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Interactions between analysts' and managers' earnings forecasts

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ABSTRACT

We examine interactions between the earnings forecasts made by analysts and those from management by investigating: (1) managers' versus analysts' comparative efficiencies at incorporating financial statement information (FSI) and the information underlying stock returns (SRI) into their forecasts; and (2) the comparative roles of FSI and SRI in improving analysts' forecasts made after management forecasts. We show: (1) managers' comparative advantage over analysts is greater for incorporating SRI into their forecasts rather than FSI; and (2) after observing management forecasts, analysts improve their forecasts more by better utilizing SRI versus FSI. We show that analysts' failure to incorporate SRI, but not FSI, into their forecasts is associated with managers' propensity to issue forecasts.
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1. Introduction

Analysts' and managers' earnings forecasts are important sources of information for capital markets. Previous research has shown that managers' voluntary disclosures help users to process information more efficiently (Kimbrough, 2005), but it has not indicated whether or not voluntary disclosures give users a better understanding of financial statement information (FSI), compared with the information underlying stock returns (SRI). We address this issue by examining the interactions between analysts' and managers' forecasts with respect to FSI and SRI. Specifically, we investigate two inter-related research questions: what is the comparative efficiency of analysts and managers at incorporating FSI versus SRI into their forecasts; and what is the relative importance of FSI versus SRI for explaining the way in which analysts improve their forecasts subsequent to managers' forecasts? The answers to these questions indicate the relative contributions of managers and analysts to the generation and dissemination of information in capital markets.

By incorporating SRI into forecasts, we contend that managers and analysts observe certain events and evaluate the impacts of these events on future earnings. We also contend that capital markets incorporate these events into stock returns, and therefore we use stock returns as a proxy for these events. The comparative advantage of managers over analysts may or may not be greater with respect to incorporating SRI rather than FSI into their forecasts. On the one hand, managers' close involvement in their firms' operations and decision making gives them an advantage in differentiating the information contained in past returns that is relevant for the prediction of future earnings. FSI is distributed widely and is perused by analysts, so managers may not have a greater information advantage over analysts for FSI relative to SRI. However, managers have more control over FSI than stock returns, so maybe they do have a greater information advantage over analysts for FSI relative to SRI. Moreover, managers and analysts may intentionally bias their forecasts for the sake of personal gain (e.g. Ke & Yu, 2006; Soffer, Thiagarajan, & Walther, 2000), meaning that their forecasts may not

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reflect their true information advantages anyway. Hence, the question of whether or not managers have a greater information advantage over analysts with respect to FSI or SRI is an empirical issue which constitutes our first research question. Our results suggest that managers have a larger advantage over analysts for incorporating SRI versus FSI into their forecasts.

Our second research question compares analyst forecasts made after management forecasts with those made before, and examines whether the latter analyst forecasts show a greater improvement at incorporating past SRI or past FSI. We find that, subsequent to managers' forecasts, analysts' forecasts improve more by incorporating SRI versus FSI. Our results are consistent with analysts being aware of managers' comparative advantage for incorporating the information underlying returns into their earnings forecasts, and using it to improve their post-management earnings forecasts accordingly.

In a supplementary analysis, we show that analyst errors are associated more closely with past SRI for firms with management forecasts than for those without, but we find no such differences for earnings changes or accruals, our two proxies for FSI. Our results are consistent with the view that managers are more likely to issue forecasts when analysts' misinterpretations of SRI are greater, but not when analysts' misinterpretations of FSI are greater. Our results support the notion that managers possess a greater comparative advantage over analysts for SRI than FSI, and are consistent with managers recognizing their comparative advantage and issuing forecasts when they are most confident that analysts are misinterpreting information. Overall, our evidence highlights the greater importance of SRI than FSI in interactions between analysts' and managers' forecasts.

