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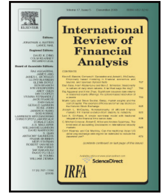

The use of management forecasts to dampen analysts' expectations by Chinese listed firms

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ABSTRACT

This paper studies the use of management earnings forecasts (MEF) to dampen analysts' expectations, i.e. expectation management, by Chinese listed companies. We reveal several important findings: Firstly, information asymmetry is positively associated with the use of MEF to dampen analysts' expectations. State control has been found to moderate this relationship. Secondly, dampening analysts' expectations using MEF leads to negative stock return reactions and downward analysts' forecast revisions. Thirdly, the effectiveness of "pre-empting bad news through MEF" appears mixed and dependent on the information content of MEF and measures of actual earnings surprises. Finally, firms that disclose MEF are found to engage in more earnings management to meet the forecasts than firms that do not.

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1. Introduction

The Chinese stock market is characterized with strong government influences, weak corporate governance, and high information asymmetry. The recent decade has seen consistent regulatory reforms in this market aimed at enhancing market efficiency and improving minority investor protection. For instance, a non-tradable shares reform took place in 2005 and transformed non-tradable shares in the form of state shares and legal person shares into tradable shares (Liao, Liu, & Wang, 2014). In addition to that, the stock exchanges in Shanghai and Shenzhen have imposed more stringent disclosure requirements on information disclosures aimed at improving corporate governance (Huang, 2015). This paper examines the nature of management earnings forecasts (MEF, or earnings guidance) and the consequences of MEF disclosures by Chinese listed companies. The disclosures of MEF by Chinese listed companies (also referred to as "performance pre-announcements" in Chinese) are currently governed by listing requirements in Shanghai and Shenzhen exchanges. Unlike the US market where MEF disclosure is voluntary, MEF disclosure in China is mandatory if firms expect their annual, or interim, or third quarter net profit will be any of the three cases: (1) negative; (2) change by more than 50% compared to the same period of the previous financial year; and (3) positive after previous loss or losses. Although these mandatory disclosure rules were instituted since 2000, and modified in 2004 and 2006, they are hardly enforced due to difficulties in detection of violations and selective punishment by regulators (Song & Ji, 2012). Furthermore, firms retain some control over the content of earnings information that is disclosed. For instance, about 60% of the listed companies have issued MEF during 2005–2013 by stating the categories of forecasted earnings, among which only about half issued range or point forecasts of earnings.[1]

The literature on MEF of US firms has mainly focused on the motivations for and the consequences of MEF disclosures under its voluntary disclosures regime. Extant studies indicate that voluntarily disclosure of management earnings forecasts by listed firms reduces information asymmetry, lowers bid-ask spread, and decreases cost of capital (Coller & Yohn, 1997; Diamond & Verrecchia, 1991; Easly & O'Hara, 2004; McNichols, 1989). Moreover, there has been an increasing tendency of firms using MEF to dampen analysts' expectations towards achievable targets and pre-empt the effects of bad earnings news (Ajinkya & Gift, 1984; Anilowski, Feng, & Skinner, 2007; Baik & Jiang, 2006; Bartov, Givoly, & Hayn, 2002; Cotter, Tuna, & Wysocki, 2006; Kross, Ro, & Suk, 2011; Matsumoto, 2002; Skinner, 1994).[2] Such activities are often referred to as "expectation management" (Cotter et al.,

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[1] See Section 3 for these categories.
[2] Alternatively, information asymmetry may decrease if managers have less pressure to manage reported earnings to meet guidance numbers (Hu, Hwang, & Jiang, 2014).

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2006). This strand of literature has mainly focused on the US stock market and very limited attention has been paid to the emerging markets where disclosure requirements are less stringent and corporate governance is weaker. Nevertheless, these markets provide ideal testing ground for empirical studies on MEF disclosures due to relatively higher information asymmetry and stronger managerial and controlling shareholder incentives to manipulate investor expectations under weaker institutional environment. A recent study by Huang, Li, Tse, and Tucker (2013) reviews the MEF disclosure rules in China and suggests that voluntary MEF have better quality than mandatory MEF and government state-owned enterprises are reluctant to provide MEF voluntarily. Although this pioneering study provides an empirical analysis of the special regulatory environment in China compared to the US, the associations among firms' information environment, analysts' forecasts, and the nature of MEF are unclear. Moreover, the stock market consequences of using MEF to dampen analysts' forecasts in the Chinese stock market remain unexplored.

Our paper therefore contributes to the existing literature by extending prior studies dominated by evidence from the US market to China, the world's largest emerging market. We show that the institutional environment and corporate governance structure in this transition economy affect firm disclosure incentives and the nature of MEF. To our knowledge, this paper is among the first studies that comprehensively examines the use of MEF for expectation management in an emerging market. Our findings are as follows: First, information asymmetry is positively associated with the use of MEF to dampen analysts' expectations and state control moderates this relationship. Second, dampening analysts' expectations using MEF leads to negative stock return reactions and downward analysts' forecast revisions. Third, the effectiveness of “pre-empting bad news through MEF” appears mixed and dependent on the information content of MEF and measures of actual earnings surprises. Finally, firms that disclose MEF engage in more earnings management to meet the forecasts than firms that do not.

The remainder of the paper is structured as follows: Section 2 discusses China's institutional background and develops our hypotheses. Section 3 outlines the data and variable measurement. Section 4 provides analysis and discusses the results. Section 5 concludes.

