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LACK OF TIMELINESS AS AN EXPLANATION OF THE LOW CONTEMPORANEOUS RETURNS-EARNINGS ASSOCIATION

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ABSTRACT

This paper empirically tests whether the low contemporaneous returns-earnings association set by previous empirical researches may be explained by lack of timeliness of accounting numbers. It hypothesises that if the criteria for accounting recognition yield a multi-period lag in earnings recognitions of economic events and if these events affect an informed market immediately when they occur, then future periods' earnings would have explanatory power for current returns as well as current earnings. To assess the significance of future earnings as an explanatory variable for stock returns we regress at first step annual returns on current earnings and at second step, annual returns on current earnings and successively next period and next two periods' earnings. Results show that future earnings continue to explain current returns. The evidence is characteristic of a substantial recognition lag in earnings that extends to the immediate next period. However, over one year, earnings do not seem reflecting any relevant economic event impounded in security prices at previous period. The earnings recognition lag seems to decrease after one year.

Keywords: Value-relevance, Accounting earnings, Lack of timeliness.

INTRODUCTION

Accounting recognition is "the process of formally recording or incorporating an item in the accounts and financial statements of an entity" (FASB 1980, SFAC N^o. 3 par. 83)¹. Most accounting standards have strict requirements regarding "recognition and measurement concepts" including reliability, objectivity, verifiability, realisability, matching, and conservatism. Application of these concepts tends however to delay recognition when there is uncertainty about either measurement or completion of transactions and events and so cause earnings to exhibit a recognition lag.

In an informed market, economic events are recognised immediately when they occur. Thus value-relevant events trigger immediate revisions in the market's expectations of future earnings, and hence immediate price changes. While earnings recognition must await compliance with formal accounting recognition criteria, then earnings will capture only a weak proportion of the information incorporated in security prices.

¹ Cited by Warfield and Wild (1992), p 823.

The extensive literature since Ball and Brown (1968) focusing on the contemporaneous relation between earnings and returns demonstrates a clear statistical association, but low explanatory power of earnings for security price variations. Many theoretical and empirical researches suggest that lack of timeliness for accounting numbers may be an explanation for this phenomenon.

The delay in accounting recognition of economic phenomena affects earnings in two ways (1) earnings recognizes the effects of certain prior periods' economic events in the current period and (2) earnings does not recognize the effects of all contemporaneous economic events until future periods. The latter suggestion implies that an inclusion of future periods' earnings in the returns-earnings relation should be significant.

This paper empirically tests whether the low contemporaneous returns-earnings association may be explained by lack of timeliness of accounting numbers. If earnings lack of timeliness, then a non-contemporaneous returns-earnings association is expected. That is current returns should well be explained by economic events reflected in future earnings. Empirically, we capture the non-contemporaneous returns-earnings association due to

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lack of timeliness of earnings by including future earnings in the returns-earnings regression model.

Results of regression models using Tunisian stock market data between 1997 and 2011 provide evidence consistent with a statically significant relation between annual returns and current earnings. They tend also to confirm the very low explanatory power earnings have regarding security price variation documented by many previous empirical researches. Indeed current earnings explanatory power to annual returns doesn't exceed 9 percent which means that annual earnings capture only a week proportion of the information incorporated in security prices. Results also provide evidence that the correlation between earnings and returns improves by the inclusion of next period and next two periods' earnings. Adjusted *R-squares* passes respectively to 9.6 percent and 9.9 percent.

However, the evidence is characteristic of a significant recognition lag in earnings that extends only to one year. Indeed next period's earnings as well as current earnings present positive and statistically different from zero response coefficient (ERC) that substantiate the inference that some economic events affecting the market throughout the year are recognized with lag in next period's earnings. For next two periods, non-significant response coefficient associated to future earnings means that recognition lag seem to cancel after one year.

The remainder of the paper is organized as follows: section 2 provides literature review and present motivation for empirical tests. Section 3 describes research design, section 4 presents and analyses the empirical results and section 5 provides summary and conclusions.

LITERATURE REVIEW AND MOTIVATION FOR EMPIRICAL TESTS

One of the major objectives of financial accounting is to provide equity investors with information relevant for estimating firm value. Value-relevance research tends to empirically analyses whether this goal is met. Do investors use accounting data to assess firm value, or do they obtain the information they need from other sources? An extensive literature since the seminal work by Ball and Brown (1968) tends to answer large numbers features of this question. This literature is commonly known as the value-relevance literature.

