Journal of Accounting and Economics 60 (2015) 161–180

Contents lists available at ScienceDirect

Journal of Accounting and Economics

journal homepage: www.elsevier.com/locate/jae

On guidance and volatility ☆

Mary Brooke Billings [a,*], Robert Jennings [b], Baruch Lev [a]

[a] New York University, USA
[b] Indiana University, USA

ARTICLE INFO

Available online 20 August 2015

JEL classification:
G13
G14
M41

Keywords:
Earnings guidance
Volatility
Earnings announcements
Bundled forecasts

ABSTRACT

In contrast to theoretical and empirical evidence linking disclosure to information environment benefits, recent research concludes that guidance increases volatility, but leaves open the question of whether volatility plays a role in prompting the issuance of guidance. Consistent with the notion that managers react to rising volatility by providing guidance, we document a link between abnormal run-ups in volatility and the decision to issue a forecast after controlling for the market's ability to anticipate the guidance. Upon disentangling pre-guidance volatility changes from post-guidance volatility changes, we find no evidence that guidance increases volatility. Indeed, our evidence consistently supports the view that managers seek to and do mitigate share price volatility with guidance.

© 2015 Elsevier B.V. All rights reserved.

1. Introduction

Theory and empirical evidence establish a close link between voluntary, value-relevant disclosure and share price volatility. Theoretical models indicate that managers engage in voluntary disclosure in order to decrease information asymmetry (Diamond, 1985; Diamond and Verrecchia, 1991) and reduce investor uncertainty (Dye, 1985; Lewellen and Shanken, 2002; Pastor and Veronesi, 2003). In these models, investors are uncertain about the parameters of the distribution of firms' future cash flows and earnings, and learn about the parameters of the distribution over time as information is revealed about the firm. Investors' uncertainty positively correlates with future stock return volatility and, as disclosure lowers uncertainty, it also lowers subsequent return volatility (Barry, 1978; Brown, 1979). In other words, disclosure increases the precision of investors' beliefs regarding the parameters of the distribution of future cash flows/earnings, and this belief precision links to forward-looking volatility of stock returns.[1] Consistent with this literature's focus on the volatility of firms' future stock returns, this paper examines the link between a specific type of disclosure—earnings guidance—and a forward-looking measure of the market's estimate of stock price volatility—option implied volatility. In so

☆ We thank Jerry Zimmerman (editor), John Bildersee, Ilan Guttman, Paul Healy (our JAE Conference discussant), Bob Holthausen, Danqi Hu (our CFEA discussant), Mike Kirschenheiter, Christian Leuz, Cathy Schrand, Doug Skinner, Phil Stocken, Li Zhang (our NYU Summer Camp discussant), workshop participants at the University of Illinois at Chicago and participants at the 2013 NYU Summer Camp, the 2014 Penn State Accounting Research Conference, the 2014 Conference on Financial Economics and Accounting, and the 2014 Journal of Accounting and Economics Conference for helpful suggestions.

* Correspondence to: New York University, Stern School of Business, Suite 10-94, 44 West Fourth Street, New York, NY 10012, USA. Tel.: +1 212 998 0097; fax: +1 212 995 4004.

E-mail addresses: mbilling@stern.nyu.edu (M.B. Billings), jennings@indiana.edu (R. Jennings), blev@stern.nyu.edu (B. Lev).

[1] Thus, in a Capital Asset Pricing Model setting, managerial supplied information about a firm's future prospects influences the stock's beta. Barry and Brown (1985) demonstrate that differential amounts of disclosure among firms affect the firm's equity cost of capital.

http://dx.doi.org/10.1016/j.jacceco.2015.07.008
0165-4101/© 2015 Elsevier B.V. All rights reserved.

doing, we provide evidence that speaks to the hotly debated question of whether managers seek to and do mitigate share price volatility with earnings guidance (Hsieh et al., 2006; Rogers et al., 2009).

A wealth of empirical evidence indicates that managers care about their firms' information environment, and specifically about stock return volatility: large stock price movements have been linked to decreased liquidity (Chordia et al., 2005), and the increased likelihood of both lawsuit filings (Kim and Skinner, 2012) and CEO turnover (Engel et al., 2003), all naturally of great concern to corporate managers. Indeed, consistent with the notion that volatility concerns influence managers' disclosure decisions, research documents that managers respond to shocks to their firm's information environment with increased disclosure (Leuz and Schrand, 2009) and, in particular, with increased guidance (Anantharaman and Zhang, 2011; Balakrishnan et al., 2014). Accordingly, a substantial literature connects managers' curative guidance efforts with various information environment benefits, including decreased information asymmetry (Coller and Yohn, 1997), reduced litigation risk (Billings and Cedergren, 2015), increased analyst coverage (Anantharaman and Zhang, 2011), economically meaningful improvements in liquidity (Balakrishnan et al., 2014), and compliance with disclose-or-abstain insider trading regulations (Li et al., 2014).[2]

