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# The effect on earnings persistence and the market's reaction to the alignment of employee and customer relations with competitive strategy

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THE EFFECT ON EARNINGS PERSISTENCE AND THE MARKET'S  
REACTION TO THE ALIGNMENT OF EMPLOYEE AND CUSTOMER  
RELATIONS WITH COMPETITIVE STRATEGY

A Dissertation

Submitted to the Graduate Faculty of the  
Louisiana State University and  
Agricultural and Mechanical College  
in partial fulfillment of the  
requirements for the degree of  
Doctor of Philosophy

in

The Department of Accounting

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I dedicate this work to my lovely wife Amber and my two daughters Emma and Adalynn.

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## ABSTRACT

Prior literature suggests that a focus on employee and customer relations alone improves financial performance. However, I find that a focus on employee and customer relations alone is not related to higher earnings persistence, but rather I hypothesize and find that the alignment of employee and customer relations with competitive strategy is related to higher earnings persistence. I further explore this relation by examining the contextual environment in which the firm operates. I consider the moderating variables of firm size, leverage, growth, and corporate governance and find that alignment impacts the persistence of earnings for leverage and governance but not for firm size or growth. I then examine the relation between a firm's alignment and the market's reaction to the firm's reported earnings. The analysis suggests that alignment is critical for cost leaders but is relatively less important for differentiators. Taken as a whole the findings suggest that firm alignment plays a role in earnings quality and is useful to investors in their interpretation of earnings.



## I. INTRODUCTION

This study examines how earnings persistence is impacted when a firm's employee and customer relations are aligned with the firm's competitive strategy. The literature supports the position that strong employee and customer relations lead to persistent earnings (Heskett et al., 2008; Heskett et al., 1994), but earnings persistence has not been the focus of these previous studies and was not tested directly. I specifically test the persistence of earnings and examine the market's reaction to reported earnings based on the alignment of the firm's employee and customer relations with its competitive strategy. My findings suggest that alignment is associated with more persistent earnings and is understood by market participants including financial analysts.

Strong employee and customer relations lead to high levels of customer satisfaction regarding the firm (Heskett et al., 2008), help connect customers to the brand (Bhattacharya and Sen, 2004), and thereby improve the firm's reputation (Bhattacharya and Sen, 2004). Highly satisfied customers are brand-loyal customers, and these branding and reputational benefits generate higher revenues (Fombrun and Shanley, 1990; Mescon and Tilson, 1987; Heskett et al., 1994) and lower operating costs through greater employee retention and productivity (Willard, 2002). Higher revenues and lower costs lead to higher profits, creating stability for the firm even during difficult economic times. By building strong employee and customer relations, firms tend to increase total earnings and earnings persistence, which has been shown to improve the company's resilience to recessions (Godfrey, 2005).

The emphasis placed on employee and customer relations varies by firm, and this variation should be highly correlated with the competitive strategy chosen by the firm. Porter

(1998) argues a firm's competitive strategy can be described as one of three basic approaches: the differentiator, the cost leader, or "caught in the middle". The differentiator is able to earn a higher gross margin on its products by creating the perception of uniqueness. The cost leader's competitive position in the marketplace is maintained by structuring its operations for high volume at the lowest possible cost, resulting in a relatively lower gross margin per transaction, but offset by higher sales volume. Porter (1998) contends that "caught in the middle" is a strategy firms should attempt to avoid. So while a firm can create value for its customers through high quality employee and customer relations, comparisons between firms that focus on employee and customer relations and those that do not should be considered within a given competitive strategy rather than between strategies. The relative importance of persistent earnings within a given competitive strategy should be similar and comparable but the relative importance of persistent earnings might not hold in comparisons between strategies.

Miles and Snow (1978) describe the focus a firm places on employee and customer relations as changing through time. Firms are always seeking to "adapt" their structures and strategies to properly align themselves within their competitive marketplace (Miles and Snow, 1985). Alignment is not a status that once achieved, no longer needs to be addressed, but rather, alignment is a continuous process whereby a firm constantly makes changes to achieve optimal performance within a given competitive strategy. Through the development of a high level of alignment the firm is able to generate more predictable earnings which, in turn, lowers estimation risk for financial statement users (Sant and Cowan, 1994). The literature suggests that lower estimation risk increases the precision of market participant's estimates (Barry and Brown, 1985; Glosten and Milgrom, 1985; Merton, 1987). More persistent earnings in combination with more precise estimates, increase financial statement user's confidence in reported numbers. As

investors rely more heavily on earnings, the relative importance of analysts' forecasts declines. Analysts have less "new" information to share with investors as more information is captured by earnings. This study shows that alignment between the firm's focus on employee and customer relations and the firm's competitive strategy, provide relatively more persistent earnings and this increase in earnings quality is understood by market participants.

In this study I contrast firms that have aligned their investment in employee and customer relations with the firm's competitive strategy (Aligned Firms) with those that have not aligned their investment in employee and customer relations with the firm's competitive strategy (Misaligned Firms), and I hypothesize that earnings persistence will be higher for Aligned Firms than for Misaligned Firms. I test this hypothesis using both a simple model with no control variables as well as a model that includes control variables which follow prior literature. I then examine key firm characteristics: firm size, the level of firm indebtedness, the level of firm growth, and the strength of the firm's corporate governance and consider the impact each of these characteristics have on earnings persistence for Aligned and Misaligned Firms.

I find that simply focusing on employee and customer relations alone does not result in higher earnings persistence; however, Aligned Firms are associated with higher earnings persistence. The results further suggest that it is this alignment of the firm's focus with its competitive strategy that is critical in understanding earnings persistence when considering the level of firm indebtedness, and corporate governance. My results provide no support for the existence of a relation between earnings persistence and firm size or the level of firm growth. Additionally I test the relation between abnormal return and unexpected earnings for Aligned and Misaligned Firms. I find a strong positive relation between unexpected earnings and abnormal returns for Aligned Firms pursuing a cost leadership strategy, but no relation between

unexpected earnings and abnormal returns for Aligned firms pursuing a differentiator strategy. These results are further supported by my findings in relation to the incremental explanatory power of consensus analysts' forecasts. For Aligned Firms, both differentiators and cost leaders, exhibit lower incremental explanatory power of analysts' forecasts as compared to Misaligned Firms. I interpret this finding to suggest that Aligned Firms have more information captured by earnings leaving analysts with less opportunity to incrementally add to the market's understanding through their forecast.

This study contributes to the literature by showing that the alignment of a firm's focus on employee and customer relations and its chosen competitive strategy is useful in understanding earnings persistence. The study also shows that the market is aware of the importance of alignment and that market participants seek out additional information in the absence of alignment. The remainder of the paper is organized as follows: Section II briefly discusses related literature and develops the hypothesis; Section III describes the sample selection and defines the variables used in the analysis; Section IV explains the design of the research methodology; Section V presents the empirical results; and Section VI summarizes the findings from the study, discusses known limitations and concludes.

## II. RELATED LITERATURE AND HYPOTHESIS DEVELOPMENT

The interconnection between employee and customer relations is well founded in the literature, and employee satisfaction is the beginning step in a chain of cause-and-effect relations which lead to improved profitability. Employee satisfaction fuels employee loyalty and productivity, which in turn boosts the level of value provided to the firm's customers, which then increases customer satisfaction and loyalty (Heskett et al., 1994). Customer satisfaction has been linked to firm profitability (Luo and Homburg, 2007) a willingness to pay a premium (Homburg et al., 2005), a decrease in sensitivity to price changes (Stock, 2005), and an increase in the likelihood of becoming a repeat customer (Mittal and Kamakura, 2001; Olsen, 2002). Firms with brand-loyal customers generate higher revenues (Fombrun and Shanley, 1990; Mescon and Tilson, 1987; Heskett et al., 1994) and enjoy lower operating costs through greater employee retention and productivity (Willard, 2002). Higher revenues and lower costs lead to higher profits. This chain of cause-and-effect relationships suggests that if a firm invests in its employee and customer relations, the firm should generate more persistent earnings, a quality that is important to current and future investors as well as financial analysts (Verrecchia, 2001; Barron et al., 2009; Demirakos et al., 2004).

However, the decision to invest in employee and customer relations must be considered in the context of the competitive strategy chosen by the firm. Porter (1998) classifies a firm's competitive strategy as one of the following: a differentiator, a cost leader, or "caught in the middle". Following this classification, a differentiator is a firm that provides a good or service that is perceived by the customers to possess certain unique features. It is this uniqueness that allows the differentiator to earn a higher gross margin than its competitors. On the other hand, the cost leader structures its operations to minimize costs. The cost leader charges a lower price

for its product and is willing to earn a lower gross margin per unit with the expectation that the cost leader will be able to sell relatively more units. Porter (1998) recommends firms avoid being “caught in the middle”. This system of classification for competitive strategy provides a reasonable basis for comparison, but just because a firm has chosen to compete within a given competitive marketplace does not mean the firm has aligned all of its operations to be effective with a given competitive environment.

Miles and Snow (1978) describe an iterative process whereby firms adjust their focus in a step-by-step process over time. This process should lead firms to make changes in all aspects of the business, including, but not limited to, changes in the firm’s product offerings, distribution system, technological inputs, communication and control processes, organizational structures, as well as processes that enable evolution and innovation. Through a process of organized change over time the focus of the firm and the competitive strategy of the firm can more optimally align. The idea that alignment of the firm’s operational and organizational structures with the firm’s strategy will facilitate efficient operations and drive long-term success is supported by a body of earlier research (Drucker, 1974; Child, 1972; Perrow, 1967; Chandler, 1962). A firm that is taking steps to become an Aligned Firm is pursuing the set of cause-and-effect relations, described by Heskett et al. (1994) which lead to more persistent earnings. The proper focus on employee and customer relations, for a particular competitive strategy, will produce more persistent earnings as compared to a focus on employee and customer relations that is misaligned with the competitive strategy of the firm. Given the broad scope of competitive strategy it seems that analysis between Aligned and Misaligned Firms should be performed within a given competitive strategy rather than between strategies. This leads to H1, which is as follows:

H1: Earnings persistence is higher for Aligned Firms as compared to Misaligned Firms.

The existing literature has noted several variables to be significant in considering the focus of a firm within its competitive surroundings. To address the role of the contextual environment, this study considers the impact of these key firm characteristics. The characteristics, deemed moderating variables, are as follows: firm size, the level of firm indebtedness, the level of firm growth, and the strength of the firm's corporate governance. These additional refinements of the analysis allow for a better understanding of the underlying relations and for a clearer interpretation of the regression results.

The first of these moderating variables is firm size. Firm size is an important firm characteristic and has been shown to influence statistical results in countless studies across a wide range of relations. As there are fundamental differences in the operations of large versus small firms, it is not surprising that this firm characteristic has been shown to be important in the analysis of a firm's competitive focus (Waddock & Graves, 1997; McWilliams & Siegel, 2001; Prior et al., 2008; Kim et al., 2012). The market-to-book ratio is used as a proxy for growth. Following Kim et al. (2012), growth is included in the study due to its significance in the analysis of prior studies. Leverage, or the level of firm indebtedness, has been studied as a possible constraint on firm spending (Barnea & Rubin, 2010); however, in this study leverage is used as a proxy for distressed firms. Highly leveraged firms face additional risks, like continuing as a going concern, which are not an issue for firms with low levels of debt (McGuire et al., 1988). Corporate governance serves as a proxy for a monitoring mechanism within the firm that increases the credibility of a firm's reporting. Kim et al. (2012) discuss the importance of governance as a separate construct and in their analysis they control for the impact of governance (Klein, 2002; Bergstresser & Philippon, 2006) rather than include it within their

composite score of KLD strengths and concerns. As such, corporate governance is examined as a separate construct herein.