Consistent with Francis and Schipper (1999), we define value-relevance as the ability of financial statement information to capture and summarize

information that determines the firm's value. Value-relevance research does not focus on how accounting information is used in valuation; instead, this line of research asks if accounting information is able to explain variations in stock prices over time and/or between companies.

Empirically, researchers assess value-relevance of accounting data via the estimation of a regression model that assumes a linear relationship between annual returns and accounting signal. A significant relationship means that accounting data may be a good summary measure of the events incorporated in security prices and thus it is value-relevant because its use might provide a value of the firm that is close to its market value (Dumontier and Raffournier, 2002). The metric of interest has been generally bottom-line earnings.

The relation between earnings and contemporaneous security returns has been analyzed with data from US, most European, Japanese and Chinese stock exchanges. Researches generally use annual return windows to examine the extent to which earnings of the reporting period reflect the information used by the market in forming prices during that period. Results of empirical analyses have been 'disappointing' in the sense of unimpressive correlations between returns and earnings. Even if coefficients obtained by regressing returns on earnings are statistically significant, regression *R-square* that measures the strength of the association, ranges on average between 5 percent and 20 percent¹.

The low returns-earnings relation imply that reported earnings do not provide good summary measure of the value-relevant events that have been reflected in stock prices during the reporting period and that earnings capture only a week proportion of the information incorporated in security prices.

Many explanations for the weak statistical relation have been put forward in prior research. In a review of the value-relevance literature, Beisland (2009) make a list of these explanations including low earnings persistence (Kormendi and Lipe (1987), Dechow (2006)), a lack of timeliness of earnings due to strict requirements regarding objectivity and verifiability of accounting numbers (Collins et al. (1994)),

¹ See reviews of the value-relevance literature made by Lev (1989), Dumontier and Raffournier (2002) and Leif Atle Beisland (2009).

conservative accounting (Basu (1997), Penman and Xiao-Jun (2002)), misspecification of statistical models (Freeman and Tse (1992), Easton and Harris (1991), Jing and Thomas (2000), Beaver et al. (1997)), inadequately short measurement intervals for returns and earnings (Easton et al. (1992)), aggregation of earnings items (Bart et al. (2001), Ohlson and Penman (1992), Thomas (1999)) and earnings management (Marquardt and Wiedman (2004), Christensen et al. (1999)).

Several studies have assessed empirically the impact of earnings' lack of timeliness on the returns-earnings relation. The basic idea behind these studies is that "information included in stock prices is often richer than the one reflected by earnings because investors focus on all events that affect expected future cash flows, while earnings incorporate only those that have met the conditions for accounting recognition. Since relevant events that are not captured in contemporaneous earnings should normally be captured in subsequent periods, there should be a lag in the inclusion of new information into earnings, and stock prices should be more prompt than earnings in reflecting new information. This recognition lag causes both an errors-in-variable problem and an omitted variable problem because earnings do not reflect some information captured in current returns, whereas they reflect some information that was captured in prior returns. Since this lag is potentially negatively correlated with earnings, *R-squares* of regressions of current returns with contemporaneous earnings are biased toward zero"².

To correct for this lag effect, Dumontier and Labelle (1998), Easton et al. (1992) and Warfield and Wild (1992) have expanded both the returns and earnings windows by regressing multiple-year-returns on multiple-year earnings. They hypothesize that for shorter reporting periods, earnings measurements are predictably more sensitive to recognition criteria, and hence, exhibit substantial recognition lag. Thus the correlation between returns and earnings will increase if one looks at long-term data. Their results show that if return intervals are expanded and earnings are aggregated over longer time intervals, the returns-earnings association improves dramatically. The empirical evaluation of this hypothesis yields impressive and consistent results. Thus, Dumontier and

