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Management earnings forecasts and analyst forecasts: Evidence from mandatory disclosure system

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ABSTRACT

Distinct from the literature on the effects that management earnings forecasts (MEFs) properties, such as point, range and qualitative estimations, have on analyst forecasts, this study explores the effects of selective disclosure of MEFs. Under China's mandatory disclosure system, this study proposes that managers issue frequent forecasts to take advantage of opportune changes in predicted earnings. The argument herein is that this selective disclosure of MEFs increases information asymmetry and uncertainty, negatively influencing analyst earnings forecasts. Empirical evidence shows that firms that issue more frequent forecasts and make significant changes in MEFs are less likely to attract an analyst following, which can lead to less accurate analyst forecasts. The results imply that the selective disclosure of MEFs damages information transmission and market efficiency, which can enlighten regulators seeking to further enhance disclosure policies.

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1. Introduction

Management earnings forecasts (MEFs) of listed companies can reduce information asymmetry and the cost of capital, improving the efficiency of resource allocation in the capital market. Since 2001, regulators have constantly changed policies to promote and perfect the management forecast system in the Chinese capital market. A firm's management must release earnings forecasts when they anticipate that the firm's

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performance may fluctuate or deviate significantly from preliminary expectations. This provides investors with more timely information and reduces information asymmetry in the capital market. The literature tends to focus either on the institutional background of voluntary management forecasts or on the alternative MEF types (e.g., Libby et al., 2006; Wang and Wang, 2012). However, few studies explore the effects of MEFs on analyst earnings forecasts (AEFs) under a mandatory system. This issue is especially important in China, as executives may make selective disclosures opportunistically under the mandatory system. The selective disclosure of MEFs may not be consistent with the regulation's original intention, thus whether and how MEFs are selectively disclosed influence the behavior of market participants, making them important but rarely addressed questions. This study fills this gap by investigating MEFs' effects on analyst forecasts.

Under the existing mandatory management forecast system, as long as predicted performance reaches the required threshold, managers must disclose their earnings forecasts. Although the system is mandatory, managers have some selectivity in their choices that allow them to strategically maximize their own benefits before the actual earnings are disclosed in an annual report, such as selecting a certain management forecast form (qualitative or quantitative, point or range estimation). Some studies investigate how the types of MEFs affect the behavior of securities analysts, such as Libby et al. (2006) and Wang and Wang (2012). In contrast, this study focuses on the important issues of forecast frequency and significant changes. A significant change in a forecast is defined as managers making opposite forecasts in multiple MEFs, such as from loss to profit or from profit to loss. The selective disclosure of MEFs, such as multiple forecasts and significant forecast changes, is common in China's capital market. For example, the listed firm "Green Earth" (stock code: 002200) forecast an increase in third-quarter earnings from 20% to 50% in 2009, then further revised the net profit range for 2009 downward to less than 30% in earnings forecasts made on January 30, 2010. A net profit for 2009 of 62.12 million yuan was forecast in a preliminary earnings estimate on February 27, 2010, only to be corrected to a loss of 127.96 million yuan on April 28, 2010. However, the earnings in 2009 were reported as a loss of 151.23 million yuan when the annual report was released on April 30, 2010. The company not only disclosed its earnings forecasts many times, but also changed their nature, prompting a significant change in earnings forecasts.

Management earnings forecasts aim to increase decision-related information for investors and reduce information asymmetry to reduce the cost of capital. As sophisticated investors, analysts rely on both public and private information to make earnings forecasts, and thus they are more sensitive to the quality and quantity of information. If a firm's management selectively discloses MEFs, then analysts face greater information risk and uncertainty, which can result in them issuing less-accurate forecasts. Anecdotal evidence shows that MEFs are always a strong focus of financial analysts as a "prelude" to the annual financial statements of listed companies.[1] As a channel of information transmission, MEFs provide more information and hence improve the quality of prediction for analysts (Libby et al., 2006). However, the error and uncertainty in MEFs may also affect analysts' forecast accuracy and dispersion (Barron et al., 1998; Zhang, 2006). If a firm's management makes a selective disclosure, such as multiple forecasts or significant forecast changes, the quantity and quality of analysts' access to public information changes, ultimately affecting their forecast quality. This study predicts that the selective disclosure of MEFs increases information uncertainty, causing analysts to change their subsequent decisions and thus reducing their forecast accuracy. The empirical results support this hypothesis and show that firms with greater forecast frequency and significant forecast changes are less likely to attract an analyst following and reduce analysts' forecast accuracy.

This study contributes to the literature in the following ways. First, it provides direct evidence of how selectively disclosing MEFs affects financial analysts' behavior. Previous studies mainly focus on the ways in which alternative MEF types influence analysts' forecasts. This study extends the research to include the economic consequences that selectively disclosing MEFs has on analysts' forecasts. Second, this study provides empirical evidence of the relationship between information disclosure and analyst behavior under an institutional background of mandatory MEFs. Unlike some mature capital markets, such as those in the United States,

[1] Analysts often use the earnings forecasts of listed companies to make forecast revisions and engage in further tracking. An example is DaYe Special Steel (000708), which published a positive profit alert for 2010 on January 24, 2011, leading Guosen Securities to issue an analysis report based on the earnings forecast. They stated that the performance of beneficial equipment manufacturing was better than expected "the next day." For details: http://stock.hexun.com/2011-01-25/127008640.html.

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