In considering firm size, positive accounting theory (Watts & Zimmerman, 1986), specifically, the political cost hypothesis, suggests that large firms are subject to greater scrutiny than small firms and therefore larger firm are subject to higher reporting standards. Small firms have a greater need to communicate information about themselves to outside parties, because smaller firms are less well-known. Firms that focus on employee and customer relations are associated with higher visibility, stronger reputation, and higher brand recognition (Fombrun & Shanley, 1990; Verschoor, 2005; Linthicum et al., 2010; Mescon & Tilson, 1987; Varadarajan & Menon, 1988), which suggests that small firms with a focus on employee and customer relations have more to gain by the increased exposure than would a large firm, as the large firm is already well-known. Therefore the impact of exposure related characteristics is likely to have a greater impact on small firms compared to large firms. As such H2(a) is as follows:

H2(a): The earnings persistence of small Aligned Firms should be higher as compared to larger firms.

In considering the level of firm indebtedness, highly leveraged firms are more likely to be financially distressed and prior literature has shown management of financially distressed firms make decisions that impact the reported accounting fundamentals differently than their non-financially distressed counterparts (Mercer, 2004). Therefore financially distressed firms are subjected to different stimuli as compared to firms that are not financially distressed, proxied here as low levels of debt. Highly leveraged firms are unlikely to fully enjoy the benefits typically associated with Aligned Firms, as the burden created by the debt will likely subsume most, if not all, of the benefit created from proper alignment. For firms with comparatively



lower debt levels the benefits typically associated with Aligned Firms will not be overshadowed by their relatively less burdensome debt structure and therefore one would expect to see higher levels of earnings persistence for firms with relatively lower levels of leverage. As such H2(b) is as follows:

H2(b): The earnings persistence of Aligned Firms with low levels of indebtedness should be higher as compared to firms with relatively higher levels of indebtedness.

In considering firm growth, firms with high levels of growth are less likely to be impacted by being an Aligned Firm because growth is such an important aspect of their business model. Penman and Zhang (2002) point out that firm growth serves to reduce current earnings by creating reserves on the balance sheet that make the firm's current accounting fundamentals less predictive of the future. Conversely, low growth firms are likely to be highly impacted by firm alignment. For low growth firms, an investment in the firm's employee and customer relations only needs to create a small impact in the firm's earnings for the change to be detected by financial statement users. Alternatively, a small change driven by these activities at a growth firm might simply be attributed to the firm's growth and as such the incremental impact would be less detectible. Therefore, H2(c) is as follows:

H2(c): The earnings persistence of Aligned Firms with low levels of growth should be higher as compared to firms with relatively higher levels of growth.

Strong corporate governance serves to inhibit managerial misconduct and adds credibility to other signals the firm might provide (Wu, 2012). Therefore a strong corporate governance environment impacts the reporting process both directly, through the controls in place that govern financial reporting, and indirectly, through an environment that eschews managerial misconduct. Additionally, well governed firms are more likely to retain high quality auditors as

compared to their more poorly governed counterparts. Regardless of the direction of this relation, whether well governed firms seek out high quality auditors or if it is the high quality of the audit that causes the firm to be well governed, these two are clearly linked. Strong corporate governance seems to add validity to the actions of the firm and therefore increases the predictive power of the firm's earnings and book value. As a result H2(d) is as follows:

H2(d): The earnings persistence of Aligned Firms with high levels of corporate governance should be higher as compared to firms with relatively lower levels of corporate governance.

The literature provides evidence regarding the likely relation Aligned Firms have with earnings persistence as well as with the moderator variables, but is the relation between Aligned Firms and earnings persistence understood by market participants? This question motivates my third hypothesis. If Aligned Firms are associated with higher levels of earnings persistence investors should value the reported earnings of Aligned Firms more than those of Misaligned Firms. Similarly, if Aligned Firms enjoy higher earnings persistence then by definition current earnings better explain next period's earnings. As current earnings better explain future earnings, the explanatory power of analysts' forecasts must decline. Therefore, the persistent earnings of Aligned Firms reduce the incremental explanatory power of analysts' forecasts, as compared to Misaligned Firms, and the incremental explanatory power of analysts' forecasts is predicted to be lower for Aligned Firms, relative to Misaligned Firms. As a result H3 is formally stated as follows:

H3: Market participants place more confidence in earnings and relatively less confidence in analysts' forecasts for Aligned Firms as compared to Misaligned Firms.

### III. VARIABLE DEFINITIONS AND SAMPLE SELECTION

Each hypothesis in this study addresses either directly or indirectly the relation between Aligned Firms and earnings persistence. To evaluate these hypotheses, I first determine which firms are Aligned and which are misaligned. This evaluation is based on a firm's focus on employee and customer relations which is operationalized using the Kinder, Lydenburg, and Domini (KLD) rating system. I proxy for the quality of the firm's employee relations using the KLD rating of "Employee Relations" and use KLD's rating of "Product Quality" as a proxy for customer relations. The use of "Product Quality" as a proxy for the customer's perspective is supported by academic research that suggests that product quality has a significant impact on customer satisfaction and even delivers a greater impact than does the product's price (Fornell et al., 1996).

KLD data is often associated with corporate social responsibility and has been called the de facto leader in estimating a firm's involvement in the greater good of society (Waddock, 2003). In this study, I use only a subset of KLD's measures that support the set of cause-and-effect relations described by Heskett et al. (1994). The KLD rating system evaluates the performance of each firm included in the dataset across seven qualitative areas and six controversial business segments, assessing a rating of the firm's strengths and concerns in each. If a firm is assessed by KLD to possess a strength in the qualitative area of "Employee Relations", "Product Quality", or both, I classify this firm as a Focused Firm; otherwise the firm is classified as a non-Focused Firm.

I do not utilize KLD's assessment of the controversial business segments, nor do I consider any assessment of concerns. The controversial business segments are not used as they

are specifically designed to capture firm behavior KLD has deemed unacceptable from the perspective of corporate social responsibility. As corporate social responsibility is not the focus of this study, KLD's designation of a firm as being involved in a controversial business segment is not relevant. KLD's assessment of concerns is excluded in an effort to focus the study and limit its scope. The prior literature includes studies that choose to net KLD strengths and concerns, however the creation of a composite score is not a sound theoretical decision and is not supported by the work of Mattingly and Berman (2006). Mattingly and Berman (2006) test the validity of netting KLD strengths and concerns and find the empirical results do not provide support for the creation of a composite score.

To determine the classification of a firm as Aligned or Misaligned I layer the competitive environments discussed by Porter (1998) on top of the Focus or non-Focus of the firm. I partition my data based on gross margin percentage calculated as total revenue minus cost of goods sold divided by total revenue. I ordered the firms based on gross margin percentage from highest to lowest and assigned firms in the top quartile to the top partition (Top Partition), firms in the bottom quartile to the bottom partition (Bottom Partition), and the remaining two middle quartiles are designated as the middle partition. Using these partitions I define Aligned and Misaligned Firms as follows: in the Top Partition, Aligned Firms are Focused Firms, and Misaligned Firms are non-Focused Firms; in the Bottom Partition, Aligned Firms are non-Focused Firms and Misaligned Firms are Focused Firms, as described in Figure 1. According to Porter (1998) the Top Partition includes the differentiators who earn a relatively high gross margin by creating the perception of uniqueness with their product offerings. Therefore these firms *should* be focused on employee and customer relations in an effort to develop this perception of uniqueness. The Bottom Partition, on the other hand, contains firms Porter (1998)

describes as cost leaders. These firms maintain their competitive advantage through careful cost management, and as such, a focus on employee and customer relations would be viewed as an additional cost layer for the cost leader. Therefore cost leaders *should not* focus the firm's resources on developing strong employee and customer relations.

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	<u>Top Partition</u> (Top 25% GM)	<u>Bottom Partition</u> (Bottom 25% GM)
Focused Firms	Aligned Firms	Misaligned Firms
Non-Focused Firms	Misaligned Firms	Aligned Firms

Figure 1  
Definition of Aligned and Misaligned Firms

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The literature indicates that certain firm characteristics are likely to influence the relation between Aligned Firms and earnings persistence. As such the analysis is structured to consider the influence of these specific firm characteristics, deemed moderator variables. To investigate the impact of these moderators (H2), I use an additional partition of the data based on the relative magnitude of the moderator within the distribution. The moderator variables are indicator variables, and therefore the partition in the data is formed between the top 50% of the distribution versus the bottom 50% of the distribution within the sample.

The moderating variables are defined as follows: firm size, leverage, growth, and corporate governance. The proxy for Firm Size ( $Size_{i,t}$ ) is an indicator variable having a value of one if the natural logarithm of the market value of equity is smaller than the median for the sample and zero otherwise for firm  $i$  at time  $t$ . The proxy for Leverage ( $Lev_{i,t}$ ) is an indicator

variable having a value of one if long-term debt scaled by total assets is larger than the median for the sample and zero otherwise for firm  $i$  at time  $t$ . The proxy for Growth ( $MB_{i,t}$ ) is an indicator variable having a value of one if the market-to-book equity ratio is larger than the median for the sample and zero otherwise, where the market-to-book equity ratio is calculated as the market value of equity over book value of equity for firm  $i$  at time  $t$ . The proxy for Corporate governance ( $Gov_{i,t}$ ) is an indicator variable having a value of one if the net KLD rating for corporate governance, measured as the number of strengths minus the number of concerns is greater than zero and zero otherwise for firm  $i$  at time  $t$ .

The window of time covered by this study was impacted by the implementation of Statement of Financial Accounting Standards No. 142 which went into effect for all fiscal years beginning after December 15<sup>th</sup>, 2001. This standard addresses the accounting for goodwill and other intangibles. Positive employee and customer relations is not typically captured by accounting, however; should a firm record goodwill, positive employee and customer relations would be capitalized onto the firms balance sheet. As the implementation of the standard would change the only way employee and customer relations is directly recorded into the accounting records the sample period was restricted, such that all observations included in the sample would fall under the same regulatory guidance.

The sample began with all firms listed in the Compustat database during the sample window. This provided an initial sample of 146,523 firm-years. As Table 1 shows, 59,045 firm-year observations were lost due to missing Compustat data. An additional 15,473 observations were deleted as they were related to financial industry firms and the definition of key financial metrics is different for financial firms. Due to a lack of data needed to calculate the necessary lagged variables, 17,276 observations were deleted. The merge with the KLD dataset reduced

the sample by an additional 37,024 firm-years, and 8,853 observations were lost as they were classified as “caught in the middle”. This resulted in the full sample consisting of 2,165 firms

Description	Firm-year Observations
Firm-years list on Compustat for the sample period	146,523
Less: Firm-years with missing Compustat data	59,045
Less: Firm-years associated with financial firms	15,473
Less: Firm-years lacking the necessary lagged variables	17,276
Less: Firm-years missing KLD data	37,024
Less: Firm-years from the middle partition, "caught in the middle"	<u>8,853</u>
Full Sample consisting of 2,165 firms from 2002 to 2011	<u>8,852</u>
Less: Firm-years with missing IBES data	3,665
Less: Firm-years with missing CRSP data	457
Less: Firm-years missing the necessary variables	<u>1,579</u>
Reduced Sample consisting of 648 firms from 2002 to 2011	3,151

covering 8,852 firm-years. To test the market’s reaction to the relation between earnings persistence and firm alignment, additional restrictions had to be placed on the data. The merge of the sample with the IBES database reduced the number of usable observation by another

3,665, and 457 more firm-year observations were lost due to the merge with the CRSP dataset. An additional 1,579 firm-year observation were deleted as they were missing the necessary variables to conduct the analysis, bringing the final sample to 3,151 firm-year observations for 648 firms covering the period from 2002 to 2011. The continuous variables for all observations were winzORIZED at the one-percent level.