2. Institutional background and hypotheses development

The stock exchanges in China were established in Shanghai and Shenzhen in the early 1990s to provide a vehicle for share issue privatization of China's state-owned enterprises (SOEs). The Chinese government kept dominant equity stakes in the listed firms after their privatizations, in the form of state shares and legal person shares which are non-tradable, to retain its control (Wei, Xie, & Zhang, 2005; Sun & Tong, 2003). The dominance of non-tradable shares in listed firms' ownership structure hindered the proper functioning of the stock market and corporate governance (Firth, Lin, & Zou, 2010; Liao et al., 2014). Although the Chinese government implemented a Split Share Structure Reform in 2005 which has significantly reduced the percentages of non-tradable shares over the past decade, controls of more than half of the listed companies in China are still in the hands of the government today. State association has been criticized for reducing operational efficiency (Liao et al., 2014), and controlling shareholder tunneling (Jiang, Lee, & Yue, 2010; Huang, 2015; Huyghebaert & Wang, 2012; Liu & Tian, 2012; Qian & Yeung, 2015; Zhang, Gao, Guan, & Jiang, 2014). Moreover, La Porta, Lopez-De-Silanes, and Shleifer (1999), Claessens, Djankov, Fan, and Lang (2002), and Lins (2003) illustrate that listed companies in the emerging markets around the world are often closely held by large and dominating shareholders. Ownership concentration is prevalent among Chinese firms. For instance, top 10 block-shareholders often collectively represent more than half of the total equity interests in listed firms. Shleifer and Vishny (1997) suggest that large shareholders who gain effective control of the firms often have incentives to pursue their own interests which are often different from the interests of minority shareholders. In this case, concentrated ownership does not improve incentive alignment and instead leads to exacerbated tunneling (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000). In addition to that, the controlling shareholders often have excess control rights beyond their cashflow/ownership rights that can facilitate expropriations of minority interests (Claessens et al., 2002; Liu & Tian, 2012). These features give strong structural power to the large shareholders of Chinese firms in determining corporate policies including information disclosures often at the cost of minority shareholders. For instance, Tan, Zhu, Zeng, and Gao (2014) suggest that Chinese non-state-owned enterprises (non-SOEs) face stronger external finance pressure than state-owned enterprises (SOEs) and document that such pressure affects corporate disclosures.

There are two channels through which China's institutional environment may influence MEF disclosures and the consequences of MEF disclosures. First, information asymmetry. Prior literature on the US firms generally document reduced information asymmetry for firms' disclose MEF (Coller & Yohn, 1997; Diamond & Verrecchia, 1991; Easly & O'Hara, 2004; McNichols, 1989). Information asymmetry problems are likely to be associated with state ownership as governments try to conceal the politically motivated diversion of corporate resources in order to pursue non-value-maximizing goals such as maximizing employment and wages, promoting regional development, and providing cheaper goods and services (Chaney, Faccio, & Parsley, 2011). In addition, earlier international studies such as Ali and Hwang (2000) and Ball, Kothari, and Robin (2000) on the value relevance of accounting information argue that the role of accounting information is more limited in environments that are characterized by low investor protection and more concentrated ownership structure. Empirical evidence on the Chinese stock market also supports these arguments. For instance, Gul, Kim, and Qiu (2010) document less share price informativeness among Chinese firms with a higher degree of ownership concentration or state ownership. Kuo, Ning, and Song (2014) find that the quality of accounting information in Chinese market has not improved after the Split Share Structure Reform because ownership concentration remains high. Haß, Vergauwe, and Zhang (2014) and Huang and Wright (2015) suggest that the quality of analysts' earnings forecasts reflects the quality of corporate governance and information environment of Chinese firms and illustrate that analysts' forecasts are poorer and more upward biased for state associated firms. Firms characterized with weak corporate governance and high information asymmetry may be incentivized to increase information disclosure to avoid adverse selection by investors (Charoenwong, Ding, & Siraprapasiri, 2011) and reduce the cost of capital (Easly & O'Hara, 2004; Zhang & Ding, 2006). In particular, when firms disclose MEF, the nature of the MEF may be associated with the quality of analysts' forecasts due to the negative association between government control and analysts' forecast quality (Haß et al., 2014; Huang & Wright, 2015).

Second, incentives of beating market expectation. The literature on the US market suggests that beating analysts' expectations leads to positive excess returns during post-earnings announcement periods (see Adut, Duru, & Galpin, 2011; Bartov et al., 2002; Kross et al., 2011 for reviews of this literature). Moshirian, Ng, and Wu (2009) analyze a sample of 13 emerging countries including China over the decade from 1996 to 2005 and find that investors can act on the valuable information provided by stock analysts to make abnormal gains in emerging markets. In a related study on Chinese firms, Truong (2011) also documents that trading on earnings surprises, defined relative to analysts' forecasts, is profitable in China. Hence, Chinese firms may be incentivized to dampen analysts' expectations using MEF as firms in the US (Ajinkya & Gift, 1984; Anilowski et al., 2007; Baik & Jiang, 2006; Bartov et al., 2002; Cotter et al., 2006; Kross et al., 2011; Matsumoto, 2002; Skinner, 1994). Consequently, such activities may lead to negative stock reactions and analysts' forecast revisions. However, the incentives to dampen analysts' expectations may differ between government-controlled firms and private-controlled firms. This argument is also grounded in

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