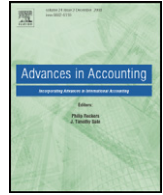




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## The impact of meeting or beating analysts' operating cash flow forecasts on a firm's cost of debt

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### ABSTRACT

Extant literature provides conflicting results with respect to the usefulness and accuracy of analysts' operating cash flow forecasts. Our study empirically examines the importance and influence of meeting or beating analysts' operating cash flow forecasts on a firm's cost of debt. Results indicate that firms meeting/beating analysts' cash flow forecasts have higher initial bond ratings as well as lower initial bond yields. Additionally, based upon an analysis of rating changes, firms meeting or beating cash flow forecasts have a higher probability of receiving a debt rating upgrade and a lower probability of a ratings downgrade compared to firms missing cash flow forecasts. A direct comparison of the importance of meeting/beating cash flow versus earnings benchmarks indicates that debt market participants appear to incrementally value both types of forecasts, and contrary to selected equity market findings, neither forecast subsumes the other for debt market participants.

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### 1. Introduction

The demand for detailed cash flow information and cash flow forecasts increased substantially following the accounting scandals identified in the early 2000's.<sup>1</sup> These scandals eroded investor confidence in the capital markets and made it clear that earnings alone do not always predict future firm performance consistently and/or reliably (Jain & Rezaee, 2006). Under certain economic circumstances, firms have incentives to use the inherent flexibility in generally accepted accounting principles to help present a favorable earnings position. In many circumstances cash flow information is arguably viewed as being more concrete and less susceptible to artificial manipulations than "pro-forma" or actual reported accounting earnings.<sup>2</sup> Our research examines the incremental benefits to a firm's cost of debt by meeting analysts' cash flow forecasts.

The usefulness and accuracy of cash flow forecasts incremental to earnings forecasts remains an unresolved issue in extant literature. Givoly, Hayn, and Lehavy (2009) conclude that analysts' cash flow

forecasts are less accurate and of lower quality than analysts' earnings forecasts. Their findings directly call into question the incremental usefulness of cash flow forecasts to capital market participants. In contrast, McInnis and Collins (2011) and Call, Chen, and Tong (2009) find that cash flow forecasts provide useful information incremental to earnings forecasts. Moreover, these cash flow forecasts can also serve as a disciplining mechanism to managers' financial reporting behavior when combined with earnings forecasts because of the implicit information contained about accruals.

Our research adds additional evidence to the debate by examining debt market participants' perceptions of the usefulness of cash flow forecasts. Specifically, we empirically examine the effect of meeting or beating cash flow<sup>3</sup> forecasts on three important measures of the firm's borrowing costs. First, we examine the effects of meeting/beating cash flow benchmarks on initial bond ratings. Bond ratings are assigned by a team of rating analysts before a new issue is sent to market and serve as an important indicator of a firm's default risk. Higher ratings typically translate into lower bond yields. Second, we directly investigate yield effects related to meeting/beating cash flow forecasts by examining the marketplace pricing of a firm's new debt issuance. Third, we investigate the effect of meeting/beating cash flow forecasts on the probability of receiving a bond rating upgrade or downgrade. As we undertake each of these analyses, we also conduct a direct comparison regarding the importance of

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<sup>1</sup> Examples of major accounting scandals during this period include Enron, WorldCom, Adelphia, HealthSouth, McKesson, Tyco, and Qwest.

<sup>2</sup> While a firm can improve both its operating cash flow and earnings by engaging in real earnings management with actions such as reducing discretionary advertising and R&D, these activities are often more costly than accrual earnings management and subsequently result in negative economic consequences for the firm. See Xu, Taylor, and Dugan (2007) for a review of the real earnings management literature.

<sup>3</sup> In all instances cash flow refers to cash flow from operations.

meeting/beating analysts' cash flow forecasts compared to meeting/beat- ing analysts' earnings forecasts.

Our results confirm our expectations that meeting or beating analysts' cash flow forecasts has positive implications for a firm's cost of debt. We find evidence that firms that meet or beat their cash flow forecasts have higher initial bond ratings and lower initial bond yields (approximately a 22 basis points differential). Additionally, we find evidence that firms meeting or beating cash flow forecasts have a higher probability of a rating upgrade while firms missing the benchmark have a higher probability of a rating downgrade. Further, for firms missing the benchmark, the probability of a downgrade is approximately twice as large as the probability of an upgrade for firms achieving the benchmark. This asymmetric reaction is consistent with Easton, Monahan, and Vasvari's (2009) assessment that bonds are far more sensitive to bad news than good news. Finally, while we are able to establish that both the cash flow and the earnings benchmarks each provide incremental information to debt market participants, we are unable to clearly document that one is statistically more important than the other with respect to a firm's cost of debt.

Our research contributes to the existing literature in at least two ways. First, we provide empirical evidence regarding the importance of meeting or beating analysts' cash flow forecasts on a firm's cost of debt. Second, in contrast to selected research conducted in the equity markets that questions the importance and accuracy of cash flow forecasts Givoly et al. (2009), we provide evidence consistent with various constituents in debt markets utilizing cash flow forecasts to help assess the default risk of a firm's debt. In this regard, our results are consistent with the findings of McInnis and Collins (2011) and Call et al. (2009) which indicate analysts' cash flow forecasts provide incremental information to the equity markets beyond that contained in earnings forecasts. Overall, the results of our study should contribute to the debate regarding the usefulness of analysts' cash flow forecasts, and also help to clarify the importance of meeting cash flow expectations to all those interested in the determinants of a firm's cost of debt.