## IV. RESEARCH DESIGN

The study's design rests upon the relation between the firm alignment and earnings persistence. Because Focused Firms include a focus on either employee, customer relations, or both, I begin the analysis with each run separately and then progress to the base model, first without controls and then adding the controls from prior literature as well as industry and year dummy variables. The full model, including all controls, is presented below:

$$E_{i,t+1} = \alpha_0 + \alpha_1 E_{i,t} + \alpha_2 \text{Align}_{i,t} + \alpha_3 (E_{i,t} * \text{Align}_{i,t}) + \alpha_4 \text{LgSI}_{i,t} + \alpha_5 \text{Loss}_{i,t} + \alpha_6 \text{Intgble}_{i,t} \\ + \alpha_7 \text{Age}_{i,t} + \alpha_8 \text{Rep}_{i,t} + \alpha_9 \text{R\&D}_{i,t} + \alpha_{10} \text{Adv}_{i,t} + \alpha_i \text{Ind\_Dummies}_{i,t} + \\ \alpha_j \text{Yr\_Dummies}_{i,t} + \varepsilon_{i,t} \quad (1)$$

where  $E_{i,t}$  is income before extraordinary items but includes special items, defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ , and  $\text{Align}_{i,t}$  is an indicator variable having the value of one if the firm is an Aligned Firm and a zero otherwise for firm  $i$  at time  $t$ ,  $\text{LgSI}_{i,t}$  is an indicator variable having the value of one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets following Elliott and Shaw (1988) for firm  $i$  at time  $t$ ,  $\text{Loss}_{i,t}$  is an indicator variable having the value of one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ ,  $\text{Intgble}_{i,t}$  is an indicator variable having the value of one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ ,  $\text{Age}_{i,t}$  is an indicator variable having a value of one if firm age is greater than the sample median and a zero otherwise, where firm age ( $\text{Age1}$ ) is the sum of the number of years since firm  $i$  was first listed on Compustat at time  $t$ ,  $\text{Rep}_{i,t}$  is reputation and is an indicator variable having the value of one if firm  $i$  is on Fortune's America's Most Admired Companies list and a zero otherwise at time  $t$ ,  $\text{R\&D}_{i,t}$  is an indicator variable having the value of one if the firm's research and development expense is greater than zero and a zero otherwise where research and

development expense (R&D1) is calculated as research and development expense divided by net sales for firm  $i$  at time  $t$ ,  $Adv_{i,t}$  is an indicator variable having the value of one if advertising expense was greater than zero and a zero otherwise, where advertising expense ( $Adv1$ ) is calculated as advertising expense divided by net sales for firm  $i$  at time  $t$ ,  $Ind\_Dummies_{i,t}$  is an indicator variable having the value of one if the firm is included in the industry portfolio and a zero otherwise, where the industry portfolios is one of the twelve Fama French industry portfolios defined by SIC code, and  $Yr\_Dummies_{i,t}$  is an indicator variable having the value of one if the observation is for the given year and a zero otherwise.<sup>1</sup>

Additional analysis is conducted by examining the impact of the moderators on the relation between earnings persistence and alignment. To conduct this analysis the data is parsed between Top and Bottom Partitions and then within each partition the data is further parsed into Aligned and Misaligned Firms. Within these partitions the relation of interest is the interaction between earnings and the moderator. The full model, including all controls, is presented below:

$$E_{i,t+1} = \beta_0 + \beta_1 E_{i,t} + \beta_2 \text{Moderator}_{i,t} + \beta_3 (E_{i,t} * \text{Moderator}_{i,t}) + \beta_4 \text{LgSI}_{i,t} + \beta_5 \text{Loss}_{i,t} + \beta_6 \text{Intgble}_{i,t} + \beta_7 \text{Age}_{i,t} + \beta_8 \text{Rep}_{i,t} + \beta_9 \text{R\&D}_{i,t} + \beta_{10} \text{Adv}_{i,t} + \beta_i \text{Ind\_Dummies}_{i,t} + \beta_j \text{Yr\_Dummies}_{i,t} + \varepsilon_{2i,t} \quad (2)$$

where  $\text{Moderator}_{i,t}$  is one of the following:  $\text{Large}_{i,t}$ ,  $\text{Lev}_{i,t}$ ,  $\text{MB}_{i,t}$ , or  $\text{Gov}_{i,t}$  and all other variables are as previously defined.

To examine the market's reaction to the relation between alignment and earnings persistence I conduct an analysis of the incremental explanatory power of earnings and analysts' forecasts. Because Aligned Firms should enjoy greater earnings persistence, Aligned Firms should have lower incremental explanatory power from analysts' forecasts as related to future

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<sup>1</sup> The work of Chiu and Sharfman (2011) and Torelli et al. (2012) among others suggest that firm visibility is a control that should be considered in this analysis. Therefore, I initially included visibility as a control variable in the analysis and found it to be insignificant, as such; firm visibility was dropped from the analysis.

earnings. To test this expectation, I follow a methodology used by Collins et al. (1997), and created three versions of the full model presented below:

$$\begin{aligned} \text{Price}_{i,t} = & \lambda_0 + \lambda_1 E_{i,t} + \lambda_2 \text{Forecast}_{i,t}^{t+1} + \lambda_3 \text{LgSI}_{i,t} + \lambda_4 \text{Loss}_{i,t} + \lambda_5 \text{Intgble}_{i,t} + \lambda_6 \text{Age}_{i,t} \\ & + \lambda_7 \text{Rep}_{i,t} + \lambda_8 \text{R\&D}_{i,t} + \lambda_9 \text{Adv}_{i,t} + \lambda_i \text{Ind\_Dummies}_{i,t} + \lambda_j \text{Yr\_Dummies}_{i,t} + \\ & \varepsilon_{3i,t} \end{aligned} \quad (3)$$

where  $\text{Price}_{i,t}$  is the closing price on the last day of the fiscal year for firm  $i$  at time  $t$ ,  $\text{Forecast}_{i,t}^{t-1}$  is the first consensus analysts' forecasts provided after the prior year's announcement for the current year end for firm  $i$  at time  $t$ , and all other variables are as previously defined. I first run Eq. (3) excluding  $\text{Forecast}_{i,t}^{t-1}$ . I then run Eq. (3) excluding  $E_{i,t}$ . The final step is to run Eq. (3) in its full model form as presented above. By subtracting the  $R^2$  of the first version of Eq. (3) from the  $R^2$  of the full model of Eq. (3) the resulting difference is the incremental predictive power provided by analysts' forecasts. This difference indicates the ability of analysts' forecasts to explain next period's price beyond the explanation provided by earnings. As stated in H3, I expect Aligned Firms to demonstrate relatively stronger earnings persistence; therefore, the incremental explanatory power of analysts' forecasts will be relatively weak.

To further test the market's understanding of the relation between alignment and earnings persistence I test the incremental impact of Aligned Firms on the relation between abnormal return and unexpected earnings. This test is conducted following the model used by Freeman and Tse (1989) presented below:

$$\begin{aligned} \text{AbRet}_{i,t} = & \omega_0 + \omega_1 \text{UE}_{i,t} + \omega_2 \text{Align}_{i,t} + \omega_3 (\text{UE}_{i,t} * \text{Align}_{i,t}) + \omega_4 \text{FirmSize}_{i,t} + \omega_5 \text{Loss}_{i,t} \\ & + \omega_6 \text{Beta}_{i,t} + \omega_7 \text{DtoE}_{i,t} + \omega_8 \text{Analysts}_{i,t} + \varepsilon_{4i,t} \end{aligned} \quad (4)$$

where  $\text{AbRet}_{i,t}$  is the daily compounded return from one day after the prior periods announcement date to one day after the current period's announcement date less the mean return from the firm's Scholes-Williams (1977) beta decile for firm  $i$  at time  $t$ ,  $\text{UE}_{i,t}$  is unexpected

earnings calculated as current period earnings less the first consensus analysts' forecasts provided after the prior year's announcement for the current year end for firm  $i$  at time  $t$ ,  $FirmSize_{i,t}$  is the natural logarithm of the market value of equity for firm  $i$  at time  $t$ ,  $Beta_{i,t}$  is the firm beta as defined by Scholes-Williams (1977) for firm  $i$  at time  $t$ ,  $DtoE_{i,t}$  is the debt to equity ratio, calculated as total debt divided by total equity for firm  $i$  at time  $t$ ,  $Anlays_{i,t}$  is the number of analysts following the firm as reported by IBES for firm  $i$  at time  $t$ , and all other variables are as previously defined. In addition to calculating abnormal return following Freeman and Tse (1989), the analysis was also conducted following the definition of abnormal return used by Abarbanell and Bushee (1998), where abnormal return is the daily compounded return as defined before less the mean daily compounded return from the value-weighted firm size decile for firm  $i$  at time  $t$ .

## V. RESULTS

Descriptive statistics related to the full sample are presented in Table 2 Panel A. In

TABLE 2  
Descriptive Statistics

*Panel A: Full Sample*

<u>Variables</u>	<u>Mean</u>	<u>Median</u>	<u>Std. Dev.</u>	<u>Min</u>	<u>25<sup>th</sup> %</u>	<u>75<sup>th</sup> %</u>	<u>Max</u>
$E_{i,t}$	0.012	0.041	0.150	-0.650	0.000	0.083	0.260
$E_{i,t+1}$	0.008	0.042	0.156	-0.693	-0.001	0.082	0.254
$LgSI_{i,t}$	0.078	0.000	0.269	0.000	0.000	0.000	1.000
$Loss_{i,t}$	0.183	0.000	0.386	0.000	0.000	0.000	1.000
$Intgble_{i,t}$	0.808	1.000	0.394	0.000	1.000	1.000	1.000
$Age1_{i,t}$	21.970	15.000	16.331	1.000	9.000	32.000	61.000
$Rep_{i,t}$	0.105	0.000	0.307	0.000	0.000	0.000	1.000
$R\&D1_{i,t}$	0.332	0.000	1.549	0.000	0.000	0.091	12.189
$Adv1_{i,t}$	0.014	0.000	0.035	0.000	0.000	0.009	0.239
$Size_{i,t}$	7.085	6.879	1.560	4.065	5.949	8.007	11.448
$Lev_{i,t}$	0.168	0.134	0.171	0.000	0.001	0.277	0.660
$MB_{i,t}$	3.397	2.320	3.335	0.489	1.476	3.941	20.160
$Gov_{i,t}$	0.115	0.000	0.319	0.000	0.000	0.000	1.000

*Panel B: Partitioned Sample*

<u>Variable</u>	<u>Top Partition</u>			<u>Bottom Partition</u>		
	<u>Mean</u>	<u>Median</u>	<u>Std Dev</u>	<u>Mean</u>	<u>Median</u>	<u>Std Dev</u>
$E_{i,t}$	0.057	0.061	0.107	-0.033	0.027	0.172
$E_{i,t+1}$	0.048	0.059	0.120	-0.031	0.030	0.178
$LgSI_{i,t}$	0.073	0.000	0.261	0.083	0.000	0.276
$Loss_{i,t}$	0.107	0.000	0.309	0.258	0.000	0.438
$Intgble_{i,t}$	0.812	1.000	0.391	0.805	1.000	0.396
$Age1_{i,t}$	20.559	15.000	15.540	23.380	16.000	16.968
$Rep_{i,t}$	0.089	0.000	0.285	0.121	0.000	0.326
$R\&D1_{i,t}$	0.096	0.012	0.355	0.567	0.000	2.135
$Adv1_{i,t}$	0.023	0.003	0.044	0.005	0.000	0.020
$Size_{i,t}$	7.347	7.150	1.598	6.824	6.622	1.476
$Lev_{i,t}$	0.153	0.097	0.175	0.182	0.159	0.166
$MB_{i,t}$	4.023	2.935	3.559	2.771	1.875	2.966
$Gov_{i,t}$	0.128	0.000	0.334	0.102	0.000	0.303

The full sample consists of 8,852 firm-year observations for 2,165 firms covering the period from 2002-2011. The Top Partition consists of 4,423 firm-year observations while the Bottom Partition consists of 4,429 firm-year observations.

