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A literature synthesis of experimental studies on management earnings guidance

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ABSTRACT

Researchers have long been interested in understanding why and how corporate managers issue earnings guidance and the effect of such guidance on stakeholders' (investors' and managers') behavior. Several recent studies have employed the experimental approach to address these issues. The purpose of this paper is to analyze and synthesize the literature on experimental studies of management earnings guidance. Consistent with the literature, I organize the synthesis to reflect (a) whether, why and how management issues guidance; (b) investors' reactions to guidance; (c) the effect of guidance on management behavior. In addition, I provide institutional information (e.g., nature and timing of guidance) about guidance as well as provide several directions for future research. The synthesis reveals that the experimental studies have made a unique contribution to this literature by (i) providing evidence on process variables that underlie some empirical associations, (ii) directly measuring managers' personal attributes and, (iii) closing the causality gap in the guidance literature.

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1. Introduction

Management earnings guidance, or management forecast, refers to "a company publicly disclosing its own projections of its financial results for the upcoming quarter or fiscal year" (Diamond & Yevmenenko, 2011, p. 44).[2] Researchers have had a long and continuing interest in examining the antecedents, characteristics, and consequences of management earnings guidance (for a review, see Hirst, Koonce, & Venkataraman, 2008). The early research focused primarily on using archival methods to test economic theories of earnings guidance (see Cameron, 1986; King, Pownall, & Waymire, 1990 for reviews). Several recent studies have employed the experimental approach to test psychology theories of earnings guidance (see Hirst et al., 2008 for a review across all methodologies).

Experimental studies in this area are important since they provide unique advantages that are unavailable to other paradigms. First, experimenters are able to hold information constant across treatment conditions, and are better able to establish stronger causal relation between the independent and dependent variables (Libby, Bloomfield, & Nelson, 2002). Second, experimenters can measure process variables and provide answers to questions such as why certain phenomena occur (Libby et al., 2002). Finally, experimental research is able to provide *ex ante* evidence on guidance issues for which little or no archival data are available (e.g., Nelson & Rupar, 2011). It thus may contribute to accounting policy research (Maines, 1994). Hence, the experimental approach has the potential to shed important insights on why and how corporate managers issue earnings guidance and the effect of such guidance on stakeholders' (investors' and managers') behavior.

The purpose of this paper is to provide a comprehensive analysis and synthesis of experimental research on management earnings guidance. This literature synthesis is important in assessing the unique insights that experimental research has offered in understanding the guidance literature, identifying gaps in the literature, evaluating the extent to which the experimental research corroborates or contradicts archival findings and identifying unresolved and important issues for further research. A synthesis is also important to managers, who seek to make better disclosure decisions by shedding light on how investors react to disclosures, and to regulators, who seek evidence of how investors are impacted by voluntary disclosures, such as earnings guidance (Elliott, Hodge, Kennedy, & Pronk, 2007).

The experimental literature has concerned itself with whether or not management will issue guidance and, if they do, why and how the guidance is issued (e.g., Libby & Rennekamp, 2012). Researchers have also been interested in the effect of the presence, nature and form of guidance on investors (e.g., Libby & Tan, 1999); and finally, how does the commitment to guide affect management's contemporaneous and subsequent operating and disclosure behaviors (Wang & Tan, 2013). Corresponding to this research focus, the remainder of this paper is structured as follows. I provide background information about the guidance environment by introducing and defining key terms and concepts in the next section. The organizing framework for synthesizing the extant research follows this (Section 3). In Section 4, I provide a synthesis of the literature on whether, why and how corporate managers issue earnings guidance. In Section 5, I synthesize the literature on whether, how and why investors react to management guidance. Section 6 focuses on whether and how the decision to guide affects the guider's behavior. The last section explores directions for future research and offers concluding remarks.

2. Background and concepts

Some public companies have a long history of voluntarily disclosing projections of their financial results for the upcoming quarter or fiscal year. This practice, referred to as providing earnings guidance, became more common during the latter half of the 1990s, after the US congress enacted the Private Securities Litigation Reform Act of 1995, which included safe harbor provisions for such projections (Hsieh, Koller, & Rajan, 2006). The impetus for providing guidance is a subject of continuing debate with lower share price volatility, higher valuations, stock liquidity and maintaining

[2] Several other terms have been used in the literature to refer to particular types of management earnings guidance. For example, earnings guidance for negative earnings prospects may be referred to as "earnings warnings" (e.g., Libby & Tan, 1999).