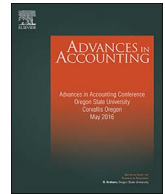




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Quality concerns over managers' quarterly earnings guidance

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ABSTRACT

This paper investigates how often and to what extent quarterly earnings guidance is of poor quality, the causes of poor quality guidance, and the ultimate effect of such guidance on investors' earnings expectations. I operationalize poor quality guidance as that guidance which is *directionally incorrect* relative to the pre-guidance analyst consensus. Results show that 12% of the sample meets this definition. In terms of what causes *directionally incorrect* guidance, expectation management and forecast difficulty play an equally important role in determining *directionally incorrect* guidance. Both analysts and market participants are adversely impacted by *directionally incorrect* guidance, but substantially less so when the likelihood of *directionally incorrect* guidance increases. Finally, market participants appear to be more capable of using publicly observable cues to access the likelihood of *directionally incorrect* guidance increases.

1. Introduction

It remains unclear whether the information content conveyed through the quarterly earnings guidance is of good quality, and if so to what extent. Critics often cite the survey-based evidence reporting that managers view short-term analyst consensus expectation as the fundamental earnings target (Graham, Harvey, & Rajgopal, 2005). Managers employ quarterly earnings guidance to walk-down analyst consensus expectation to the level that is meetable or beatable (Cotter, Tuna, & Wysocki, 2006; Matsumoto, 2002), and managers may be willing to sacrifice guidance accuracy to achieve this short-termism objective. This has mounted to calls by the U.S. Chamber of Commerce, CFA institute, Business Roundtable Institute for Corporate Ethics, and Aspen Institute, among others to eliminate quarterly earnings guidance (Call, Chen, Miao, & Tong, 2010; Houston, Lev, & Tucker, 2010; Kim, Su, & Zhu, 2017).¹ However, proponents of quarterly earnings guidance suggest that the benefit of quarterly earnings guidance may have been possibly overlooked. For instance, Larocque (2013) finds that the propensity of quarterly guidance issuance increases in pre-guidance analyst forecast errors. Larocque interprets these finding to mean that managers attempt to align analyst consensus expectation *closer* to the actual earnings. In addition, Choi, Myers, Zang, and Ziebart (2011) show that quarterly earnings guidance increases the association between stock returns and future earnings beyond annual and long-term guidance. Thus, even short-term, quarterly guidance allow investors to form better expectations about future earnings.

Despite the opposite views of quarterly earnings guidance, there is

little formal evidence on how often and to what extent quarterly earnings guidance is of poor quality, the causes of poor quality guidance, or the ultimate effect of such guidance on investors' earnings expectations. Examining these issues is the focus of the current paper.

Evidence for these issues may help to inform the debate over the merits of providing quarterly earnings guidance. For instance, finding that poor quality guidance is frequent, caused mostly by aggressive expectations management, and adversely affects market participants, buttresses the call to eliminate quarterly. On the other hand, finding that such guidance is either infrequent, immaterial, or that market participants' largely discount it, may support guidance proponents who believe that the benefits outweigh the costs and that guidance is, on balance, a useful mechanism to align investors' earnings expectations with those of management (Ajinkya & Gift, 1984; King, Pownall, & Waymire, 1990; Lev, 2012; NIRI, 2009).

To address the first question concerning the frequency and extent of poor quality guidance, I develop a measure that captures guidance which potentially adversely affects investors. Although relative accuracy is commonly used to assess guidance quality (Hirst, Koonce, & Venkataraman, 2008), poor relative accuracy has an ambiguous effect on investors. For instance, if analysts are too optimistic (by \$0.05) and management gives guidance that is too pessimistic (by \$0.06), the guidance is relatively less accurate. However in this example, managers have at least provided investors with a directionally correct signal (albeit too far), and investors can benefit from positively weighting this signal. Therefore, I choose guidance that is *directionally incorrect* vis-à-vis the pre-guidance consensus as a more precise proxy

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¹ Coinciding with these calls, many prominent corporations such as Pfizer, Intel, Motorola, AT & T, Coca-Cola, Google, and McDonalds have either dropped or curtailed their quarterly earnings projections (Dolvin, 2009).

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for poor quality guidance since any positive weighting on such guidance will increase the earnings expectation error.

I find approximately 12% of the quarterly earnings guidance sample, spanning from 1996 to 2010, to be *directionally incorrect*. What causes *directionally incorrect* guidance? This is an important question to address since some critics allege that poor quality guidance is caused by strategic reasons such as expectations management (Browning, 2006). However, poor guidance can also arise from non-strategic reasons such as task difficulty, or simple changes in the firm information environment (e.g., post-guidance news events).

I consider the following three classes of determinants. First, consistent with the views of critics (Browning, 2006), as well as academic research (Matsumoto, 2002; Richardson, Teoh, & Wysocki, 2004), I measure the nature of guidance news and managers' recent history of actively managing expectations. Second, I consider a variety of task difficulty measures such as forecast horizon and earnings variability. Although some might assert that management should not forecast when facing uncertainty, it is likely that managers face enhanced demand by investors (who are even more uncertain). Thus, managers may tradeoff an increased probability of *directionally incorrect* guidance with satisfying an investor demand. As the final factor, I consider firm news occurring after the guidance date but before the earnings announcement. Modeling these factors, I find that proxies for active expectations management and forecast difficulty play equally important roles in determining *directionally incorrect* guidance. On the other hand, post-guidance news events play fairly minor roles.