$E_{i,t}$  is income before extraordinary items but including special items defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ .

$LgSI_{i,t}$  is an indicator variable that is one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm  $i$  at time  $t$

$Loss_{i,t}$  is an indicator variable that is one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ .

(Table 2 continued)

$Intgble_{i,t}$  is an indicator variable that is one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$AgeI_{i,t}$  is a sum of the number of years since the firm was first listed on Compustat for firm  $i$  at time  $t$ .

$Rep_{i,t}$  is reputation and is an indicator variable of one if the firm is on Fortune's America's Most Admired Companies list and a zero otherwise for firm  $i$  at time  $t$ .

$R\&D I_{i,t}$  is calculated as research and development expense divided by net sales for firm  $i$  at time  $t$ .

$AdvI_{i,t}$  is calculated as advertising expense divided by net sales for firm  $i$  at time  $t$ .

$Size_{i,t}$  is an indicator variable having a value of one if the natural logarithm of the market value of equity is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$Lev_{i,t}$  is an indicator variable having a value of one if long-term debt scaled by total assets is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$MB_{i,t}$  is an indicator variable having a value of one if the market-to-book equity ratio is smaller than the median and zero otherwise, where the market-to-book equity ratio is calculated as the market value of equity over book value of equity for firm  $i$  at time  $t$ .

$Gov_{i,t}$  is the net KLD rating for corporate governance, measured as the number of strengths minus the number of concerns for firm  $i$  at time  $t$ .

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general, I find no unexpected anomalies in the data and the variables appear to be consistent with extant literature. Almost 8% of the firm-year observations included a large special item with over 18% of the observations being periods where the firm experienced a loss. The sample tends to be composed of mature firms with an average age of almost 22 years, which is consistent with Kim et al. (2012). However, the mean for firm age is somewhat inflated by very mature firms as the median age in the sample is somewhat less at only 15 years. As captured by  $Rep_{i,t}$ , over 10% of the sample is listed on Fortune's "America's Most Admired Companies" list. Research and development costs with a mean of 0.332 are slightly higher as compared to the sample examined by Kim et al. (2012), while advertising expenses with a mean of 0.014 are slightly lower than this previous study. The size of the firms in the sample tends to be quite large, even slightly larger than the firms considered by Kim et al. (2012). Large firms are expected in this sample as firm size is a characteristic used in KLD's selection process. In considering  $Lev_{i,t}$  and  $MB_{i,t}$  the mean of both appear reasonable in comparison to the levels reported by Kim et al. (2012). Additionally, in untabulated results, Aligned Firms make up just over 52% of the sample.

Panel B, Table 2, presents comparative descriptive statistics between the Top and Bottom Partitions which are based on gross margin percentage. The Top Partition consists of 4,423 firm-year observations while the Bottom Partition includes 4,429 firm-years. Firms in the Top Partition, on average, exhibit higher current period earnings ( $E_{i,t}$ ), which seems reasonable given the partition is based on gross margin percentage. In untabulated results, the Top Partition is composed of 24.7% Aligned Firms while the Bottom Partition contains 79.4% Aligned Firms. Top Partition firms also tend to be younger, by more than three years, are less well-known as captured by the reputation variable, spend more on research and development and advertising, and have higher levels of growth, than their bottom partition counterparts. However the strength of the corporate governance environment is statistically the same between the partitions.

I present the Pearson correlations above the diagonal and the Spearman correlations below the diagonal, in Table 3.  $E_{i,t}$  is highly positively correlated with  $E_{i,t+1}$ , and negatively correlated with  $Loss_{i,t}$ , at statistically significant levels.  $Align_{i,t}$  is positively correlated with  $E_{i,t}$  as well as  $Loss_{i,t}$ ,  $Intgble_{i,t}$ ,  $Age1_{i,t}$ ,  $Rep_{i,t}$ , and  $Lev_{i,t}$ , but negatively correlated with  $E_{i,t+1}$ ,  $LgSI_{i,t}$ ,  $R\&D1_{i,t}$ ,  $Adv1_{i,t}$ ,  $Size_{i,t}$ ,  $MB_{i,t}$ , and  $Gov_{i,t}$ . Interestingly, Table 3 indicates that firm size is not correlated with the level of either research and development expense or advertising expense based on the Pearson correlations but are statistically significant following the Spearman correlation.

Table 4 presents the results of the multivariate regression analysis of the relation between earnings persistence and firm alignment, partitioned based on the magnitude of the firm's gross

TABLE 3

Correlation Matrix - Pearson (above diagonal) and Spearman (below diagonal) - (p-values shown in italics below correlation)

	$E_{i,t}$	$E_{i,t+1}$	$Align_{i,t}$	$LgSI_{i,t}$	$Loss_{i,t}$	$Intgble_{i,t}$	$Age1_{i,t}$	$Rep_{i,t}$	$R\&D1_{i,t}$	$Adv1_{i,t}$	$Size_{i,t}$	$Lev_{i,t}$	$MB_{i,t}$	$Gov_{i,t}$
$E_{i,t}$	1.000	0.714	0.171	0.016	-0.687	0.192	0.160	0.126	-0.5307	0.0599	0.366	-0.041	-0.041	0.012
		<.0001	<.0001	0.1390	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.0001	0.0001	0.2651
$E_{i,t+1}$	0.716	1.000	-0.147	-0.036	-0.571	0.189	0.167	0.128	-0.5199	0.0543	0.349	0.001	0.031	0.012
	<.0001		<.0001	0.0008	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.9268	0.004	0.2461
$Align_{i,t}$	0.160	-0.128	1.000	-0.016	0.106	0.040	0.049	0.047	0.1154	-0.1475	-0.023	0.031	-0.076	-0.019
	<.0001	<.0001		0.1343	<.0001	0.0001	<.0001	<.0001	<.0001	<.0001	0.0321	0.0033	<.0001	0.0813
$LgSI_{i,t}$	0.018	-0.027	-0.016	1.000	0.060	-0.064	-0.097	-0.042	0.0512	0.0033	-0.061	0.028	0.084	-0.021
	0.0828	0.0121	0.1343		<.0001	<.0001	<.0001	<.0001	<.0001	0.7549	<.0001	0.0092	<.0001	0.0537
$Loss_{i,t}$	-0.621	-0.494	0.106	0.060	1.000	-0.253	-0.191	-0.135	0.3995	-0.0315	-0.338	-0.099	0.096	0.011
	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	0.0031	<.0001	<.0001	<.0001	0.2844
$Intgble_{i,t}$	0.106	0.104	0.040	-0.064	-0.253	1.000	0.106	0.130	-0.2102	0.0104	0.205	0.104	-0.104	-0.025
	<.0001	<.0001	0.0001	<.0001	<.0001		<.0001	<.0001	<.0001	0.3276	<.0001	<.0001	<.0001	0.0205
$Age1_{i,t}$	0.137	0.144	0.060	-0.147	-0.199	0.101	1.000	0.289	-0.1497	-0.0707	0.389	0.111	-0.120	0.004
	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.7315
$Rep_{i,t}$	0.157	0.154	0.047	-0.042	-0.135	0.130	0.266	1.000	-0.0667	0.0269	0.508	0.020	0.037	-0.001
	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	0.0114	<.0001	0.0583	0.0005	0.9258
$R\&D1_{i,t}$	-0.1685	-0.1453	-0.0161	0.0191	0.3657	-0.0263	-0.1747	-0.0598	1.0000	-0.0334	-0.1524	-0.0770	0.1487	0.0005
	<.0001	<.0001	0.1294	0.0721	<.0001	0.0134	<.0001	<.0001		0.0017	<.0001	<.0001	<.0001	0.9655
$Adv1_{i,t}$	0.1619	0.1502	-0.1814	-0.0271	-0.0927	0.0916	-0.0486	0.0231	0.0206	1.0000	0.0498	-0.0762	0.1264	0.0316
	<.0001	<.0001	<.0001	0.0108	<.0001	<.0001	<.0001	0.0297	0.0529		<.0001	<.0001	<.0001	0.0029
$Size_{i,t}$	0.407	0.401	-0.046	-0.065	-0.355	0.213	0.334	0.428	-0.0635	0.0615	1.000	0.073	0.174	-0.062
	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001
$Lev_{i,t}$	-0.175	-0.140	0.054	0.012	-0.139	0.139	0.166	0.067	-0.3158	-0.0952	0.159	1.000	0.018	-0.081
	<.0001	<.0001	<.0001	0.2737	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		0.0841	<.0001
$MB_{i,t}$	0.313	0.346	-0.112	0.053	0.020	-0.087	-0.146	0.071	0.3072	0.1240	0.301	-0.141	1.000	0.013
	<.0001	<.0001	<.0001	<.0001	0.0631	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		0.2118
$Gov_{i,t}$	0.032	0.022	-0.019	-0.021	0.011	-0.025	-0.012	-0.001	-0.0091	0.0041	-0.093	-0.088	0.029	1.000
	0.0026	0.0368	0.0813	0.0537	0.2844	0.0205	0.2399	0.9258	0.3931	0.6969	<.0001	<.0001	0.0067	

The full sample consists of 8,852 firm-year observations for 2,165 firms covering the period from 2002-2011.

$E_{i,t}$  is income before extraordinary items but including special items defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ .

$Align_{i,t}$  is an indicator variable having the value of one if the firm is an Aligned Firm and a zero otherwise for firm  $i$  at time  $t$ .



(Table 3 continued)

$LgSI_{i,t}$  is an indicator variable that is one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm  $i$  at time  $t$ .

$Loss_{i,t}$  is an indicator variable that is one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Intgble_{i,t}$  is an indicator variable that is one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$AgeI_{i,t}$  is a sum of the number of years since the firm was first listed on Compustat for firm  $i$  at time  $t$ .

$Rep_{i,t}$  is reputation and is an indicator variable of one if the firm is on Fortune's America's Most Admired Companies list and a zero otherwise for firm  $i$  at time  $t$ .

$R\&D I_{i,t}$  is calculated as research and development expense divided by net sales for firm  $i$  at time  $t$ .

$AdvI_{i,t}$  is calculated as advertising expense divided by net sales for firm  $i$  at time  $t$ .

