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# Investors' reactions to retractions and corrections of management earnings forecasts

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A B S T R A C T

Timely voluntary disclosure of information by companies sometimes results in erroneous disclosure that must be later retracted (i.e., withdrawn) and/or corrected (i.e., replaced with a corrected disclosure). Although such retractions and corrections appear to be relatively easy and costless ways to fix the erroneous disclosure, our results generally show that both actions have unexpected effects on investor judgment. The results of four experiments, which are consistent with affect theory from psychology, indicate when a company provides a retraction of a previous erroneous voluntary disclosure, investors' judgments continue to reflect the implications of the initial erroneous information. That is, investors under-adjust. In contrast, when a company provides a correction (alone or with a prior retraction) with an opposite earnings implication, investors tend to over-adjust. Our results also show that if investors do not form a strong initial affective reaction to the initial erroneous forecast, they are less prone to over-adjustment when the correction is later received. Implications for regulators and standard setters are provided.

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## Introduction

Timely voluntary disclosure of information to investors, creditors and others has been shown to be valued by the market (e.g., Ajinkya & Gift, 1984; Brown, Hillegeist, & Lo, 2004; Healy, Hutton, & Palepu, 1999). Regulators and standard setters also have pushed for more timely release of information to the market (FASB, 2000; SEC, 2001). One potential cost of such timely disclosures is that a reduction in their accuracy may occur (SEC, 2002). Indeed, prior research indicates that the number of companies retracting and/or correcting previous disclosures has risen in recent years (Tan & Tan, 2009). Retraction occurs when a company withdraws a previously issued disclosure, such as an earnings forecast. Correction occurs when a company provides a replacement disclosure, with corrected information.[2] These two events are distinct because a retraction can be present without a correction, a correction can be present without a prior retraction, or both can be present. Although such retractions and corrections seem to be relatively easy and costless fixes to erroneous disclosure, a concern exists that investors will nevertheless rely on the initial disclosure in ways that have unintended economic consequences.

Prior research has explored the judgment effects associated with retraction of voluntarily disclosed information by companies. Specifically, Tan and Tan (2009) find that retractions of prior voluntary disclosures systematically affect investors' judgments in ways that arguably are non-

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[2] Another way to view these two distinct constructs is that retraction is a *subtraction* of the original information while correction is a *replacement* of the original information. Further, correction differs from an updated disclosure which is based on new information arising from the passage of time or new events occurring. Rather, correction involves fixing an erroneous original disclosure.

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normative (also see Tan & Tan, 2008, in auditing).[3] Their study documented that erroneous information given to investors had an undue influence on their judgments, *even after* the information was retracted. That is, their post-retraction judgments incorporated the implications of information contained in the erroneous press release. However, their study did not also examine how the correction of the erroneous disclosure affected investor judgment. That is, they did not provide investors with new information to replace the erroneous initial disclosure. Because most retractions eventually lead to correction, the important issue of how investors behave in light of voluntary disclosure correction remains unexplored.

In this study, we experimentally investigate how correction of erroneous information influences investors' judgments. Specifically, we conduct four experiments to investigate how investors react to quantitative earnings forecasts that are issued by company management and then later replaced with corrected forecast. We chose the earnings forecast domain because such forecasts are a valuable tool for a company to communicate its expectations to market participants. Such forecasts have the potential to inform investors, reduce information asymmetry and information risk, and decrease the firm's cost of capital (Hirst, Koonce, & Venkataraman, 2008). In addition, most forecasts are quantitative in nature, thereby allowing us to investigate our ideas in a context where it is clear that a correction has occurred.

We employ a similar research design in each of our four experiments. Specifically, we manipulate whether a company initially issues a high or low quantitative earnings (i.e., EPS) forecast that is later revealed to be erroneous. These initial forecasts are high or low relative to the prior year's actual earnings. Depending on the experiment, the company's actions include one or more of the following—retraction only, correction only, and both retraction and correction. Although prior research in accounting has previously studied retraction (Tan & Tan, 2008, Tan & Tan, 2009), its inclusion in our study allows us to draw stronger inferences about the theoretical mechanism at work. An important feature of our research design is that after either a retraction or correction (or both) is provided to study participants, the judgments in the high and low EPS forecast conditions arguably should converge.[4]

We draw on two distinct lines of research from psychology to develop competing predictions regarding how investors are likely to respond to retractions and corrections of earnings forecasts. Specifically, a cognitive-based theory, belief perseverance, suggests that when investors receive either a retraction or a correction (or both) of a previously issued earnings forecast, their initial beliefs about the earnings potential and investment attractiveness of the company will persevere. That is, they will be unduly influenced by the erroneous information, thus under-adjusting for the erroneous earnings forecast. In contrast, affect theory indicates that investors are likely to behave differently. Specifically, when given a retraction, investors will under-adjust as traces of the positive/negative affective response to the erroneous earnings forecast persist and have a lingering effect on judgments. However, when given a correction replacing the initially higher/lower forecast (alone or with a prior retraction), an opposite affective reaction is triggered by the implicit counterfactual comparison (i.e., what earnings could have been before the correction) which, in turn causes investors to over-adjust.

Our experiment one results show that when the company action involves a retraction of a previously issued erroneous forecast (retraction only), investors under-adjust in their evaluations of a company. That is, even after the company retracts their initial forecast, those receiving a high earnings forecast still judge the earnings potential and investment attractiveness of the company to be higher than those who initially received a low earnings forecast. When the company action involves a correction of an erroneous forecast—either alone (correction only) or with a prior retraction (both retraction and correction)—our results show a different pattern. Here, we find that investors over-adjust in their evaluations of a company. Although the corrected forecast in our study is identical in both the high and low (initial erroneous) forecast conditions, we observe that those receiving a high earnings forecast judge the earnings potential and investment attractiveness of the company as significantly lower after correction than those who initially received a low earnings forecast. That is, participants in the high and low forecast conditions "flip" (or over-adjust in) their assessments of the company once the correction, with or without a prior retraction, is received. Overall, these results are consistent with affect theory.

We conducted three other experiments to test the robustness of these findings. In experiment two, we document that our over-adjustment results are robust even with a more-sophisticated set of study participants. In experiment three, we provide additional evidence ruling *out* belief perseverance theory by showing that a cognitive task used to increase belief perseverance effects—namely, explanation—has no effect on under- and over-adjustment. Experiment four provides further evidence ruling *in* affect theory. Specifically, we show that when the investor makes an initial judgment based on the erroneous forecast, the affective response to a subsequent correction is heightened (as compared to when an initial judgment is not made). The initial judgment task causes the investor to form a strong affective response to the initial erroneous (favorable or unfavorable) forecast which, in turn, creates a larger opposite affective response when the subsequent correction is received.

Our paper advances the literature in several ways. First, we focus on a company action taken in light of an erroneous voluntary disclosure—namely, correction—that has not

[3] Although Tan and Tan (2009) refer to their study as one involving "correction," their study examines "retraction" as defined herein. That is, the participants in their study were told that the outcome in the original press release was to be disregarded. Importantly, they were not provided with an alternative outcome (i.e., correction).

[4] Importantly, we do not make predictions about the appropriate levels of the post-retraction and post-correction judgments for our low and high EPS conditions. That is, our design does not allow us to make predictions about whether the low- and high-EPS judgments should be, for example, 6 and 6 or 4 and 4 (on a response scale of 1–11, as described in the design section of experiment one) respectively. Rather, we can only assert that these two judgments should be equal, on average.

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