Discussion of “Expectations Management and Beatable Targets: How Do Analysts React to Explicit Earnings Guidance?”*

JEFFREY L. CALLEN, University of Toronto

Cotter, Tuna, and Wysocki (2006) are intent on demonstrating that management uses public forecasts to guide security analysts toward beatable earnings targets. Three major questions arise. First, have the authors made a convincing case for management guidance? Second, are their hypotheses adequately formulated and tested? Third, assuming that they have made their case for management guidance, what implications if any does this have for capital-market policymakers?

1. The case for public management guidance

Although the authors make a fairly convincing case for public management guidance, the analysis could be strengthened. Their case is based on the following four pieces of evidence. First, consistent with their hypotheses, they find that the likelihood of guidance increases in analyst optimism and decreases in the dispersion of analyst forecasts. Second, almost 50 percent of analysts revise their earnings forecasts quickly, within 5 days (on average) of public management forecasts, suggesting a direct connection between management information releases and analysts’ earnings revisions. Third, the fraction of analysts who revise their forecasts within 5 days increases with analyst optimism. Fourth, the likelihood that analysts revise their forecasts to beatable targets increases with guidance. In addition, there are trends in the data that are consistent with guidance toward beatable earnings targets increasing over time, especially in the post—Regulation FD subperiod.

Although each result on its own is consistent with the guidance story, the devil is in the linkages. In fact, each of the four pieces of evidence is analyzed independently of the others, making it difficult to conclude conclusively that analysts revise their earnings forecast toward management’s forecasts. Consider instead the following alternative analyses that simultaneously evaluate the separate pieces of evidence.

Keywords Analysts; Earnings guidance; Expectations management; Management earnings forecasts

JEL Descriptors M41, G14, D82, D84

* Accepted by Greg Waymire. An earlier version of this paper was presented at the 2002 Contemporary Accounting Research Conference, generously supported by the CGA-Canada Research Foundation, the Canadian Institute of Chartered Accountants, CMA Canada — Ontario, the Certified General Accountants of Ontario, and the Institute of Chartered Accountants of Ontario. I wish to thank Mozaffar Khan for helpful comments on an earlier draft.
evidence and potentially account for the linkages. Sequence the data for each guidance firm and quarter using the following format: (A) early-quarter consensus analyst forecast; (B) management forecast; (C) revised analyst forecast (possibly restricted to be within 5 days of the management forecast); and (D) realized earnings. Consistency with the authors’ guidance story dictates the following sequence of firm-level relations: A ≥ D (pre-guidance optimism); B ≤ D (guidance); B ≤ C ≤ A (Bayesian updating and revision by analysts); and D ≥ C (meet or beat earnings). Any other sequence of relations is less likely to be consistent with a guidance story. The sequences can be tested using, for example, Bernoulli tests for the proportion of sequences of a given type, or runs tests [AU: is “runs” an adjective? if not, please clarify] on the pairwise sign differences between A through D.1

There are alternative ways to link some of the results and, at the same time, make better use of the data. The authors analyze the determinants of management guidance on the condition that firms are guidance firms. [AU: ok? if not, please clarify] But surely there is a joint decision process here. Management must decide whether or not to issue a public management forecast; if it does, it must then decide whether to issue a meetable or beatable forecast. After all, not all management forecasts are pessimistic. These are, of course, not independent events and should be analyzed simultaneously as a joint decision. A two-stage panel data probit model might do the trick.2 If p(MF) is the probability of a management forecast being issued and p(PF/MF) is the probability of a pessimistic forecast being issued on the condition that a management forecast is issued, then the two are linked: p(MF and PF) = p(PF/MF)p(MF). What one gains is a model that links both decisions — after all, not all relevant explanatory variables are common to both decisions — and mitigates sample selection bias. In addition, the information contained in the data of the nonguidance firms is far better utilized, because p(MF) can be estimated using the data on both guidance and nonguidance firms.3

2. Hypotheses formulation and tests

To bolster their case, the authors formulate a number of hypotheses, which they test using ordinary least squares (OLS) and logistic regression analyses. Are the hypotheses convincing and are the tests adequate? In my opinion, there is some room for improvement.

Since the paper does not present a model, it is difficult to know under what conditions the hypotheses do or do not obtain. While my intuition of Hypotheses 1 and 3 accords with that of the authors, Hypothesis 2 is far from obvious to me. It may be that the greater the dispersion of analysts’ initial forecasts is, the less incentive there is for management guidance, or it could be that dispersion itself induces management to guide analysts toward a specific consensus earnings target.

In general, the rationale the authors provide for including specific independent variables in the regressions is fairly convincing. Why do the authors control for return on assets? Ostensibly, because the ability to meet or beat earnings is a function of firm productivity. [AU: ok?] But, by the same token, why not control for the variance of earnings? Why is firm size not relevant? The authors are very careful to control for firm fixed effects but do not control for quarter fixed effects. Yet,
we know that many firm activities, including accounting-related activities, tend to vary by quarter, with most of the action occurring in the fourth quarter.4

3. Capital-markets policy
Assuming that policymakers are convinced by the findings of this study that management does indeed guide security analysts toward meetable or beatable earnings targets, what implications does this have for their capital-markets policies? Unfortunately, this study sheds little light on policy because the authors do not tie their analysis directly to stock returns. If, by nature or because of the incentives they face, analysts are initially optimistic, then guiding analysts toward a more realistic earnings numbers may be beneficial to investors. On the other hand, investors may be able to back out analyst optimism on their own and may not need the guidance offered through management forecasts. Even if management is manipulative and succeeds in managing analysts down to some earnings number that managers themselves concocted (or if current earnings are being driven by prior years' earnings management), who is to say that this will have any effect on equity returns? If anything, the evidence provided by Bartov, Givoly, and Hayn 2002 suggests that markets react positively to meeting or beating earnings even when earnings have been managed. Indeed, they show that the "meet or beat it" strategy signals future growth and productivity by the firm, which implies that policymakers should not have any concerns regarding this strategy. Now, the Bartov et al. study does not incorporate management forecasts, nor does this study incorporate returns. Extending the analysis to include returns would add substantively to this study and is essential if this study is to have policy implications.

Endnotes
2. See Krishnan and Krishnan 1996 for such a model in an auditing context.
3. The authors report that their results are robust to two-stage estimation techniques that explicitly model management’s first-stage decision to issue public guidance. Unfortunately, the nature of the models and the results are not reported in the paper.
4. See, for example, Callen, Livnat, and Ryan 1996 on capital expenditures; Das and Shroff 2002 on accruals; and Ettredge, Simon, Smith, and Stone 2000 on auditor adjustments.

References