Labelle (1998) obtained average R^2 that ranges from 15 percent for a one-year interval to 28 percent for a two-year interval and 39 percent for a five-year interval. Easton et al. (1992) findings show that (i) for a ten-year return interval the market and earnings variables have an R^2 off approximately 63 percent and (ii) as expected, this correlation decreases when decreasing the return interval period. R^2 falls to 33 percent for five-year return interval and it decreases even further to 15 percent and 5 percent respectively for two and one-year return periods. Warfield and Wild (1992) show that the explanatory power of earnings for returns in quarterly periods is about one-fourth that for semiannual periods, less than one-tenth that for annual periods, and less than one-thirtieth that for two-year periods. Moreover, the explanatory power of the regression when using quarterly earnings is less than 1 percent, but exceeds 39 percent when using four-year earnings and returns. Moreover these authors present evidence that earnings lag current returns for several future periods. In certain instances, the recognition lag is of such magnitude that the explanatory power of future periods' earnings for current returns more than triples that of current earnings. For example, with quarterly reporting periods, the inclusion of future periods' quarterly earnings increases the adjusted R^2 of the returns-earnings relation by more than 400 percent. With annual reporting periods, R^2 jumps from 5.41 percent to 16.20 percent when including next two periods' earnings. In the same vein and consistent with Warfield and Wild's findings, Collins et al. 1994 show that the explanatory power of the contemporaneous returns-earnings model that don't exceed 15 percent, increases roughly to 35-50 percent when adding future realized earnings. These evidences are consistent with a substantial lag in accounting recognition of economic events that spans a number of reporting periods. Further results reported by Warfield and Wild (1992) emphasizes the significant role that accounting recognition plays in determining earnings' explanatory power for returns. Thus they show that, when earnings measurements are less sensitive to accounting recognition criteria, earnings have greater explanatory power for returns. For example, with biennial reporting periods, current earnings' explanatory power for current returns exceeds 50 percent for companies whose earnings measurements are less sensitive to accounting recognition criteria, but is less than 20 percent for companies more sensitive to these criteria.

² Dumontier and Raffournier (2002), p 132.

Using a sample of Swiss firms, Cormier et al. 2000 regressed the market returns not only on contemporaneous and following year earnings but also on the previous year earnings. Their results indicate that lead, lag and contemporaneous earnings are all significantly related to returns. Moreover, when lead and lag earnings are added to contemporaneous earnings as explanatory variables for returns, R^2 strongly increase from 37 percent to 52 percent.

RESEARCH DESIGN

Hypotheses development: This paper empirically tests whether the low contemporaneous returns-earnings association can be explained by earnings' lack of timeliness.

Earnings' lack of timeliness originates from a delay in accounting recognition of economic phenomena due to application of generally accepted accounting principles. This delay affects earnings in two ways (i) earnings recognizes the effects of certain prior periods' economic events in the current period and (ii) earnings does not recognize the effects of all contemporaneous economic events until future periods. Our empirical analysis concerns the second issue.

Building upon previous empirical studies³, our premise regarding accounting recognition lag is that earnings contains both value-relevant and value-irrelevant information for explaining current returns, and the value-irrelevant component consists of information that was recognized in prior periods' returns. In conformance with this premise we hypothesize that, if the criteria for accounting recognition yield a multi-period lag in earnings recognition of economic phenomena, then future periods' earnings possess explanatory power for current returns.

Our hypotheses are twofold. At first step, we address the commonly tested hypothesis relating to the value-relevance of earnings. If annual earnings are value-relevant so they can explain security price changes. Econometrically, this hypothesis translates into a higher earnings response coefficient and explanatory power of earnings for price changes due to the fact that much of the value-relevant events affecting security prices throughout the fiscal year are recognized in annual earnings. At second step, we examine whether earnings' lack of timeliness affects the returns-earnings association as this is reflected in future earnings' explanatory power for current period returns.

³ See for example Warfield and Wild (1992).

Econometrically, this hypothesis implies that including future earnings results (i) in an improvement of the explanatory power of the returns-earnings association and (ii) positives coefficients associated to future earnings variables indicating incremental information content of future earnings relative to current earnings.

So the hypotheses to be tested are:

H1: Annual earnings are significantly associated with annual security returns.

H2: If earnings recognition lags that of the market, then future earnings are associated with current returns.

Empirical models: Several models have been proposed in the literature to evaluate the returns-earnings relation. Difference between these models stems from the theoretical models to which they refer⁴. In fact several returns and earnings metrics have been used. Most studies use annual raw return to assess the dependent variable of the model. An abnormal return, measured as the difference between realised and expected return, is sometimes used. The accounting earnings variable metric also differs across studies. Four measures are commonly used: earnings level deflated by the beginning of period stock price; earnings change (or unexpected earnings) deflated by the beginning of period stock price; earnings levels and change (or unexpected earnings) each deflated by the beginning of period stock price, earnings change (or unexpected earnings) deflated by the previous period earnings.