The remainder of this paper is organized as follows. Section 2 provides relevant background information and reviews the related research. Section 3 develops the hypothesis while Section 4 describes the research design utilized to test our hypothesis. Section 5 describes the sample selection process. Results are presented in Section 6 and sensitivity analysis is reported in Section 7. Finally, Section 8 provides a summary and conclusions overview.

## 2. Background and related research

### 2.1. Background

Analysts' cash flow forecasts provide a heuristic benchmark for which a firm's stakeholders can evaluate firm performance with limited information processing costs.<sup>4</sup> Missing this benchmark can provide a useful signal to investors related to management's ability to meet their budget or the firm's ability to continue with its scheduled capital expenditures or debt repayments Minton and Schrand (1999). While a large body of literature documents the importance of meeting or beating analysts' earnings forecasts (Brown, 2001; Brown & Caylor, 2005; Jiang, 2008), only recently have researchers begun to investigate the importance of meeting or beating analysts' cash flow forecasts (Brown & Pinello, 2009; Defond & Hung, 2003; Zhang, 2009). This avenue of research has focused exclusively on the equity markets. Our research extends this literature by exploring the importance of meeting or beating analysts' cash flow forecasts in debt markets

where investors maintain different residual claims to a firm's assets and future prospects.

Investigating the effects of meeting or beating analysts' cash flow forecasts in debt markets is important for several reasons. Most importantly, the economic claims of bondholders are fundamentally different from equity shareholders. Equity investors represent the residual owners of a firm whose incentives are aligned with the firm and their returns are limited only by the firm's opportunities and management's motivations (Jensen & Meckling, 1976). Given their position, shareholders are greatly concerned with a firm's announced earnings which provide a signal regarding whether their return expectations are likely to be met and place secondary importance on operating cash flow and solvency (Ettredge & Fuller, 1991; Hayn, 1995). Unlike shareholders, bondholders possess a fixed claim against the firm's assets. They bear downside risks but do not fully share in the firm's future profits (Fischer & Verrecchia, 1997; Plummer & Tse, 1999). Given that bondholders are promised a set schedule of payments that critically depend upon a firm's ability to generate the necessary cash flow, we conjecture that these stakeholders are predisposed to be most interested in information related to assessing liquidity and solvency. Moreover, researchers have argued that cash flow is a better metric than earnings for assessing the liquidity and solvency of a firm (Defond & Hung, 2003; Graham, Harvery, & Rajgopal, 2005).<sup>5</sup> Because of the differences that exist with respect to the contingent claims of bondholders versus shareholders, inferences drawn from research regarding analysts' cash flow forecasts in equity markets are not necessarily valid in debt markets without empirical substantiation (Holthausen & Watts, 2001). For example, Brown and Pinello (2009) document that equity investors reward firms that meet/beat their earnings forecast more than firms that meet/beat their cash flow forecasts. Given the different contingent claims of bondholders and their emphasis on liquidity and cash flow information, it remains an open empirical question regarding the nature of this relationship in the debt markets.

Debt markets are also important to investigate because they serve as the primary source of new capital for many firms. New corporate debt issues underwritten in the U.S. average \$1136 billion each year compared to an average of \$142 billion from equity issues.<sup>6</sup> Consequently, managers committed to lowering a firm's cost of capital are particularly interested in understanding the type of general benchmarks rating agencies and debt investors utilize to evaluate firm risk and performance. In addition, the assigned credit ratings supplied by the large rating agencies<sup>7</sup> play an important role in our capital market system. Firms with higher bond ratings typically receive better financing terms (i.e. lower yields), which can substantially lower the firm's cost of capital.

While other methods exist to estimate a firm's overall cost of debt capital (e.g. Francis, LaFond, Olsson, & Schipper, 2005), these techniques often divide some measure of interest expense by outstanding debt. This provides an overall average based on all debt outstanding for the firm which can include bonds issued 10 to 20 years ago. Since we are interested in measuring the effects of meeting cash flow forecasts on the cost of newly issued debt, we examine three important current proxies for a firm's cost of debt (i.e. the initial bond rating, initial bond yield, and bond rating changes). Each of these three proxies provides a fresh assessment by market participants of the default probability of the firm's debt issue and provides valuable

<sup>4</sup> There is an extensive body of work examining the importance of meeting or beating heuristic targets. For examples see Burgstahler and Dichev (1997), DeGeorge, Patel, and Zeckhauser (1999), Bartov, Givoly, and Hayn (2002), Roychowdhury (2006), and Jiang (2008).

<sup>5</sup> For example, in its analytical methodology literature, Standard & Poor's describes its interest in looking to the future; and states "the core underlying concept of a credit rating is determined by the ability to generate cash—not earnings" (S&P, 2008). Additionally, Moody's Investor Service's (2009) indicates in its Rating Methodologies that firms often benefit when they produce more predictable cash flow streams.

<sup>6</sup> Based on 1990–2006 underwriting data, reported by the Securities Industry and Financial Markets Association (<http://www.sifma.org/news/faq.html>).

<sup>7</sup> The largest and most dominant rating agencies are Moody's, Standard & Poor's, and Fitch.

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