$Size_{i,t}$  is an indicator variable having a value of one if the natural logarithm of the market value of equity is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$Lev_{i,t}$  is an indicator variable having a value of one if long-term debt scaled by total assets is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$MB_{i,t}$  is an indicator variable having a value of one if the market-to-book equity ratio is smaller than the median and zero otherwise, where the market-to-book equity ratio is calculated as the market value of equity over book value of equity for firm  $i$  at time  $t$ .

$Gov_{i,t}$  is the net KLD rating for corporate governance, measured as the number of strengths minus the number of concerns for firm  $i$  at time  $t$ .

TABLE 4  
Tests of the persistence of earnings

$$E_{i,t+1} = \alpha_0 + \alpha_1 E_{i,t} + \alpha_2 \text{Align}_{i,t} + \alpha_3 (E_{i,t} * \text{Align}_{i,t}) + \alpha_4 \text{LgSI}_{i,t} + \alpha_5 \text{Loss}_{i,t} + \alpha_6 \text{Intgble}_{i,t} + \alpha_7 \text{Age}_{i,t} + \alpha_8 \text{Rep}_{i,t} + \alpha_9 \text{R\&D}_{i,t} + \alpha_{10} \text{Adv}_{i,t} + \alpha_j \text{Ind\_Dummy}_{i,t} + \alpha_j \text{Yr\_Dummy}_{i,t} + \varepsilon_{i,t}$$

	Top Partition (Top 25% GM)				Bottom Partition (Bottom 25% GM)			
	Employee	Customer	Either	Either	Employee	Customer	Either	Either
Intercept	0.025 ***	0.025 ***	0.009 ***	0.025 ***	0.023 **	0.015	0.007 *	0.021 **
$E_{i,t}$	0.562 ***	0.561 ***	0.632 ***	0.553 ***	0.502 ***	0.598 ***	0.679 ***	0.507 ***
$\text{Align}_{i,t}$	0.006 *	-0.007	0.006	0.004	-0.010 *	-0.001	-0.015 ***	-0.008 *
$E_{i,t} * \text{Align}_{i,t}$	0.004	0.106	0.080 **	0.073 *	0.080 ***	-0.026	0.099 ***	0.077 ***
$\text{LgSI}_{i,t}$	-0.005	-0.006		-0.005	-0.017 ***	-0.017 ***		-0.017 ***
$\text{Loss}_{i,t}$	-0.044 ***	-0.044 ***		-0.044 ***	-0.054 ***	-0.054 ***		-0.054 ***
$\text{Intgble}_{i,t}$	-0.005	-0.004		-0.005	0.010 **	0.010 **		0.010 **
$\text{Age}_{i,t}$	0.005	0.006 *		0.005	0.013 ***	0.013 ***		0.013 ***
$\text{Rep}_{i,t}$	0.014 **	0.018 ***		0.014 **	0.009	0.009 *		0.008
$\text{R\&D}_{i,t}$	-0.001	0.000		-0.001	-0.029 ***	-0.029 ***		-0.028 ***
$\text{Adv}_{i,t}$	0.005	0.005		0.005 *	0.002	0.002		0.002
<i>Includes industry and year dummies</i>								
N	4,423	4,423	4,423	4,423	4,429	4,429	4,429	4,429
Adj R <sup>2</sup>	0.3743	0.3737	0.3378	0.3520	0.6055	0.6044	0.5494	0.6055

The full sample consists of 8,852 firm-year observations for 2,165 firms covering the period from 2002-2011, and \*, \*\*, and \*\*\* indicate significance at 0.10, 0.05, and 0.01 level, respectively.

$E_{i,t}$  is income before extraordinary items but including special items defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ .

$\text{Align}_{i,t}$  is an indicator variable having the value of one if the firm is an Aligned Firm and a zero otherwise for firm  $i$  at time  $t$ .

$\text{LgSI}_{i,t}$  is an indicator variable that is one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm  $i$  at time  $t$ .

$\text{Loss}_{i,t}$  is an indicator variable that is one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ .

$\text{Intgble}_{i,t}$  is an indicator variable of one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$\text{Age}_{i,t}$  is a sum of the number of years since the firm was first listed on Compustat for firm  $i$  at time  $t$ .

$\text{Rep}_{i,t}$  is an indicator variable of one for firms on Fortune's America's Most Admired Companies list and zero otherwise for firm  $i$  at time  $t$ .

$\text{R\&D}_{i,t}$  is an indicator variable having the value of one if the firm's research and development expense is greater than zero and a zero otherwise firm  $i$  at time  $t$ .

$\text{Adv}_{i,t}$  is an indicator variable of one if the firm's advertising expense is greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

margin percentage. The table includes analysis for firms with a focus on employee relations, customer relations, as well as *either* employee or customer relations. The data was run separately for employee and customer relations to ensure that combining the two together did not produce an anomalous result. In Table 4 the relation of interest is the interaction between earnings and alignment ( $E_{i,t} * \text{Align}_{i,t}$ ). In the Top Partition the interaction term is 0.004 and 0.106 for employees and customers, respectively, and both are statistically insignificant. In the Bottom Partition the interaction term for employees is 0.080 and is statistically significant while the interaction term for customers is -0.026 but statistically insignificant. After considering both the statistical significance of these coefficients and their sign I concluded that it was reasonable to conduct the remaining analysis by considering firms focused on either employee relations, customer relations, or both.

H1 predicts that in both the Top Partition and in the Bottom Partition, Aligned Firms will have more persistent earnings than Misaligned Firms. For both partitions H1 is supported. In the Top Partition the support for H1 is somewhat weak, and appears to be impacted by the inclusion of the controls, with an interaction term of 0.073 that is significant at the 10% level. In the Bottom Partition the support for H1 is strong, with an interaction term of 0.077 that is significant at the 1% level. The stronger relation associated with the Bottom Partition, or the cost leaders, seems reasonable in that cost leaders are highly focused on costs. For a firm in the Bottom Partition, allocating the firm's resources to initiatives that promote strong employee and customer relations effectively creates an additional cost layer for the firm. Such actions work directly contrary to the competitive strategy of the firm. Therefore the need to maintain alignment between the firm's competitive strategy and the firm's operational decisions is critical for the cost leader. For firms in the Top Partition, or differentiators, a lack of focus on employee

or customer relations might not create a direct impact to the firm in the short run. Additionally, due to the relatively high gross margin enjoyed by firms in the Top Partition, these firms have added flexibility in their operational choices. This flexibility is likely to lead firms in the Top Partition to try “new” approaches from time to time. As with anything, some of these changes will be successful but others will not. This flexibility with mixed results could partially explain the weaker results for the Top Partition. However, when viewed as a whole, these results support H1, Aligned Firms are associated with relatively higher levels of earnings persistence.

In an effort to ensure that alignment was critical I also examined the relation between firms that simply focused on employee or customer relations, without regard to whether this focus created alignment with the firm’s competitive strategy or not (Focused Firms). In untabulated results, I interact Focused Firms with earnings and estimate the coefficients. This interaction results in a negative and significant coefficient which suggests that firms that are not Focused Firms would enjoy higher earnings persistence as compared to Focused Firms. This finding supports the position that focusing on employee and customer relations is not enough. For a firm to reap the benefits of focus on employee and customer relations, that focus needs to align with the firm’s competitive strategy or else the firm’s action may serve to hinder earnings persistence.

The alignment of a firm’s focus on its employee and customer relations is different in each classification of competitive strategy. A focus on the firm’s employee and customer relations would align with the competitive strategy of a differentiator. Here the firm has chosen to position itself to provide a unique product and charge a relatively higher price for the product. To follow this strategy the firm needs for its customers to be highly satisfied with the product offering. For a firm following a cost leadership strategy, employee and customer relations are of

less importance with the emphasis being placed on lowering costs. Under this competitive strategy fostering strong employee and customer relations creates an additional layer of expense within the firm's cost structure and therefore constitutes a misalignment from the firm's chosen competitive strategy. Porter (1998) argues that competitive strategies are not absolute in that differentiators must consider cost impacts and cost leaders must maintain some level of product quality. Likewise firm alignment or misalignment between the firm's focus on its employee and customer and its chosen competitive strategy is also relative to one another and not absolute, but the results suggest that alignment is critical in understanding the persistence of earnings.

Table 5 presents the results of the interaction between earnings and the moderators for both the Top and Bottom Partition. The relation between alignment and earnings persistence is further explored by examining the impact of four firm characteristics, termed moderators, which the extant literature suggests are worthy of consideration within this setting. Specifically, these four firm characteristics are firm size, the level of firm indebtedness, firm growth, and the strength of the firm's corporate governance. In this analysis the relation of interest is the interaction term between earnings and the moderator. Therefore the predictions for H2(a) through H2(d) will be evaluated based on this coefficient ( $\beta_3$ ).

The results for the first moderator examined, firm size, are presented in Table 5 Panel A. H2(a) states that small firms are most likely to benefit from being an Aligned Firm. The hypothesis suggests that the incremental effect of firm size on earnings persistence will be strongest for small, Aligned Firms. However the results suggest that firm size is not a significant factor. The difference between Aligned and Misaligned Firms in the Top and Bottom Partition is 0.075 and -0.026, respectively and both are statistically insignificant. The results in Panel A do

TABLE 5

Tests of the persistence of earnings for moderator variables

$$E_{i,t+1} = \beta_0 + \beta_1 E_{i,t} + \beta_2 \text{Moderator}_{i,t} + \beta_3 (E_{i,t} * \text{Moderator}_{i,t}) + \beta_4 \text{LgSI}_{i,t} + \beta_5 \text{Loss}_{i,t} + \beta_6 \text{Intgble}_{i,t} + \beta_7 \text{Age}_{i,t} + \beta_8 \text{Rep}_{i,t} + \beta_9 \text{R\&D}_{i,t} + \beta_{10} \text{Adv}_{i,t} + \beta_{11} \text{Ind\_Dummy}_{i,t} + \beta_{12} \text{Yr\_Dummy}_{i,t} + \varepsilon_{2i,t}$$

***Panel A: Firm Size***

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
Intercept	-0.022	0.022 **	-0.044 **	0.003	0.040 **	-0.037 *
$E_{i,t}$	0.583 ***	0.522 ***	0.061	0.585 ***	0.554 ***	0.031
$\text{Size}_{i,t}$	0.030 ***	0.027 ***	0.003	0.026 ***	0.025 ***	0.002
$E_{i,t} * \text{Size}_{i,t}$	0.085	0.009	0.075	-0.184 ***	-0.158 ***	-0.026
$\text{LgSI}_{i,t}$	-0.009	-0.004	-0.005	-0.012	-0.025 **	0.013
$\text{Loss}_{i,t}$	-0.008	-0.043 ***	0.035 **	-0.062 ***	-0.026 **	-0.036 ***
$\text{Intgble}_{i,t}$	0.009	-0.012 ***	0.021 **	0.010 *	-0.017 *	0.027 **
$\text{Age}_{i,t}$	0.002	0.001	0.001	0.011 ***	-0.001	0.012
$\text{Rep}_{i,t}$	0.004	0.004	0.001	-0.005	0.014 *	-0.019
$\text{R\&D}_{i,t}$	0.006	-0.003	0.009	-0.030 ***	-0.019 **	-0.011
$\text{Adv}_{i,t}$	0.005	0.005	-0.001	0.001	-0.002	0.002
<i>Includes industry and year dummies</i>						
N	1,094	3,329		3,516	913	
Adj R <sup>2</sup>	0.3693	0.3811		0.6120	0.5920	