We use the earnings level model to evaluate the returns-earnings relation on the Tunisian stock market. The specification is analogous to that proposed by Ohlson (1991), Easton and Harris (1991) and Easton et al. (1992). This model has been shown more relevant to explain stock price changes on the Tunisian stock market. Thus results of a study conducted by JE.Trabelsi (2013) are consistent with earnings changes having no incremental information content beyond earnings level in explaining stock price changes.

The regression models to be tested are classified below on current earnings-returns relation and current and future earnings-returns relation:

1. Current earnings-returns relation: the following model is used to test the first hypothesis.

⁴ See Dumontier and Labelle (1995), Dumontier and Raffournier (2002) and Khotari (2001) for a presentation of the theoretical foundation of the empirical models associating returns to earnings.

Model 1: $BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + e_{it}$

2. Current and future earnings-returns relation: the following two models are used to test the second hypothesis. Model 2 regress current returns on both current earnings and next period's earnings. Model 3 regress current returns on both current earnings and the next two periods' earnings.

Model 2:

$BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + \alpha_2 E_{it+1} / P_{it-1} + e_{it}$

Model 3:

$BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + \alpha_2 E_{it+1} / P_{it-1} + \alpha_3 E_{it+2} / P_{it-1} + e_{it}$

Where:

BHR_{it} : denote the buy and hold stock returns for firm i over the fiscal year t .

$BHR_{it} = \prod_{t=1}^m (1 + R_{it}) - 1$, where R_{it} is the rate-

of-return for stock i in week t , $m = 52$ weeks.

E_{it} : is accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year t .

E_{it+1} : is accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year $t+1$.

E_{it+2} : is accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year $t+2$.

P_{t-1} : is the price per share of firm i at the beginning of the fiscal year (at time $t-1$).

Sample selection and descriptive statistics: Data used in the present study are collected from the database that is published by the Tunisian stock exchange (BVMT). Our sample is drawn from the period 1997-2011 and consists of companies that meet the following criteria: (1) availability of data to calculate earnings per share for at least three consecutive years. (2) availability of weekly market price to calculate annual security returns. This selection procedure results initially in 427 observations. We exclude from

the sample all observations having negative earnings over the period selected. Previous researches conducted by Hayn (1995) and Basu (1997) have shown that the returns-earnings relation exhibit lower earnings response coefficients and lower explanatory power for losses compared to profits. Hayn (1995) hypothesizes that the lower stock price response to losses is due to the liquidation option that investors have. Losses are not expected to perpetuate, and they are perceived by investors as temporary. Shareholders can always liquidate the firm rather than suffer from indefinite losses. Basu (1997) predicts and finds that negative earnings changes are less persistent than positive earnings changes. Consistent with this asymmetric persistence, he finds that the earnings response coefficients are higher for positive earnings changes than for negative changes. Accordingly, 103 negative observations are dropped leaving 324 firm-year observations.

Table 1 provides some summary statistics relative to variables used in the study. Pearson correlation analysis as shown in Table 2 reveals significant and positive correlation between annual returns and current earnings realization. Thus, the correlation is 0.305 and statistically significant at the 1% level. Earnings' realization measured over one period ahead exhibit alike positive and significant correlation with annual returns. The correlation is lower compared to current earnings realization (0.262) but is positive and significant at the 1% level. One may suggest that regression analysis will provide significant statistical association between annual returns and current earnings and one next period earnings. Correlation analysis does not show however any significant association between current returns and the next two periods' earnings. This result suggests that the earnings recognition lag diminishes after two year.

Table 1. Descriptive Statistics:

	Mean	Median	Variance	Minimum	Maximum
BHR	0.125	0.043	0.270	-0.870	3.760
E_t/P_{t-1}	0.115	0.082	0.077	0.002	4.600
E_{t+1}/P_{t-1}	0.112	0.077	0.027	0.002	1.490
E_{t+2}/P_{t-1}	0.124	0.071	0.170	0.003	7.147

Number of observations = 324 firm-years for the period 1997 -2011. BHR is the buy and hold return calculated over the fiscal year. E_t/P_{t-1} , E_{t+1}/P_{t-1} and E_{t+2}/P_{t-1} are respectively accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year t , $t+1$ and $t+2$, scaled by price per share of firm i at the beginning of the fiscal year (at time $t-1$).

