

Do managers use earnings guidance to influence street earnings exclusions?

Theodore E. Christensen
Kenneth J. Merkley
Jennifer Wu Tucker
Shankar Venkataraman

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Mark T. Bradshaw
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What, Why, How?

■ What

- Examine whether management earnings guidance is associated with a more exclusions from analysts' earnings forecasts

■ Why

- Prior research on the composition of STREET earnings is analyst-centric
 - This study is manager-centric (... maybe both)

■ How

- Calculate differences between STREET and GAAP earnings, and see if positively associated with an indicator variable for whether the manager issued guidance ("GUIDE"). Findings: GUIDE has + coefficients.

■ Star of the show = GUIDE

Thoughts

- 1. Nomenclature
- 2. **Interesting?**
- 3. Additional/alternative motivation
- 4. St. Thomas Aquinas
- 5. **Research design**
- 6. **GUIDE**
- 7. **Empirical wish list and conclusion**

“Despite the apparent importance of street earnings to investors, we know little about the composition of this earnings metric”
“and the process through which it is determined.”

▪ **But,**

- Lipe (1986)
- Elliott and Hanna (1996)
- Schrand and Walther (2000)
- Bradshaw and Sloan (2002)
- Bhattacharya, Black, Christensen and Larson (2003)
- Doyle, Lundholm and Soliman (2003)
- Bowen, Davis and Matsumoto (2005)
- Elliott (2006)
- Abarbanell and Lehavy (2007)
- Riedl and Srinivasan (2010)

▪ **Latter is where they can clearly contribute**

1. Nomenclature

- **Authors attempt to make us adhere to a set of definitions (per share):**

- STREET IBES actuals

- CORE OPREPSX (or data 323)

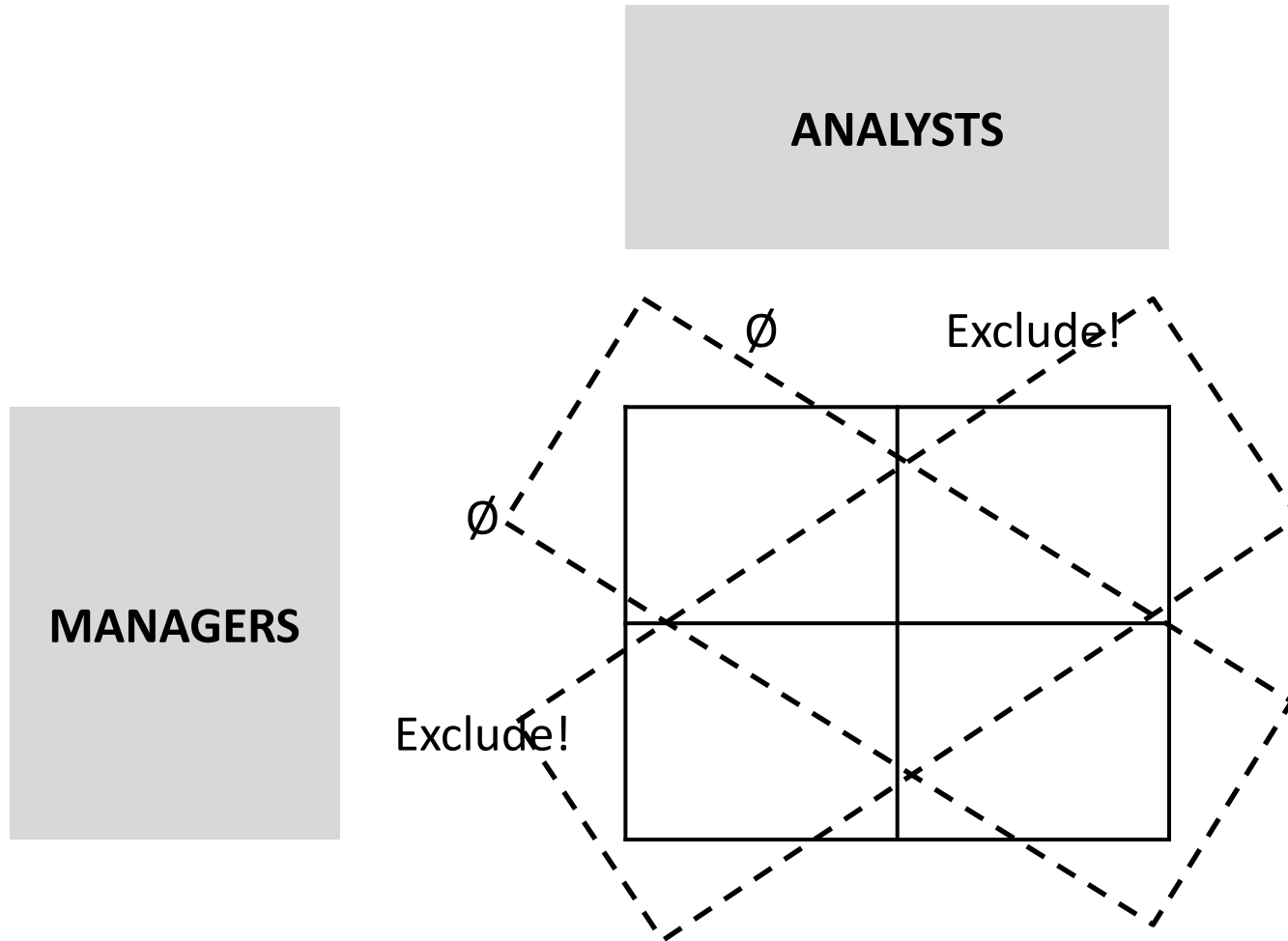
- GAAP Earnings before extraordinary items, EPSFX (or data 57)