***Panel B: Leverage***

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
Intercept	-0.005	0.029 ***	-0.034 *	0.010	0.056 ***	-0.046 **
$E_{i,t}$	0.692 ***	0.586 ***	0.105 **	0.625 ***	0.545 ***	0.080 **
$\text{Lev}_{i,t}$	-0.003	0.003	-0.006	0.003	-0.016 **	0.019 **
$E_{i,t} * \text{Lev}_{i,t}$	-0.037	-0.156 ***	0.119	-0.172 ***	-0.035	-0.136 ***
$\text{LgSI}_{i,t}$	-0.008	-0.004	-0.003	-0.012 *	-0.026 **	0.014
$\text{Loss}_{i,t}$	-0.013	-0.046 ***	0.033 **	-0.062 ***	-0.023 **	-0.040 ***
$\text{Intgble}_{i,t}$	0.014	-0.007	0.021 **	0.012 **	-0.008	0.020 *
$\text{Age}_{i,t}$	0.005	0.005	0.000	0.014 ***	0.002	0.011
$\text{Rep}_{i,t}$	0.010 *	0.018 *	-0.008	0.005	0.017 **	-0.012

(Table 5 continued)

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
R&D <sub>i,t</sub>	0.007	-0.001	0.008	-0.029 ***	-0.023 ***	-0.006
Adv <sub>i,t</sub>	0.006	0.004	0.002	0.001	-0.001	0.003
<i>Includes industry and year dummies</i>						
N	1094	3329		3516	913	
Adj R <sup>2</sup>	0.3578	0.3748		0.6114	0.5857	

***Panel C: Growth***

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
Intercept	-0.035 **	0.015	-0.050 ***	0.004	0.032 *	-0.028
E <sub>i,t</sub>	0.541 ***	0.351 ***	0.190 **	0.424 ***	0.444 ***	-0.020
MB <sub>i,t</sub>	0.044 ***	0.028 ***	0.016 **	0.025 ***	0.036 ***	-0.011
E <sub>i,t</sub> *MB <sub>i,t</sub>	0.087	0.213 ***	-0.126	0.222 ***	0.140 ***	0.082
LgSI <sub>i,t</sub>	-0.006	-0.004	-0.002	-0.012 *	-0.029 **	0.017
Loss <sub>i,t</sub>	-0.013	-0.050 ***	0.038 ***	-0.067 ***	-0.024 **	-0.044 ***
Intgble <sub>i,t</sub>	0.021 **	-0.006	0.027 ***	0.013 **	-0.005	0.018
Age <sub>i,t</sub>	0.003	0.008 **	-0.006	0.017 ***	0.003	0.014
Rep <sub>i,t</sub>	0.005	0.007	-0.003	0.001	0.011	-0.011
R&D <sub>i,t</sub>	0.003	-0.006	0.009	-0.030 ***	-0.023 ***	-0.007
Adv <sub>i,t</sub>	0.004	0.003	0.001	0.001	0.000	0.001
<i>Includes industry and year dummies</i>						
N	1094	3329		3516	913	
Adj R <sup>2</sup>	0.3918	0.3941		0.6164	0.6014	

***Panel D: Governance***

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
Intercept	-0.004	0.031 ***	-0.035 *	0.008	0.047 ***	-0.039 **
E <sub>i,t</sub>	0.678 ***	0.552 ***	0.126 ***	0.568 ***	0.555 ***	0.013
Gov <sub>i,t</sub>	-0.010	0.011 *	-0.021	0.007	-0.008	0.015
E <sub>i,t</sub> *Gov <sub>i,t</sub>	0.096	-0.072 *	0.168	0.048	-0.116 *	0.164 **
LgSI <sub>i,t</sub>	-0.009	-0.005	-0.004	-0.013 *	-0.029 **	0.017
Loss <sub>i,t</sub>	-0.013	-0.049 ***	0.036 **	-0.060 ***	-0.023 **	-0.038 ***

(Table 5 continued)

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Aligned	Misaligned	Difference	Aligned	Misaligned	Difference
Intgble <sub>i,t</sub>	0.013	-0.008 *	0.021 **	0.015 ***	-0.012	0.027 **
Age <sub>i,t</sub>	0.004	0.004	0.000	0.015 ***	0.002	0.013
Rep <sub>i,t</sub>	0.010	0.017 *	-0.007	0.005	0.018 **	-0.013
R&D <sub>i,t</sub>	0.007	-0.002	0.008	-0.030 ***	-0.018 **	-0.012
Adv <sub>i,t</sub>	0.005	0.005	0.001	0.002	-0.001	0.003
<i>Includes industry and year dummies</i>						
N	1094	3329		3516	913	
Adj R <sup>2</sup>	0.3575	0.3715		0.6060	0.5848	

The full sample consists of 8,852 firm-year observations for 2,165 firms covering the period from 2002-2011, and \*, \*\*, and \*\*\* indicate significance at 0.10, 0.05, and 0.01 level, respectively.

$E_{i,t}$  is income before extraordinary items but including special items defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ .

$LgSI_{i,t}$  is an indicator variable that is one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm  $i$  at time  $t$ .

$Loss_{i,t}$  is an indicator variable that is one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Intgble_{i,t}$  is an indicator variable that is one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Age_{i,t}$  is a sum of the number of years since the firm was first listed on Compustat for firm  $i$  at time  $t$ .

$Rep_{i,t}$  is reputation and is an indicator variable of one if the firm is on Fortune's America's Most Admired Companies list and a zero otherwise for firm  $i$  at time  $t$ .

$R\&D_{i,t}$  is an indicator variable having the value of one if the firm's research and development expense is greater than zero and a zero otherwise firm  $i$  at time  $t$ .

$Adv_{i,t}$  is an indicator variable of one if the firm's advertising expense is greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Moderator_{i,t}$  is one of the following:

$Size_{i,t}$  is an indicator variable having a value of one if the natural logarithm of the market value of equity is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$Lev_{i,t}$  is an indicator variable having a value of one if long-term debt scaled by total assets is smaller than the median and zero otherwise for firm  $i$  at time  $t$ .

$MB_{i,t}$  is an indicator variable having a value of one if the market-to-book equity ratio is smaller than the median and zero otherwise, where the market-to-book equity ratio is calculated as the market value of equity over book value of equity for firm  $i$  at time  $t$ .

$Gov_{i,t}$  is the net KLD rating for corporate governance, measured as the number of strengths minus the number of concerns for firm  $i$  at time  $t$ .



not support H2(a) but rather suggest that firm size is not an important influence on earnings persistence.

Table 5 Panel B reports the analysis for leverage as the moderator variable. H2(b) suggests that earnings persistence will be higher for firms with relatively lower levels of debt. The results in the Top Partition provide no support for H2(b). The difference in the interaction term in the Top Partition is 0.119 and is statistically insignificant. However in the Bottom Partition the difference in the interaction term is -0.136 and is statistically significant at the 1% level. These results suggest that leverage is not all that important in the relation with earnings persistence for differentiators, but a high level of leverage is negatively associated with earnings persistence for the cost leader. I interpret these results to indicate that leverage is little more than a financing choice for the differentiator, presumably, because generating the necessary cash to pay off this debt is achievable for a firm with a relatively high gross margin. However for the cost leader, who tends to be more entrenched in a given line of business and generates relatively low gross margins, high levels of debt have a destructive impact on earnings persistence. The results in Panel B do not support H2(b) in the Top Partition but do support H2(b) in the Bottom Partition.

Table 5 Panel C reports the analysis for firm growth as the moderator variable. H2(c) suggests that earnings persistence will be higher for firms with relatively lower levels of growth. The results in the Top Partition provide no support for H2(c). The difference in the interaction term in the Top Partition is -0.126 and is statistically insignificant. Likewise the results in the Bottom Partition provide no support for H2(c). In the Bottom Partition the difference in the interaction term is 0.082 and is statistically insignificant. These results suggest that firm growth

is not an important factor in the relation with earnings persistence for differentiators or for cost leaders.

Table 5 Panel D reports the analysis for corporate governance as the moderator variable. H2(d) suggests that earnings persistence will be higher for firms that are relatively well governed. The results in the Top Partition provide no support for H2(d). The difference in the interaction term in the Top Partition is 0.168 and is statistically insignificant. However in the Bottom Partition the difference in the interaction term is 0.164 and is statistically significant at the 5% level. These results suggest that corporate governance is not all that important in the relation with earnings persistence for differentiators, but firms competing as cost leaders enjoy more persistent earnings if they have high levels of corporate governance. Beyond just the difference in the coefficients in this panel is the negative and significant coefficient for Misaligned Firms in both partitions. I interpret this finding to indicate that well governed Misaligned Firms are restrained in their ability to manipulate earnings and therefore these firms are subject to more volatility in their reported earnings. This increase in volatility reduces earnings persistence and drives the negative sign reported in Table 5 Panel D.

Table 6 presents the first set of results designed to consider the market's reaction to firm alignment. The previous analysis all focused on the relation between Aligned Firms and earnings persistence, with results that suggest that there is a positive relation between these two. This next series of tests are designed to determine if the relation between Aligned Firms and earnings persistence is understood by market participants.

Table 6 examines earnings persistence parsed between the Top and Bottom Partitions, based on gross margin, and then parsed again between Aligned and Misaligned Firms. In this

analysis I indirectly test the explanatory power of earnings by examining the  $R^2$  from three different versions of Eq. (3). In Panel A the analysis is conducted using a version of Eq. (3) that excluded consensus analysts' forecasts to provide an  $R^2$  that captures the explanatory power of earnings. In Panel B the analysis is conducted using a version of Eq. (3) that excluded current earnings and therefore provide an  $R^2$  that captures the explanatory power of analysts' forecasts. And then in Panel C the analysis is conducted using the full model of Eq. (3) that included both consensus analysts' forecasts and current earnings. The analysis is then based on the  $R^2$  from the three versions of the model. Subtracting the  $R^2_F$  in Panel B from the  $R^2_{EF}$  in Panel C results in the incremental explanatory power of earnings as reported in Panel A. Subtracting the  $R^2_E$  in Panel A from the  $R^2_{EF}$  in Panel C results in the incremental explanatory power of analysts' forecasts as reported in Panel B, and it is this estimation that is of most interest.

If market participants understand the relation between Aligned Firms and earnings that is documented in Table 4 then they should place greater confidence in the reported earnings of Aligned Firms as compared to Misaligned Firms. As users of financial reporting place more emphasis on current earnings due to their higher persistence, the relative earnings persistence, with results that suggest that there is a positive relation between these two. This next series of tests are designed to determine if the relation between Aligned Firms and earnings persistence is understood by market participants.