Table 2. Pearson Correlation Analysis:

	BHR	E_t/P_{t-1}	E_{t+1}/P_{t-1}	E_{t+2}/P_{t-1}
BHR	1	0.305***	0.262***	0.07
E_t/P_{t-1}		1	0.620***	0.207***
E_{t+1}/P_{t-1}			1	0.672**
E_{t+2}/P_{t-1}				1

***, ** Statistically significant at a= 0.01 and 0.05 respectively.

Number of observations = 324 firm-years for the period 1997 -2011. BHR is the buy and hold return calculated over the fiscal year. E_t/P_{t-1} , E_{t+1}/P_{t-1} and E_{t+2}/P_{t-1} are respectively accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year t, t+1 and t+2, scaled by price per share of firm i at the beginning of the fiscal year (at time t-1).

Empirical results: This section discusses results of the estimates of the regression models. We first analyse results obtained with Model 1 which associates annual returns with annual earnings, the two variables measured over the same fiscal year, and provides tests of hypothesis 1. We then provide results of Models 2 and 3 which associate current returns with current earnings and successive combinations of future periods' earnings: (1) current and next period's earnings (Model 2) and (2) current and the next two periods' earnings (Model 3). Evidence on these models provides tests of hypothesis 2.

Current earnings- returns relation: Table 3 reports results of the estimate of Model 1. Overall, results indicate an acceptance of hypothesis 1 and substantiate the value-relevance of earnings. In fact, the earnings response coefficient estimate (α_1) exhibit positive value

(0.572) that is significantly different from zero at the 0.01 level. The Fisher-value (32.92) is as well statistically significant at the 0.01 level which indicates that the model is globally well specified.

While these statistics are impressive, the adjusted *R-square* value is very low. In fact, current earnings explain only 9 percent of stock price variations. This result implies that annual earnings do not recognize all the economic events that are reflected in company's stock prices. The low explanatory power maybe consistent with a reporting lag of the recognition of the economic events in earnings due to application of accounting recognition and measurement concepts. So, lack of timeliness for accounting numbers maybe an explanation for the low returns-earnings association being evidenced.

Table 3. Regression of Current Returns on Current Earnings.

Model 1: $BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + e_{it}$

	Coefficients (t-statistics)(P-value)			
Intercept	E_{it}/P_{it-1}	R^2	Adj. R^2	F-value
0.06	0.572	9.30%	9.00%	32.92***
(1.998)	(5.738)***			
(0.047)	(0.000)			(0.000)

*** : Statistically significant at a= 0.01.

Number of observations = 324 firm-years for the period 1997 -2011. BHR is the buy and hold returns calculated over the fiscal year. E_t/P_{t-1} is accounting earnings (excluding extraordinary items) per share of firm i for the fiscal year t scaled by price per share of firm i at the beginning of the fiscal year (at time t-1).

Current and next periods' earnings- returns relation: Tables 4 and 5 provide respectively results on the incremental contribution of the immediate next period (Model 1) and the two next periods' earnings (Model 2) in explaining current returns behind current earnings.

Regression estimates of Model 2 displayed in table 4 yields an adjusted *R-square* of 9.6 percent which represents a 6.667 percent increase in comparison with

the adjusted *R-square* obtained with Model 1 relating returns to current earnings. The Model is well specified according to the fisher value (18.10 sign at a = 0.01) and reveals positive and statistically different from zero response coefficients. For current earnings, the ERC is 0.434 and is significant at the 0.01 level. For one next period's earnings, the ERC is 0.376 and is statistically significant at the 0.10 level. The incremental information content of the immediate next period's

earnings imply that although current earnings do recognize some value-relevant events that are contemporaneously recognized in companies' stock returns, other economic events affecting the market throughout the year are recognized with lag in next period's earnings.

The results obtained from the regression estimates of Model 3 indicate that the inclusion of the next two period's earnings increases the regression explanatory power. The adjusted *R-square* obtained with Model 3 is 9.9 percent, which is superior to any obtained from Model 1 (9 %) or Model 2 (9.6 %). Nevertheless, the ERCs of the model do not reveal any incremental information content of the next two period's earnings.

Thus, ERCs are positive and statistically different from zero for current earnings (0.365 sign at $\alpha = 0.01$) and next period's earnings (0.680 sign at $\alpha = 0.05$) but negative and not significant for next two periods' earnings (-0.137).

Results obtained with Model 3 yield similar inferences as those revealed by Model 2 and suggest that the immediate next period's earnings continue to explain a significant portion of returns beyond that explained by current earnings. However, over one year's ahead, earnings do not seem reflecting any relevant economic event impounded in security prices at previous period. The earnings recognition lag seems to decrease after one year.