We make two major contributions to the literature. First, we show that managers have a greater information advantage over analysts in understanding how SRI impacts future earnings, compared to FSI. The literature has shown that analysts and managers are inefficient at incorporating public information into their earnings forecasts (e.g. Bradshaw, Richardson, & Sloan, 2001; Gong, Li, & Xie, 2009). Extant studies suggest that management forecasts are more accurate than analyst forecasts (e.g. Gong, Li, & Zhou, 2013; Waymire, 1986), but do not identify the *sources* of managers' information advantage. Our study shows that managers' advantage over analysts is greater with respect to the information underlying stock returns than for the information in financial statements.

Second, our finding that improvements in analysts' forecasts after perusing management forecasts are due more to the incorporation of SRI rather than FSI highlights the way in which managers' forecasts facilitate information dissemination to analysts. The literature (e.g. Bowen, Davis, & Matsumoto, 2002; Kimbrough, 2005) contends that managers' voluntary disclosures help analysts to improve their forecasts, but it does not show the type of information that helps analysts. Our paper reveals that managers help analysts more by improving their interpretation of SRI rather than FSI, thus furthering our understanding of the role of voluntary disclosures.

We organize the rest of our paper as follows. Section 2 reviews the related literature. Section 3 develops our research questions. Section 4 describes our sample and summary statistics. Section 5 contains the results of our empirical tests. Section 6 concludes.

2. Literature review

Our paper is derived from and helps to integrate four strands of the literature in the earnings forecasting domain, namely determinants of: (1) analyst forecast errors; (2) management forecast errors; (3) factors affecting managers' decisions to issue forecasts; and (4) factors enabling analysts to improve their post-management forecasts. We combine our review of the first two strands of the literature because we focus on managers' comparative advantage relative to analysts in incorporating both FSI and SRI into their forecasts, and we consider the third and fourth strands separately.

2.1. Determinants of analysts' and managers' earnings forecast errors

Abarbanell (1991) and Lys and Sohn (1990) show that analysts underreact to past stock returns; Elgers and Lo (1994) find that analysts underreact to their past forecast errors, past earnings changes, and past stock returns; Abarbanell and Bushee (1997) and Lev and Thiagarajan (1993) find that analysts do not incorporate fundamental signals into their forecasts efficiently; and Bradshaw et al. (2001) show that analysts do not incorporate past accruals into their forecasts fully.[2] Management forecasts and other voluntary disclosures help markets to incorporate information (Kimbrough, 2005), but managers do not incorporate all publicly-available information into their forecasts efficiently. Managers underutilize information in past returns (McNichols, 1989); overestimate the persistence of past accruals (Gong et al., 2009; Xu, 2010); and underutilize the information in past earnings changes (Gong, Li, & Zhou, 2010). In summary, neither analysts nor managers incorporate past stock returns, past earnings changes or past accruals into their forecasts efficiently, thus leading to predictable errors.

Past earnings changes and accruals are key components of FSI. Past stock returns is a fundamental aggregation variable that incorporates FSI and many other factors, including managers' private information, risk and noise.[3] As is described in Section 3, these two strands of the literature form the basis for our first research question.

2.2. Determinants of the issuance of management earnings forecasts

Management earnings forecasts have been researched extensively, as an important voluntary disclosure mechanism. Numerous studies have examined the factors that

[2] For detailed literature reviews, see Brown (1993, 2000, 2008) and Ramnath, Rock, and Shane (2008).

[3] Hutton, Lee, and Shu (2012) compare the accuracy levels of analyst and management forecasts, and find that long-term analyst forecasts are more accurate when a firm's performance is synchronized with macroeconomic factors, but that management forecasts are more accurate when a firm's performance is more idiosyncratic. Instead of macro versus firm-specific information, we study analysts' and managers' comparative advantages regarding FSI and SRI, information which is known to have important valuation implications (Bernard & Thomas, 1989; Jegadeesh & Titman, 1993, 2001; Sloan, 1996).

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