Table 6 examines earnings persistence parsed between the Top and Bottom Partitions, based on gross margin, and then parsed again between Aligned and Misaligned Firms. In this analysis I indirectly test the explanatory power of earnings by examining the  $R^2$  from three different versions of Eq. (3). In Panel A the analysis is conducted using a version of Eq. (3) that excluded consensus analysts' forecasts to provide an  $R^2$  that captures the explanatory power of

TABLE 6

Tests of the market reaction to firm alignment using analysts' forecasts

$$\text{Price}_t = \lambda_1 + \lambda_2 E_{i,t} + \lambda_3 \text{Forecast}_{i,t}^{-1} + \lambda_4 \text{LgSI}_{i,t} + \lambda_5 \text{Loss}_{i,t} + \lambda_6 \text{Intgble}_{i,t} + \lambda_7 \text{Age}_{i,t} + \lambda_8 \text{Rep}_{i,t} + \lambda_9 \text{R\&D}_{i,t} + \lambda_{10} \text{Adv}_{i,t} + \lambda_{11} \text{Ind\_Dummy}_{i,t} + \lambda_{12} \text{Yr\_Dummy}_{i,t} + \varepsilon_{3i,t}$$

*Panel A: Analysis with Earnings only*

	Top Partition (Top 25% GM)		Bottom Partition (Bottom 25% GM)	
	Aligned	Misaligned	Aligned	Misaligned
Intercept	13.844 **	21.364 ***	14.791 ***	31.614 ***
$E_{i,t}$	68.111 ***	68.835 ***	66.542 ***	49.916 ***
$\text{LgSI}_{i,t}$	1.359	-6.004 **	-8.510 ***	-2.286
$\text{Loss}_{i,t}$	-6.722	-7.269 **	-1.911	-5.768 *
$\text{Intgble}_{i,t}$	3.368	3.714 *	2.243	2.853
$\text{Age}_{i,t}$	6.950 ***	1.189	3.461 ***	-1.810
$\text{Rep}_{i,t}$	8.511 ***	11.624 ***	12.882 ***	11.064 ***
$\text{R\&D}_{i,t}$	-2.205	1.818	3.558 ***	4.313 *
$\text{Adv}_{i,t}$	-1.032	-7.530 ***	-2.889 **	-2.637
<i>Includes industry and year dummies</i>				
N	549	795	1,130	329
Adj $R^2_E$	0.2400	0.1889	0.2677	0.2668
Incremental Explanatory Power of Earnings				
$R^2_{EF} - R^2_F$	0.0097	0.0165	0.0271	0.0266

*Panel B: Analysis with Forecast only*

	Top Partition (Top 25% GM)		Bottom Partition (Bottom 25% GM)	
	Aligned	Misaligned	Aligned	Misaligned
Intercept	15.437 ***	12.291 ***	11.516 ***	21.811 ***
$\text{Forecast}_{i,t}$	8.248 ***	9.262 ***	6.311 ***	5.968 ***
$\text{LgSI}_{i,t}$	5.328	-4.586 *	-4.132	0.821
$\text{Loss}_{i,t}$	-5.802	-0.722	-2.973 *	-4.290 *
$\text{Intgble}_{i,t}$	1.639	2.821	-0.992	0.414
$\text{Age}_{i,t}$	1.296	-0.936	3.085 ***	-1.280
$\text{Rep}_{i,t}$	5.104 ***	5.256 **	5.833 ***	9.318 ***
$\text{R\&D}_{i,t}$	0.793	2.133	4.317 ***	3.994 *

(Table 6 continued)

	Top Partition (Top 25% GM)		Bottom Partition (Bottom 25% GM)	
	Aligned	Misaligned	Aligned	Misaligned
$Adv_{i,t}$	-1.688	-3.614 ***	-2.359 **	-3.359 *
<i>Includes industry and year dummies</i>				
N	549	795	1,130	329
Adj $R^2_F$	0.4091	0.4328	0.4136	0.4345
Incremental Explanatory Power of Forecast				
$R^2_{EF} - R^2_E$	0.1788	0.2604	0.1730	0.1943

*Panel C: Analysis with both Earnings and Forecast*

	Top Partition (Top 25% GM)		Bottom Partition (Bottom 25% GM)	
	Aligned	Misaligned	Aligned	Misaligned
Intercept	12.786 ***	10.268 ***	9.426 ***	20.309 ***
$E_{i,t}$	34.037 ***	38.275 ***	47.557 ***	42.620 ***
$Forecast_{i,t}$	7.779 ***	8.798 ***	5.934 ***	5.824 ***
$LgSI_{i,t}$	4.258 **	-4.947 **	-5.840 **	-1.161
$Loss_{i,t}$	-0.436	3.737	3.688 *	2.297
$Intgble_{i,t}$	1.893	3.507 **	-0.275	0.188
$Age_{i,t}$	1.769	-0.667	3.058 ***	-1.628
$Rep_{i,t}$	5.015 ***	5.372 **	6.232 ***	8.419 ***
$R\&D_{i,t}$	0.201	1.875	3.832 ***	4.297 **
$Adv_{i,t}$	-1.920	-4.128 ***	-2.790 **	-2.942
<i>Includes industry and year dummies</i>				
N	549	795	1,130	329
Adj $R^2_{EF}$	0.4188	0.4493	0.4407	0.4611

The reduced sample consists of 3,151 firm-year observations for 648 firms covering the period from 2002-2011, and \*, \*\*, and \*\*\* indicate significance at 0.10, 0.05, and 0.01 level, respectively. In the table above  $R^2_E$  is the  $R^2$  from the analysis that includes earnings only,  $R^2_F$  is the  $R^2$  from the analysis that includes analysts' forecasts only, and  $R^2_{EF}$  is the  $R^2$  from the analysis that includes earnings and analysts' forecasts.

$Price_{i,t}$  is the closing price on the last day of the fiscal year as reported by CRSP for firm  $i$  at time  $t$ .

$E_{i,t}$  is income before extraordinary items but including special items defined as net income plus discontinued operations and income taxes all scaled by total assets for firm  $i$  at time  $t$ .

(Table 6 continued)

$Forecast_{i,t}^{t-1}$  is the first consensus analysts' forecasts provided after the prior year's announcement for the current year end for firm  $i$  at time  $t$ .

$LgSI_{i,t}$  is an indicator variable that is one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm  $i$  at time  $t$ .

$Loss_{i,t}$  is an indicator variable that is one for firms with net income that is less than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Intgble_{i,t}$  is an indicator variable that is one for firms with intangible assets that are greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

$Age_{i,t}$  is a sum of the number of years since the firm was first listed on Compustat for firm  $i$  at time  $t$ .

$Rep_{i,t}$  is reputation and is an indicator variable of one if the firm is on Fortune's America's Most Admired Companies list and a zero otherwise for firm  $i$  at time  $t$ .

$R\&D_{i,t}$  is an indicator variable having the value of one if the firm's research and development expense is greater than zero and a zero otherwise firm  $i$  at time  $t$ .

$Adv_{i,t}$  is an indicator variable of one if the firm's advertising expense is greater than zero and a zero otherwise for firm  $i$  at time  $t$ .

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earnings. In Panel B the analysis is conducted using a version of Eq. (3) that excluded current earnings and therefore provide an  $R^2$  that captures the explanatory power of analysts' forecasts. And then in Panel C the analysis is conducted using the full model of Eq. (3) that included both consensus analysts' forecasts and current earnings. The analysis is then based on the  $R^2$  from the three versions of the model. Subtracting the  $R^2_F$  in Panel B from the  $R^2_{EF}$  in Panel C results in the incremental explanatory power of earnings as reported in Panel A. Subtracting the  $R^2_E$  in Panel A from the  $R^2_{EF}$  in Panel C results in the incremental explanatory power of analysts' forecasts as reported in Panel B, and it is this estimation that is of most interest. Assuming, market participants understand the relation between Aligned Firms and earnings persistence the incremental explanatory power of analysts' forecasts should be lower for Aligned Firms as compared to Misaligned Firms. Lower incremental explanatory power of analysts' forecasts for Aligned Firms is consistent with H3.

The results presented in Table 6 (Panel B) show the incremental explanatory power of analysts' forecasts for the Top Partition to be 0.1788 and 0.2604 for Aligned and Misaligned Firms respectively, and for the Bottom Partition 0.1730 and 0.1943 for Aligned and Misaligned Firms respectively. As the incremental explanatory power of analysts' forecasts is higher for Misaligned Firms in both the Top and Bottom Partitions, the results support H3. I interpret these findings to suggest that market participants are aware of the relation between Aligned Firms and earnings persistence and in settings where misalignment occurs investors seek out additional information beyond the information contained in earnings, specifically relying on the "new" information provided in analysts' forecasts.

Table 7 examines the impact alignment has on the relation between abnormal returns and unexpected earnings. In this analysis the variable of interest is the interaction of unexpected

TABLE 7

Tests of the market reaction to firm alignment where actuals equaled or beat forecast by 1 cent or less

$$\text{AbRet}_{i,t} = \omega_0 + \omega_1 \text{UE}_{i,t} + \omega_2 \text{Align}_{i,t} + \omega_3 (\text{UE}_{i,t} * \text{Align}_{i,t}) + \omega_4 \text{FirmSize}_{i,t} + \omega_5 \text{Loss}_{i,t} + \omega_6 \text{Beta}_{i,t} + \omega_7 \text{DtoE}_{i,t} + \omega_8 \text{Analysts}_{i,t} + \varepsilon_{4i,t}$$

*Panel A: Abnormal return based on decile portfolios formed using Scholes-Williams' betas*

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Model 1	Model 2	Model 3	Model 1	Model 2	Model 3
Intercept	0.442 ***	0.552	0.316	-0.039	-1.835	-1.192
UE <sub>i,t</sub>	7.661 ***	6.978 **	4.588	1.771	-7.653	-7.643
Align <sub>i,t</sub>	-0.594 ***	-0.567 ***	-0.318	1.445 **	1.171 **	1.329 **
UE <sub>i,t</sub> *Align <sub>i,t</sub>	-7.374 **	-6.811 *	-5.174	20.806 **	19.873 **	24.315 ***
FirmSize <sub>i,t</sub>		-0.038	0.008		0.019	-0.035
Beta <sub>i,t</sub>		0.025	0.157		1.044 ***	1.006 ***
DtoE <sub>i,t</sub>		0.008	-0.025		-0.066	-0.241 *
Analysts <sub>i,t</sub>		0.013	-0.010		0.031	0.059
<i>Industry and year dummies</i>			<i>Included</i>			<i>Included</i>
Adj R <sup>2</sup>	0.1959	0.1624	0.2881	0.1273	0.3668	0.5484

*Panel B: Abnormal return based on decile portfolios formed using firm size*

	Top Partition (Top 25% GM)			Bottom Partition (Bottom 25% GM)		
	Model 1	Model 2	Model 3	Model 1	Model 2	Model 3
Intercept	0.392 **	0.263	0.030	-0.009	-1.987	-1.328
UE <sub>i,t</sub>	8.088 **	6.913 **	4.733	3.607	-6.295	-6.181
Align <sub>i,t</sub>	-0.595 ***	-0.592 **	-0.321	1.371 **	1.113 **	1.299 **
UE <sub>i,t</sub> *Align <sub>i,t</sub>	-7.727 *	-7.052	-4.821	18.553 *	18.097 **	22.225 **
FirmSize <sub>i,t</sub>		-0.024	0.039		0.021	-0.033
Beta <sub>i,t</sub>		0.111	0.252		1.122 ***	1.101 ***
DtoE <sub>i,t</sub>		0.013	-0.022		-0.026	-0.225 *
Analysts <sub>i,t</sub>		0.014	-0.013		0.030	0.064
<i>Industry and year dummies</i>			<i>Included</i>			<i>Included</i>
Adj R <sup>2</sup>	0.1478	0.1303	0.2998	0.1167	0.3866	0.5808

The reduced sample consists of 3,151 firm-year observations for 648 firms covering the period from 2002-2011, and \*, \*\*, and \*\*\* indicate significance at 0.10, 0.05, and 0.01 level, respectively. Model 1 is the base model without any controls, Model 2 includes the controls but



(Table 7 continued)

excluded the industry and year dummies, and Model 3 is the full model, including all controls as well as the industry and year dummies.

