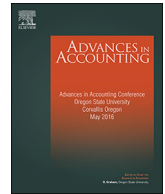


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How informative is qualitative management earnings guidance?

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ABSTRACT

In this paper I examine the information content of qualitative management earnings guidance relative to quantitative guidance. Hirst et al. (2008) note that managers may issue earnings forecasts in either qualitative or quantitative forms. Prior research on the consequences of forecast form has focused primarily on different forms of quantitative earnings guidance. This work either finds no effect of forecast form or that more precise guidance is more credible or informative. Using a sample of 14,468 quantitative EPS forecasts and 1265 qualitative EPS forecasts, I find that qualitative bad news forecasts are more informative to investors (i.e., have a stronger market reaction) and analysts (i.e., have larger earnings revisions) than quantitative bad news forecasts. By way of an explanation, I find that qualitative bad news forecasts are more accurate *ex post* than quantitative bad news forecasts. The results indicate that in the case of bad news EPS forecasts, the qualitative forecast form itself provides a signal to market participants, above and beyond the actual earnings expectation, that the forthcoming earnings surprise may be more negative than anticipated, and that investors and analysts react accordingly.

1. Introduction

Management earnings guidance is one of the primary sources of earnings expectations, informing both investors and analysts.¹ As noted by Hirst, Koonce, and Venkataraman (2008), managers can issue earnings forecasts in either qualitative or quantitative forms. For example, a recent earnings forecast from FedEx stated that, "...it expects to earn \$1.45 to \$1.55 per share in the second quarter..." In contrast to this type of forecast which explicitly identifies a numeric range, other forecasts offer only verbal cues about the ultimate earnings outcome. To illustrate, American Eagle Outfitters announced that they "...expect to report earnings which will exceed Wall Street's consensus estimates...."

Theory predicts that the form of a disclosure matters to both investors and analysts (Kim and Verrecchia 1991; Mercer, 2004). Hirst et al. (2008) provide a framework for evaluating management earnings forecasts and note that the consequences of management earnings guidance are a function of forecast characteristics and that forecast form is one of the characteristics over which managers have the most discretion. However, previous archival research on the consequences of forecast form generally focuses only on quantitative guidance. For example, Pownall, Wasley, and Waymire (1993) examine the differential stock price effects of point, range and open-interval numeric forecasts. Rogers and Stocken (2005) include point and range forecasts in their

study of managers' incentives to bias their forecasts and the market response to these forecasts. More recently, Rakow (2010) utilizes point and range forecasts to investigate the effect of forecast form on the cost of capital. Also, Baginski, Hassell, and Wieland (2011) utilize alternative forms of quantitative guidance to investigate the effects of forecast form on the consensus analyst revision. These studies acknowledge that by excluding qualitative forecasts their samples are missing a significant number of management earnings forecasts.²

In this study I build upon prior research by examining the information content of qualitative earnings guidance relative to quantitative guidance.³ For investors, I define informativeness as the extent to which investors react to the forecast, as measured by the magnitude of the three-day cumulative market-adjusted return around management's forecast date of quarterly EPS. I measure informativeness to analysts as the magnitude of analysts' earnings revisions following management's quarterly EPS forecast.

Hirst et al. (2008) note that previous studies on the consequences of forecast form have mixed results, although more recent work suggests that investors view more precise forecasts as more credible. For example, Baginski, Conrad, and Hassell (1993) find that investors react more to point forecasts than other forms of quantitative forecasts. However, Pownall et al. (1993) do not find any effect of forecast form on stock prices. In experimental work, Hirst, Koonce, and Miller (1999)

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¹ See for example Patell (1976), Jaggi (1978), Penman (1980), Waymire (1984), Pownall and Waymire (1989), Jennings (1987), Hassell et al. (1988), Williams (1996), Clement et al. (2003), Rogers and Stocken (2005), Anilowski et al. (2007), Rakow (2010), and Baginski et al. (2011).

² See for example footnote #8 in Rakow (2010) or footnote #7 in Rogers and Stocken (2005).

³ As discussed in Section 4.1, I classify management earnings forecasts as "qualitative" in the same manner as Anilowski et al. (2007). See their appendix A.

found that investors' differential response to point versus range forecasts was conditional on prior forecasting accuracy. Rakow (2010) finds that less specific forecasts (range forecasts) are associated with higher cost of equity capital than point forecasts. Also, Baginski et al. (2011) find that more precise earnings forecasts lead to greater revisions in the consensus analyst forecast for a given level of unexpected earnings. Extending these results to qualitative forecasts may indicate that qualitative earnings forecasts are less informative than quantitative forecasts.⁴

However, recent work also demonstrates that managers are more likely to issue voluntary—albeit, less specific—disclosures during periods of poor earnings performance and when exposure to legal liability is high (Baginski, Hassell, & Kimbrough, 2002; Bamber & Cheon, 1998; Kasznik & Lev, 1995; Skinner, 1994; Wynn, 2008). Because qualitative guidance is the least specific form of EPS guidance, the qualitative forecast form itself may be a signal from managers, even beyond the actual earnings expectation, that the forthcoming earnings news is worse than anticipated. In this case qualitative EPS guidance may be even more informative than quantitative guidance, at least in the case of bad news forecasts.⁵

I therefore begin this study by investigating the relative information content of qualitative management EPS guidance compared to quantitative guidance. Specifically, I utilize the Heckman two-stage approach to first model managers' decision to issue either a qualitative or quantitative EPS forecast and then, in the second stage, I compare the informativeness of forecast form by regressing a short-window market response on guidance form (qualitative versus quantitative) and the type of news (good versus bad), while also controlling for the selection bias inherent in managers' choice of forecast form.⁶ While I find no significant differences between qualitative and quantitative good news forecasts, results indicate that qualitative bad news EPS forecasts are significantly more informative to investors than quantitative bad news forecasts. I evaluate the economic magnitude of this result by dividing quantitative bad news forecasts into deciles by the magnitude of news contained in the forecast and find that the median price response to qualitative bad news forecasts is equivalent to that of the ninth decile of quantitative bad news. Thus, investors view only forecasts in the most extreme decile of quantitative bad news more negatively than qualitative bad news forecasts.

