The rewards to meeting or beating earnings expectations

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Abstract

This paper finds that firms that meet or beat current analysts’ earnings expectations (MBE) enjoy a higher return over the quarter than firms with similar quarterly earnings forecast errors that fail to meet these expectations. Further, such a premium to MBE, although somewhat smaller, exists in the cases where MBE is likely to have been achieved through earnings or expectations management. The findings also indicate that the premium to MBE is a leading indicator of future performance. This premium and its predictive ability are only marginally affected by whether the MBE is genuine or the result of earnings or expectations management. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Meeting or beating analysts’ forecasts of earnings is a notion well entrenched in today’s corporate culture. From corporate boards’ deliberations to financial press reports and Internet chats, emphasis is placed on whether a company meets its earnings forecasts. The following comment typifies the view of the financial press regarding the importance of meeting Wall Street’s expectations:

In January, for the 41st time in 42 quarters since it went public, Microsoft reported earnings that meet or beat Wall Street estimates….This is what chief executives and chief financial officers dream of: quarter after blessed quarter of not disappointing Wall Street. Sure, they dream about other things…But the simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: Did you make your earnings last quarter? (see Fox, 1997, p. 77).

The importance assigned to meeting earnings expectations is not surprising given the valuation relevance of earnings information. Recent anecdotal evidence, however, suggests that companies are not merely passive observers in the game of meeting or beating contemporaneous analysts’ expectations (hereafter referred to as MBE). Rather, they are active players who try to win the game by altering reported earnings or managing analysts’ expectations (see for example McGee, 1997; Vickers, 1999). The motivations often suggested for such a behavior are to maximize the share price, to boost management’s credibility for being able to meet the expectations of the company’s constituents (e.g., stockholders and creditors), and to avoid litigation costs that could potentially be triggered by unfavorable earnings surprises.

In this paper, we test whether, after controlling for the earnings forecast error for the period, there is a market premium to firms that MBE formed just prior to the release of quarterly earnings. Note that finding a premium to firms that meet or beat market expectations, after controlling for the earnings forecast error for the period, is quite distinct from the well-established finding in the literature of a positive relation between earnings and stock returns first documented by Ball and Brown (1968). For a premium to MBE to exist, the return over the period must be a function of not only unexpected earnings for the period (measured relative to the expectations held at the beginning of the period) but also the manner by which earnings expectations changed over the period, or the expectation path. This point is further discussed in Section 3. Exploring the MBE phenomenon further, we examine the extent to which the data on earnings forecast revisions and earnings surprises are consistent with expectations management or earnings management. Expectations management takes place whenever management purposefully dampens analysts’ earnings forecasts to produce a positive earnings surprise (or avoid a negative earnings surprise) upon the earnings release. Earnings management generally involves using accrual accounting in order to produce earnings that surpass the forecasted earnings target. In the cases where earnings or expectations are likely to have been managed, we examine whether the premium to MBE still exists. Finally, various explanations for the potential payoffs from an MBE strategy are explored that are consistent with investor rationality.
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