$AbRet_{i,t}$  is the daily compounded return from one day after the prior periods announcement date to one day after the current period's announcement date less the mean return from the portfolio decile for firm  $i$  at time  $t$ .

$UE_{i,t}$  is unexpected earnings calculated as current period earnings less the first consensus analysts' forecasts provided after the prior year's announcement for the current year end for firm  $i$  at time  $t$ .

$Align_{i,t}$  is an indicator variable having the value of one if the firm is an Aligned Firm and a zero otherwise for firm  $i$  at time  $t$ .

$FirmSize_{i,t}$  is the natural logarithm of the market value of equity for firm  $i$  at time  $t$ .

$Beta_{i,t}$  is the firm beta as defined by Scholes-Williams (1977) for firm  $i$  at time  $t$ .

$DtoE_{i,t}$  is the debt to equity ratio, calculated as total debt divided by total equity for firm  $i$  at time  $t$ .

$Anllysts_{i,t}$  is the number of analysts following the firm as reported by IBES for firm  $i$  at time  $t$ .

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earnings with Aligned Firms ( $UE_{i,t} * Align_{i,t}$ ). For the analysis presented in Table 7 the data is parsed into four groups based on the accuracy of forecasted earnings as compared to reported earnings. These four groups are as follows: large miss, defined as actual earnings per share (EPS) being more than one cent below consensus analysts' forecasts; miss, defined as EPS that is between one cent below consensus analysts' forecasts and meeting consensus analysts' forecasts; meet or beat, defined as EPS that is between consensus analysts' forecasts and one cent above consensus analysts' forecasts; and exceed, defined as EPS that is more than one cent above consensus analysts' forecasts. Within each of these four groups the data is then parsed into the Top or Bottom Partition based on gross margin percentage. After conducting the analysis, the interaction term ( $\omega_3$ ) was insignificant for all groups except for the meet or beat group. As such only the meet or beat group is reported in Table 7.

For Table 7 Panel A the calculation of abnormal returns is based on the creation of ten portfolios formed using the Scholes-William (1977) betas. For the Top Partition the coefficient on the interaction term ( $\omega_3$ ) declines in significance as the controls are added, and once all controls are included that coefficient is insignificant. However, in the Bottom Partition the coefficient remains significant in all version of the model. These results do not provide support for H3 in the Top Partition but support H3 in the Bottom Partition. These results show that alignment is important for the cost leader but less important for the differentiator.

In Table 7 Panel B the calculation of abnormal returns is based on the creation of ten portfolios formed using firm size. For the Top Partition the coefficient on the interaction term declines in magnitude and in significance as the controls are added, and once all controls are included the coefficient is insignificant. However, in the Bottom Partition the coefficient remains significant in all version of the model. These results do not support H3 in the Top Partition but support H3

in the Bottom Partition. As above in Panel A these results suggest alignment is most important for the cost leader but less important for the differentiator, which is consistent with the results presented in Table 6. I interpret these findings to indicate that every cost must be carefully managed by the cost leader and therefore any cost that does not align with the minimal cost structure is a hindrance to the firm. For the differentiator, the results suggest that the perception of uniqueness within the product can be created in many ways, and while employee and customer relations, is an important avenue it is not the only option.

## VI. CONCLUSION AND FUTURE DEVELOPMENT

In this paper I examine the impact of the alignment of a firm's employee and customer relations with the firm's competitive strategy on earnings persistence and the market's reaction to this relation. I use a subset of the KLD ratings to assess firm alignment, specifically the qualitative areas of employee relations and product quality. These ratings serve as a proxy for the firm's focus on employee and customer relations, respectively. To determine alignment the firm's focus on employee and customer relations must be evaluated within a competitive context, namely the classification system described by Porter (1998). By narrowing the sample to only include differentiators and cost leaders the study has a sound theoretical foundation upon which to conduct the analysis. To operationalize Porter's classification system I partition the sample based on gross margin percentage, with the top 25% of the distribution designated as differentiators and the bottom 25% as cost leaders.

Because the testing will be based on firms with a focus on either employee relations, customer relations, or both, I begin by demonstrating that combining employee and customer relations together is a reasonable approach. By testing that a focus on employee and customer relations alone will not drive an increase in earnings persistence, the study shows it is the alignment of a firm's focus that is critical in the relation with earnings persistence. I then examine the key firm characteristics of: firm size, the level of firm indebtedness, the level of firm growth, and the strength of the firm's corporate governance and consider the impact each of these characteristics have on earnings persistence. My results suggest that firm size and growth are of little importance when considering the alignment of a firm's focus and its competitive strategy. However, for cost leaders, the characteristics of leverage and corporate governance are impacted by firm alignment.

In an effort to further my understanding of firm alignment I tested the market's reaction to alignment employing two different tests. First I considered the implications of firm alignment on the incremental explanatory power of analysts' forecasts. In conducting this analysis I use the full model that is then compared to two variations of that model. The interpretation of the analysis relies on the difference in the  $R^2$  between the different versions of the model. By examining the differences in the  $R^2$ , I am able to estimate the incremental explanatory power of analysts' forecasts and show that incremental explanatory power of analysts' forecasts is lower for Aligned Firms as they have more persistent earnings. I also test the market's reaction to firm alignment by examining the relation between abnormal earnings and unexpected earnings when reported EPS meets or beats consensus analysts' forecasts by one cent or less. These results show investors in the Bottom Partition place more confidence in unexpected earnings for Aligned Firms than for Misaligned Firms.

Taken as a whole this study demonstrates that firm alignment plays a role in earnings quality and that alignment is a useful characteristics to investors. When firms are not aligned, investors rely more heavily on the efforts of financial analysts to provide a deeper understanding of the firm beyond the information provided by earnings alone. As with any study this analysis is subject to weaknesses. It is possible that proxies used do not adequately represent the constructs intended as such the inferences are erroneous; however, given the theoretical underpinnings of the study I do not believe this to be the case. It is also possible that circumstance may exist where it is optimal for a firm to choose to be misaligned. Such cases work against the findings herein and an examination of these cases will be left for future research. Additionally, as suggested by Kim et al. (2012), the use of subcategories of KLD

ratings provides a fertile academic research space, and one that needs to be further explored with future studies.

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## APPENDIX

### Variable Definitions

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Aligned Firms	having an assessment greater than zero in the KLD category of “Employee Relations”, “Product Quality” or both for firms in the Top Partition, or having a zero in KLD’s assessment of “Employee Relations” and “Product Quality” for firms in the Bottom Partition.
Misaligned Firms	having a zero in KLD’ assessment “Employee Relations” and “Product Quality” for firms in the Top Partition, or having an assessment greater than zero in the KLD category of “Employee Relations”, “Product Quality” or both for firms in the Bottom Partition.
Top Partition	is the top quartile of firms after the firms were ordered based on gross margin percentage from highest to lowest.
Bottom Partition	is the bottom quartile of firms after the firms were ordered based on gross margin percentage from highest to lowest.

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AbRet <sub><i>i,t</i></sub>	is the daily compounded return from one day after the prior periods announcement date to one day after the current period’s announcement date less the mean return from the decile for firm <i>i</i> at time <i>t</i> .
Adv <sub><i>i,t</i></sub>	is an indicator variable having the value of one if advertising expense (Adv1) was greater than zero and a zero otherwise firm <i>i</i> at time <i>t</i> .
Adv1 <sub><i>i,t</i></sub>	is calculated as advertising expense divided by net sales for firm <i>i</i> at time <i>t</i> .
Age <sub><i>i,t</i></sub>	is an indicator variable having a value of one if firm age (Age1) is greater than the sample median and a zero otherwise firm <i>i</i> at time <i>t</i> .
Age1 <sub><i>i,t</i></sub>	is the sum of the number of years since firm <i>i</i> was first listed on Compustat at time <i>t</i> .
Align <sub><i>i,t</i></sub>	is an indicator variable having the value of one if the firm is an Aligned Firm and a zero otherwise for firm <i>i</i> at time <i>t</i> .
Anlaysts <sub><i>i,t</i></sub>	is the number of analysts following the firm per IBES for firm <i>i</i> at time <i>t</i> .
Beta <sub><i>i,t</i></sub>	is the firm beta as defined by Scholes-Williams (1977) for firm <i>i</i> at time <i>t</i> .
DtoE <sub><i>i,t</i></sub>	is total debt divided by total equity for firm <i>i</i> at time <i>t</i> .
E <sub><i>i,t</i></sub>	is net income plus discontinued operations and income taxes all scaled by total assets for firm <i>i</i> at time <i>t</i> .
FirmSize <sub><i>i,t</i></sub>	is the natural logarithm of the market value of equity for firm <i>i</i> at time <i>t</i> .

$Gov_{i,t}$	is an indicator variable having a value of one if the net KLD rating for corporate governance, measured as the number of strengths minus the number of concerns is greater than zero and zero otherwise for firm $i$ at time $t$ .
$Ind\_Dummies_{i,t}$	is an indicator variable having the value of one if the firm is included in the industry portfolio and a zero otherwise, where the industry portfolios is one of the twelve Fama French industry portfolios defined by SIC code.
$Intgble_{i,t}$	is an indicator variable having the value of one for firms with intangible assets that are greater than zero and a zero otherwise for firm $i$ at time $t$ .
$Lev_{i,t}$	is an indicator variable having a value of one if long-term debt scaled by total assets is larger than the median for the sample and zero otherwise for firm $i$ at time $t$ .
$LgSI_{i,t}$	is an indicator variable having the value of one for firms with large special items and zero otherwise, where large special items is defined as total special items that exceed 1% of average total assets for firm $i$ at time $t$ .
$Loss_{i,t}$	is an indicator variable having the value of one for firms with net income that is less than zero and a zero otherwise for firm $i$ at time $t$ .
$MB_{i,t}$	is an indicator variable having a value of one if the market-to-book equity ratio is larger than the median for the sample and zero otherwise, where the market-to-book equity ratio is calculated as the market value of equity over book value of equity for firm $i$ at time $t$ .
$Rep_{i,t}$	is an indicator variable having the value of one if firm $i$ is on Fortune's America's Most Admired Companies list and a zero otherwise at time $t$ .
$R\&D_{i,t}$	is an indicator variable having the value of one if the firm's research and development expense (R&D1) is greater than zero and a zero otherwise for firm $i$ at time $t$ .
$R\&D1_{i,t}$	is research and development expense divided by net sales for firm $i$ at time $t$ .
$Size_{i,t}$	is an indicator variable having a value of one if the natural logarithm of the market value of equity is smaller than the median for the sample and zero otherwise for firm $i$ at time $t$ .
$UE_{i,t}$	is unexpected earnings calculated as current period earnings less the first consensus analysts' forecasts provided after the prior year's announcement for the current year end for firm $i$ at time $t$ .
$Yr\_Dummies_{i,t}$	is an indicator variable having the value of one if the observation is for the given year and a zero otherwise.

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## VITA

Robert S. Hogan, a native of Arkansas, received his bachelor's degree in accounting at the University of Arkansas in 1999, and his masters of accountancy at the University of Arkansas the following summer. Thereafter he worked as an auditor for Arthur Andersen and then found employment in industry working his way up to the position of manager of financial accounting. As his interest in academics grew, he made the decision to pursue a PhD, and was accepted into the program at Louisiana State University. Upon graduation, Robert plans to pursue a career as an accounting professor at the College of Charleston, in Charleston, SC.