Survey evidence corroborates the above findings: when asked about their ongoing communication with investors, managers express concern about excessive share price volatility, which they widely believed to escalate investors' risk perceptions about the firm and increase the likelihood of costly shareholder litigation. Consequently, executives often mention guidance's effectiveness in promoting a reputation for transparency, attracting analyst following, and constraining volatility, when explaining why they are committed to guidance (Graham et al., 2005; Johnson, 2009; National Investor Relations Institute, 2009). Thus, from managers' points of view, reducing volatility is an important objective, and guidance is an effective means for achieving this objective.

Yet, in contrast to the theoretical and empirical evidence linking disclosure to information environment benefits, recent research links guidance to both *increased* volatility (Rogers et al., 2009) and increased crash risk (Hamm et al., 2014). In so doing, it provides support for consultants and influential institutions (including McKinsey, Deloitte, the Business Roundtable and the CFA Institute) who advise against providing guidance — citing litigation and market penalties associated with missed earnings targets, as well as a lack of evidence that disclosure actually curbs volatility (Hsieh et al., 2006). Thus, while empirical evidence suggests that managers can use guidance to positively shape their firm's information environment, recent research examining volatility and crash risk contends that guidance achieves just the opposite.

Weighing in on this important debate, we consider the interplay between guidance and volatility. Consistent with recent theoretical work by Clinch and Verrecchia (2015) that underscores the importance of considering the endogeneity of disclosure choice when examining hypothesized benefits to disclosure, we begin our analysis by investigating whether volatility concerns play a role in prompting the issuance of guidance—a question left open by the prior literature. Then, controlling for determinants of disclosure, we examine the link between guidance and subsequent share price volatility. In particular, as shown in Panel A of Fig. 1, we focus on: (1) whether abnormal increases in volatility are associated with managers' decisions to bundle a forecast (guidance) with current-quarter earnings news, and (2) how volatility changes after the issuance of a bundled forecast compare to volatility changes in quarters in which earnings are released without guidance.

Our analyses examine a sample of 107,307 quarterly earnings announcements made during the decade since Regulation Fair Disclosure ("Reg FD") took effect in October of 2000. In our primary empirical tests, we compare the volatility dynamics surrounding quarterly earnings announcements bundled with guidance to quarterly earnings announcements without guidance. Recognizing that not all managers may seek to quiet volatility and because the theoretical disclosure literature emphasizes that it is a sustained commitment to disclosure that improves a firm's information environment (Diamond and Verrecchia, 1991; Leuz and Verrecchia, 2000; Clinch and Verrecchia, 2015), our tests concentrate on firms with a demonstrated willingness to guide.[3] Thus, because we aim to predict *when* a firm with a guiding history chooses to supply guidance (as opposed to *if* a firm chooses to be a guiding firm), we use firms' guiding histories to narrow our focus to the firm-quarters in which guiding firms choose whether to guide or not.

Prior work linking guidance to increases in volatility examines volatility *surrounding unbundled forecasts* (Rogers et al., 2009) and in the context of crash risk studies a yearly count of only *annual forecasts* (Hamm et al., 2014). Our research design and main tests, in contrast, focus on whether a *bundled quarterly or annual forecast* is given and the volatility dynamics *both before and after* that forecast (although we do examine unbundled forecasts in some of our empirical tests to corroborate our results). The overwhelming majority of guidance now arrives bundled with a quarterly earnings release. Over our sample period, approximately 80% of all forecasts are bundled and, in later years, the proportion climbs above 90%. Further, excluding either quarterly or annual forecasts leaves out approximately half of all post-Reg-FD guidance. Thus, bundled forecasts of *both* quarterly and annual earnings offer the most representative sample of guidance practices. Consistent with

[2] Prior work also links improvements in analysts' ratings of firms' disclosure policies to capital market benefits (Lang and Lundholm, 1993, 1996; Healy et al., 1999; Healy and Palepu, 2001).

[3] In particular, it is possible that some management teams face conflicting incentives that cause them to remain silent in the face of rising volatility. For example, So (2013) finds that firms with high sensitivities of firm value to changes in underlying volatility (i.e., "high-vega" firms) are more likely to be firms that abstain from giving guidance (i.e., "non-guiding" firms), consistent with the notion that these managers enjoy benefits associated with increased volatility. In our analyses, we test whether volatility concerns help to explain when a guiding firm chooses to give guidance.

Download English Version:

https://daneshyari.com/en/article/5086600

Download Persian Version:

https://daneshyari.com/article/5086600

Daneshyari.com