper, an associate professor of accounting at Stanford GSB. "The spillover effect from fraud announcements similarly seems to change ordinary people's behavior."

People sharply lower their spending once they realize past earnings reports were inflated. In effect, they rein in discretionary spending once they learn they've overspent. For example, when WorldCom announced it had fraudulently overstated its assets in 2002 by more than $11 billion, economic activity plunged in its hometown of Clinton, Mississippi.

The takeaway: Corporate governance and transparency affects more than investors and employees. It matters to the pocketbooks of everyday consumers. "Corporations might not fully internalize how their actions affect local households," Kim says. "Being transparent and not engaging in fraudulent activity is another kind of responsible act."

More information: Brandon Gipper et al, Earnings News and Local Household Spending, *SSRN Electronic Journal* (2024). DOI: 10.2139/ssrn.4727285

Provided by Stanford University