Table 4. Regression of Current Returns on Current Earnings and Next Period's Earnings.

Model 2: $BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + \alpha_2 E_{it+1} / P_{it-1} + e_{it}$

<i>Coefficients (t-statistics) (p-value)</i>					
<i>Intercept</i>	E_{it}/P_{it-1}	E_{it+1}/P_{it-1}	R^2	$Adj.R^2$	<i>F-value</i>
0.033	0.434	0.376	10.1%	9.6%	18.10***
(1.003)	(3.434)***	(1.757)*			
(0.317)	(0.001)	(0.08)			(0.000)

***, **, *: Statistically significant at $\alpha = 0.01, 0.05, \text{ and } 0.10$, respectively.

Number of observations = 324 firm-years for the period 1997 -2011. BHR is the buy and hold returns calculated over the fiscal year. E_t/P_{t-1} and E_{t+1}/P_{t-1} are respectively accounting earnings (excluding extraordinary items) per share of firm *i* for the fiscal year *t* and *t+1*, scaled by price per share of firm *i* at the beginning of the fiscal year (at time *t-1*).

Table 5. Regression of Current Returns on Current Earnings and Next Two Period's Earnings.

Model 3: $BHR_{it} = \alpha_0 + \alpha_1 E_{it} / P_{it-1} + \alpha_2 E_{it+1} / P_{it-1} + \alpha_3 E_{it+2} / P_{it-1} + e_{it}$

<i>Coefficients (t-statistics)(p-value)</i>						
	E_{it+1}/P_{it-1}	E_{it+2}/P_{it-1}	R^2	$Adj.R^2$	<i>F-value</i>	
0.024	0.365	0.680	-0.137	10.7%	9.9%	12.78***
(0.715)	(2.691)***	(2.245)**	(-1.417)			
(0.475)	(0.007)	(0.025)	(0.158)			(0.000)

***, **, *: Statistically significant at $\alpha = 0.01, 0.05, \text{ and } 0.10$, respectively.

Number of observations = 324 firm-years for the period 1997 -2011. BHR is the buy and hold returns calculated over the fiscal year. E_t/P_{t-1} , E_{t+1}/P_{t-1} and E_{t+2}/P_{t-1} are respectively accounting earnings (excluding extraordinary items) per share of firm *i* for the fiscal year *t*, *t+1* and *t+2*, scaled by price per share of firm *i* at the beginning of the fiscal year (at time *t-1*).

Summary and conclusion: This paper examines whether earnings' recognition of economic events lags that of the market as this is reflected in future earnings' explanatory power for current period returns.

Earnings tend to lag the market because the historical cost accounting measurement process is not designed to fully reflect expectations of future net cash flows on a timely basis. With its emphasis on historical cost measurement and transaction-based accounting, accountants often trade off timeliness in recognizing

changes in net asset values in favor of concepts like objectivity, verifiability, and/or conservatism. Hence, expected future cash flows from new investments, advertising, research and development expenditures are only partially reflected in current earnings, and will be reflected in future periods' earnings as they fulfill required accounting recognition criteria. However, these events cause immediate revisions in the market's expectations of future earnings, and hence price changes. Thus, one may expect the relation between

annual returns and contemporaneous earnings to be low.

A statistical consequence of earnings' lack of timeliness is that stock returns of one time period should be related with future earnings. Hence, we hypothesize that, if earnings recognition lags that of the market, then future earnings explain current returns. At first step, we regress annual returns on current earnings. We then regress current returns on both current earnings and two combinations of future period's earnings: (1) current and next period's earnings, (2) current and the next two periods' earnings.

Findings reveal that future periods' earnings are related to current returns. Specifically, our modifications to the traditional contemporaneous returns-earnings regression model yield an increase in explanatory power. Specifically, the adjusted *R-square* of the contemporaneous returns-earnings model is 9 percent. When, adding the immediate and the next two periods' earnings, the explanatory power of the model passes respectively to 9.6 percent and 9.9 percent. Although this increase in explanatory power seems to be not important, the statistically different from zero response coefficients associated to current and immediate next periods' earnings suggest that some economic events affecting the market are partially reflected in current earnings and they are reflected with lag in the following year. This earnings recognition lag seems to cancel after one year. In fact, the ERC associated to the next two periods' earnings present, as not be expected, negative and not statistically different from zero value.

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