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Strategic management guidance and insider trading activities

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A B S T R A C T

We assess whether managers engage in ex ante strategic behavior when issuing earnings forecasts in a novel context. We posit that some managers provide inaccurate downward guidance to increase the positive surprise and pricing premium at the earnings announcement, thereby maximizing profits from selling shares following the earnings announcement. In support, we document that managers are more likely to have issued prior inaccurate downward guidance when they sell more shares or increase their selling activities following the earnings announcement. Further, we show that these managers benefit economically by linking inaccurate downward guidance to greater pricing premiums at the earnings announcement date and more positive cumulative stock returns over the period from inaccurate downward guidance to subsequent earnings announcement.

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1. Introduction

Prior research suggests that managers engage in strategic behavior when issuing earnings forecasts by examining whether managers buy (sell) more shares in the days immediately following bad (good) news forecasts (Noe, 1999; Cheng and Lo, 2006). However, these studies generally fail to control for manager guidance issued to satisfy the legal requirement under SEC Rule 10b-5 prior to insider

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trading, which Li et al. (2014) show can lead to erroneous conclusions.[1] Further, insider trading immediately after issuing management forecasts could be the result of managers' *ex post* perceptions of investor mispricing (Li et al., 2012). For example, Das et al. (2012) find that investors overreact to bad news management forecasts. Thus, Cheng and Lo's (2006) evidence of more insider buying following bad news forecasts could be the result of managers' *ex post* recognition of the overreaction rather than an *ex ante* forecasting strategy. These confounding factors and alternative hypotheses challenge the reliability of evidence and conclusions these studies can make about whether managers issue forecasts strategically *in anticipation* of personally benefiting via subsequent insider trading activities. We identify a unique context and management insider trading strategy that controls for SEC Rule 10b-5 and mispricing as alternative explanations by examining only inaccurate management guidance issued well in advance of the insider trading activities of interest. This represents a more powerful setting to investigate whether managers issue forecasts opportunistically.

We rule out management forecasts to satisfy SEC Rule 10b-5 by focusing on management forecasts that are inaccurate (i.e., guide expectations away from actual earnings). Managers guide expectations inaccurately by either issuing inaccurate upward guidance when expectations are already optimistic or by issuing inaccurate downward guidance when expectations are already pessimistic.[2] Of the two, we expect ex ante strategic behavior is more likely when managers issue inaccurate downward guidance given managers' concerns about litigation risk and since downward guidance is viewed as more credible. We further eliminate Rule 10b-5 disclosures and control for investor mispricing by examining the relation between management forecasts issued early in the quarter and insider trading that occurs after the subsequent quarterly earnings announcement. In particular, we expect that managers who anticipate selling more shares may strategically issue inaccurate downward guidance to increase the likelihood of a larger positive surprise at the earnings announcement. This, in turn, would result in a larger pricing premium at the earnings announcement than would have been achieved absent the inaccurate downward guidance. Managers can then take advantage of the higher stock price by selling more shares. Thus, our study investigates a particular context and strategy not examined in prior studies assessing whether managers may use management forecasts (i.e., a voluntary disclosure) to increase their profits from insider trading.

Our context is appealing for assessing ex ante strategic behavior for several other reasons. First, manager's perceived culpability for forecast inaccuracy resulting from this strategy is likely reduced given the longer time between forecast and earnings announcement, while the longer time between forecast issuance and trading activity reduces the likelihood of associating the two events. Second, we focus on downward guidance that prior studies suggest is interpreted by investors as more credible than upward guidance (e.g., Jennings, 1987; Williams, 1996; Hutton et al., 2003; Anilowski et al., 2007), increasing the likelihood that this strategy will be effective. Third, as reported in prior studies, a market pricing premium for downward guidance that ultimately yields a positive surprise at the earnings announcement provides a strong economic incentive for ex ante strategic behavior prior to insider trading (Bartov et al., 2002; Koh et al., 2008). We document a larger pricing premium for these firms relative to all other firms with a positive surprise. Fourth, managers are typically net sellers to diversify their portfolios, so selling for opportunistic reasons may be more easily disguised. Fifth, prior studies assessing litigation as a motivating factor for forecast guidance suggest that forecasts issued early in the quarter may be less litigation-motivated (Kasznik and Lev, 1995; Skinner, 1997; Rogers and Stocken, 2005). However, we control for litigation risk in our regression models.

[1] Rule 10b-5 prohibits anyone from defrauding, making false statements, omitting relevant information or otherwise conducting operations of business that would deceive another person related to transactions involving stock and other securities. With regard to insider trading activities, the SEC argues that anyone with material, non-public information must either disclose that information or abstain from trading.

[2] Expectations are classified as optimistic or pessimistic at the time of the management forecast based on the most recent prior analyst forecast. We reasonably assume that when managers issue management guidance, they have a more well-informed estimate of actual earnings so are able to discern, to some degree, between optimistic and pessimistic current expectations. Errors in those estimates should be random, thus evenly distributed across firms. Basing our classification on the most recent consensus forecast produces little difference in the classification percentages and test results. Since at least half of the forecasts comprising the consensus are in agreement with the optimistic or pessimistic classification, classification based on the most recent forecast represents optimism or pessimism that prevails in outstanding forecasts.

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