Because prior research finds that investors may be more prone to biases than analysts in the use of public information (Abarbanell & Bernard, 1992), I also investigate the informativeness of qualitative earnings forecasts to analysts. Similar to the market response test, I utilize the two-stage Heckman procedure to control for the selection bias in the quantitative/qualitative choice. I measure informativeness to analysts as the magnitude of analysts' earnings revisions issued in the three days following management's forecast. Consistent with the market response test, findings reveal that qualitative bad news EPS forecasts are more informative to analysts.

To follow up on my primary findings that qualitative bad news forecasts are more informative to market participants than quantitative bad news forecasts, I investigate whether this incremental informa-

⁴ This reasoning is consistent with psychology research that suggests decision makers view quantitative information as more precise, credible and persuasive than qualitative information (Budescu et al., 1988; Rapoport et al., 1990).

⁵ This argument is consistent with economic theory which suggests that variations in the description or format of information may provide signals to the market about the meaning of this information (Spence, 1973).

⁶ My focus is on the differential information content of qualitative earnings forecasts (forecast form) compared to quantitative forecasts and not the impact of type of news (good versus bad). It is well established in the literature that bad news forecasts illicit a stronger market reaction than other forecasts (see for example, Anilowski et al., 2007; Hutton et al., 2003; Kothari, Shu, & Wysocki, 2009; Skinner, 1994). In my empirical tests I interact the type of news with forecast form to be able to compare, for example, qualitative bad news forecasts with quantitative bad news forecasts.

tiveness is supported by *ex post* forecast accuracy.⁷ Because a continuous measure of forecast accuracy cannot be calculated for qualitative forecasts, I construct a directional (i.e., binary) accuracy measure by comparing the actual earnings realization with the analyst consensus. By applying a simple, directional measure of accuracy to both quantitative and qualitative forecasts, *ceteris paribus* each type of forecast has an equal chance of being accurate *ex post*. Specifically, a forecast – whether quantitative or qualitative – is considered directionally accurate if a good (bad) news forecast from management is followed by a positive (negative) earnings surprise, where the earnings surprise is based on the analyst consensus prior to management's forecast. The results of the accuracy test show that qualitative bad news forecasts are more accurate than quantitative bad news forecasts and thus provide support for the findings of the primary analyses.

In this paper I build upon prior studies that have investigated the consequences of forecast form by being the first to focus on the relative information content of qualitative earnings guidance compared to quantitative guidance. I find that, at least in the case of bad news forecasts, qualitative guidance is actually more informative to market participants than quantitative guidance. I interpret this result as market participants viewing qualitative bad news guidance as a signal that the forthcoming earnings surprise may be more negative than anticipated and reacting accordingly.

Given the ongoing debate over managerial earnings guidance, including calls by some to stop the practice of issuing quarterly earnings forecasts (Aspen Institute, 2007; U.S. Chamber of Commerce, 2006), policy-makers should be interested in the findings of this study because they extend our understanding of the consequences of forecast form. This study should also inform managers as to the consequences of their choices. For example, I find that, on average, qualitative bad news forecasts evoke the same market reaction as quantitative forecasts in the ninth decile of bad news. Thus, in choosing between alternative forecast forms, managers should weigh the potential consequences of the forecast signal. By giving due consideration to forecast form, managers can avoid sending an undesired signal to market participants. Finally, investors should be aware of the full scope of options available to managers when making earnings projections, including the consequences of such managerial choices.

The remainder of the paper is organized as follows. The next section presents related literature and motivation for the empirical tests. Section 3 describes the sample selection procedures and presents descriptive statistics. Section 4 describes the specification of the empirical tests and reports multivariate results. Section 5 concludes.

2. Related literature and motivation

2.1. Informativeness of qualitative earnings forecasts to investors

Apart from the decision to issue an earnings forecast, managers must also decide which form the forecast will take (Hirst et al., 2008). In general, managers disclose their guidance either quantitatively (e.g., a point or range forecast) or qualitatively (e.g., 'earnings will be less than expectations'). While no prior study explicitly considers the binary decision of why firms issue qualitative versus quantitative forecasts, several papers examine determinants of forecast specificity using several levels of specificity (including multiple levels of quantitative guidance). In this work, forecast specificity refers to the level of precision contained in management's guidance, with point forecasts being the most precise and qualitative forecasts being the least precise.

Using a sample of point, range, and qualitative management

⁷ I focus on the accuracy of earnings forecasts because prior literature has shown that both analyst and management accuracy is important to investors (Clement, 1999; Hirst et al., 1999; Hutton & Stocken, 2007; Mikhail, Walther, & Willis, 1997; O'Brien, 1990; Stickel, 1992). Prior research also demonstrates that management forecast accuracy is important for subsequent analyst revisions (Williams, 1996).

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