The final objective of this paper is to examine if *directionally incorrect* guidance is potentially detrimental to investors' earnings expectations. This is important to assess since regulators are clearly concerned by the potential of quarterly earnings guidance to mislead investors (Aspen Institute, 2007; U.S. Chamber of Commerce, 2007). Investors do not normally interpret earnings guidance on their own; rather, many active investors (e.g., institutions) rely on sell-side analysts to interpret guidance, while passive investors rely explicitly or implicitly on price. Therefore, how these "interpreters" fare at discounting *directionally incorrect* guidance impacts a broad class of investors' decisions. Overall, I find that analysts discount *directionally incorrect* guidance by 41% to 67%, and the market discounts such guidance by 68% to 79%, varying with the level of likelihood that the guidance is *directionally incorrect*.²

I see the current study contributes to the literature in the following ways. First, although much literature has examined the topic of management forecast accuracy (e.g., Waymire, 1984; Williams, 1996), there is limited evidence on the quantity of forecasts that would misguide investors, as well as relevant benchmark comparisons. I argue that this is critical to inform any debate over the merits of quarterly guidance. I provide a relatively unambiguous measure of when guidance is poor quality (i.e., when it is *directionally incorrect*), and find that approximately 12% of the earnings guidance sample meets this criterion.

Second, prior research documents a link between guidance quality and difficulty proxies (e.g., Ajinkya, Bhojraj, & Sengupta, 2005). Due to critics concerns, I broaden the set of determinants normally examined to entertain earnings expectation management proxies, as well as post-

² Since the evidence suggests that the market provides more complete discounts than do the analysts, I consider the effect of a potential downward analyst response bias. Similar to prior work, the main tests define the analyst response based on the difference between analysts' current forecasts and a forecast benchmark. However, a potential concern with this measure is that the revisions of analysts who simply ignore incorrect earnings guidance are excluded from the sample. I address this concern with two approaches. In one approach, I estimate non-responding analysts by the number of analysts not issuing a forecast revisions but who previously forecasted within the 30-day window. In a second approach, I estimate non-responding analysts via a cross-sectional model. In both approaches, I re-calculate the analyst revision variable based on the weighted-average of the responders and estimated non-responders, where the latter are assigned a zero revision. These results are similar to those based on the original analyst revision variable.

guidance news events. In terms of what causes *directionally incorrect* guidance, I find unique roles for expectations management practices, post-guidance firm news, and task difficulty proxies.

Finally, of interest to market participants in general and regulators in particular, is whether and to what extent investors' earnings expectations are misguided when *directionally incorrect* guidance is issued. Prior research suggests that analysts (e.g., Williams, 1996) and the market (e.g., Rogers & Stocken, 2005) condition their responses to guidance on factors associated with guidance quality. However, this work evaluates either the market or the analyst response.³ I add to this work in two ways. First, I quantify the discounts allowing the readers to make inferences regarding the materiality of the discount. Second, I evaluate *both* the market and the analyst performance since reliance on the market price (passive strategy) versus analyst research (active strategy) speaks to a broader set of investors and investment allocation choices than does either individual approach alone. Examining this empirical question, I find that both analysts and market participants are adversely impacted by *directionally incorrect* guidance, but substantially less so when the likelihood of *directionally incorrect* guidance increases. I also find market participants appear to be more capable of using publicly observable cues to access the likelihood of *directionally incorrect* guidance increases.

I organize the paper as follows. The next section describes sample selection, key variables, and descriptive statistics. Section 3 specifies empirical tests and provides results. Section 4 concludes.

2. Sample selection, key variables, and descriptive statistics

2.1. Sample selection

Table 1, Panel A provides a summary of the sample selection procedures from the First Call Historical Database containing quarterly earnings guidance observations from 1996 to 2010 with either a point or range forecast. Primarily, attrition is due to IBES non-split-adjusted detail history file necessary to calculate the analyst forecast revision variable, and the analyst consensus estimates that serve as the benchmark to classify earnings guidance as *directionally incorrect*.⁴ Most additional attrition stems from non-split-adjusted CRSP price and Compustat data necessary to calculate the market response and financial variables, respectively.

Panel B compares key financial variables among Compustat-CRSP firm-quarters, the generic intersection of Compustat-CRSP and management guidance, and the final sample. I make these comparisons to gain insights as to the effects of attrition on the generalization of the results. I view the comparison between the generic intersection (Column 2) and the final sample (Column 3) of guidance firm-quarters as the most germane. That is, by construction, the results pertain only to those firms that make voluntary earnings guidance disclosures. Compared to the generic intersection, the final sample firms are larger, have more sales and leverage, have larger market-to-book ratios, and are more profitable, consistent with the findings in prior research (e.g., Anilowski, Feng, & Skinner, 2007; Lang & Lundholm, 1993; Lev & Penman, 1990).

These findings are also consistent with Chuk, Matsumoto, and Miller (2013) who compare the CIG database to hand-collected earnings

³ In an exception, Atiase, Rees, and Tse (2010) also examine both analyst and market responses to the relative accuracy of guidance.

⁴ Although First Call reports both management and analyst forecast estimates, the management forecasts are not split-adjusted, whereas analyst forecasts are split-adjusted. To avoid potential inaccuracies when reversing split-adjusted analyst forecasts documented in prior literature (e.g., Baber & Kang, 2002; Payne and Thomas 2003), I use the non-split-adjusted analyst forecasts from IBES and match them to the non-split-adjusted management forecasts from First Call. To ensure that each individual analyst forecast used to compute the consensus is based on the same number of outstanding shares, I follow Robinson and Glushkov (2006) and Ng, Tuna, and Verdi (2013) and adjust each forecast using the split-adjustment factor obtained from the CRSP daily file.

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