- PRO FORMA Earnings forecasted by managers

2. Is this interesting?

- **Depends on what the definition of “this” is**
- **I think the authors see their study as a pro forma/street/core earnings one**
 - They focus on COMPOSITION, not LEVELS
 - * Substantive benefit is examining what happens DURING the year
- **We all know that the communication is iterative.**
 - This game IS interesting
 - Fewer studies have attempted to examine the dynamic back-and-forth

2. Is it interesting? (cont.)



2. Is it interesting? (cont.) ... The Story

- **On the surface, straightforward**

- e.g., H_1 : Analysts are more likely to exclude *special items* if managers say they should vs. when they don't say they should

- **However, things get complex quickly**

- e.g., H_2 : Analysts are more likely to exclude *other stuff* if managers say they should vs. when they don't say they should, *except if the guidance triggers skepticism by analysts who then perceive manipulation and then don't exclude the other stuff*

- **The old question**

- Informational vs. manipulative
 - By managers? By analysts? By data providers?
 - Text seems to make GUIDE seem pejorative towards analysts; feels like managers are nefarious

3. Additional/alternative institutional motivation

- **Current joint FASB/IBAS projects**
 - Statement of Comprehensive Income
 - Financial Statement Presentation
 - Heavy reliance on ‘management approach’

- **January 2010 SEC Compliance and Disclosure Interpretation**
 - Increased leniency
 - Esp. wrt non-recurring
 - Goal to better match in- and out-of f/s disclosures

**Illustration 1A: ToolCo Financial Statements
(Proposed Format)**

		For the year ended	
		2010	2009
STATEMENT OF COMPREHENSIVE INCOME			
BUSINESS			
Operating			
Sales—wholesale		2,790,080	2,591,400
Sales—retail		697,520	647,850
	<i>Total revenue</i>	<i>3,487,600</i>	<i>3,239,250</i>
Cost of goods sold			
Materials		(1,043,100)	(925,000)
Labour		(405,000)	(450,000)
Overhead—depreciation		(219,300)	(215,000)
Overhead—transport		(128,640)	(108,000)
Overhead—other		(32,160)	(27,000)
Change in inventory		(60,250)	(46,853)
Penion		(51,975)	(47,250)
Loss on obsolete and damaged inventory		(29,000)	(9,500)
	<i>Total cost of goods sold</i>	<i>(1,969,425)</i>	<i>(1,828,603)</i>
	<i>Gross profit</i>	<i>1,518,175</i>	<i>1,410,647</i>
Selling expenses			
Advertising		(60,000)	(50,000)
Wages, salaries and benefits		(56,700)	(32,500)
Bad debt		(23,068)	(15,034)
Other		(13,500)	(12,500)
	<i>Total selling expenses</i>	<i>(153,268)</i>	<i>(130,034)</i>
General and administrative expenses			
Wages, salaries and benefits		(321,300)	(297,500)
Depreciation		(59,820)	(58,500)
Penion		(51,975)	(47,250)
Share-based remuneration		(22,023)	(17,000)
Interest on lease liability		(14,825)	(16,500)
Research and development		(8,478)	(7,850)
Other		(15,768)	(14,600)
	<i>Total general and administrative expenses</i>	<i>(494,189)</i>	<i>(459,200)</i>
	<i>Income before other operating items</i>	<i>870,718</i>	<i>821,413</i>
Other operating income (expense)			
Share of profit of associate A		23,760	22,000
Gain on disposal of property, plant and equipment		22,650	
Realized gain on cash flow hedge		3,996	3,700
Loss on sale of receivables		(4,987)	(2,025)
Impairment loss on goodwill		-	(35,033)
	<i>Total other operating income (expense)</i>	<i>43,419</i>	<i>(11,358)</i>
	Total operating income	916,137	810,055
Investing			
Dividend income		54,000	50,000
Realized gain on available-for-sale securities		18,250	7,500
Share of profit of associate B		7,500	3,250
	Total investing income	79,750	60,750
	TOTAL BUSINESS INCOME	995,887	870,805
FINANCING			
Interest income on cash		8,619	5,500
	Total financing asset income	8,619	5,500
Interest expense		(111,352)	(110,250)
	Total financing liability expense	(111,352)	(110,250)
	TOTAL NET FINANCING EXPENSE	(102,733)	(104,750)
	<i>Profit from continuing operations before taxes and other comprehensive income</i>	<i>893,154</i>	<i>766,055</i>
INCOME TAXES			
Income tax expense		(333,625)	(295,266)
	<i>Net profit from continuing operations</i>	<i>559,529</i>	<i>470,789</i>
DISCONTINUED OPERATIONS			
Loss on discontinued operations		(32,400)	(35,000)
Tax benefit		11,340	12,250
	NET LOSS FROM DISCONTINUED OPERATIONS	(21,060)	(22,750)
	NET PROFIT	538,469	448,039
OTHER COMPREHENSIVE INCOME (after tax)			
Unrealized gain on available-for-sale securities (investing)		17,193	15,275
Revaluation surplus (operating)		3,653	-
Foreign currency translation adjust—consolidated subsidiary		2,094	(1,492)
Unrealized gain on cash flow hedge (operating)		1,825	1,690
Foreign currency translation adjust—associate A (operating)		(1,404)	(1,350)
	TOTAL OTHER COMPREHENSIVE INCOME	23,361	14,173
	TOTAL COMPREHENSIVE INCOME	561,830	462,212
	Basic earnings per share	7.07	6.14
	Diluted earnings per share	6.85	5.96

4. St. Thomas Aquinas

- All researchers dream about causal models and proving them
- Complex information flows and noisy data hinder such dreams

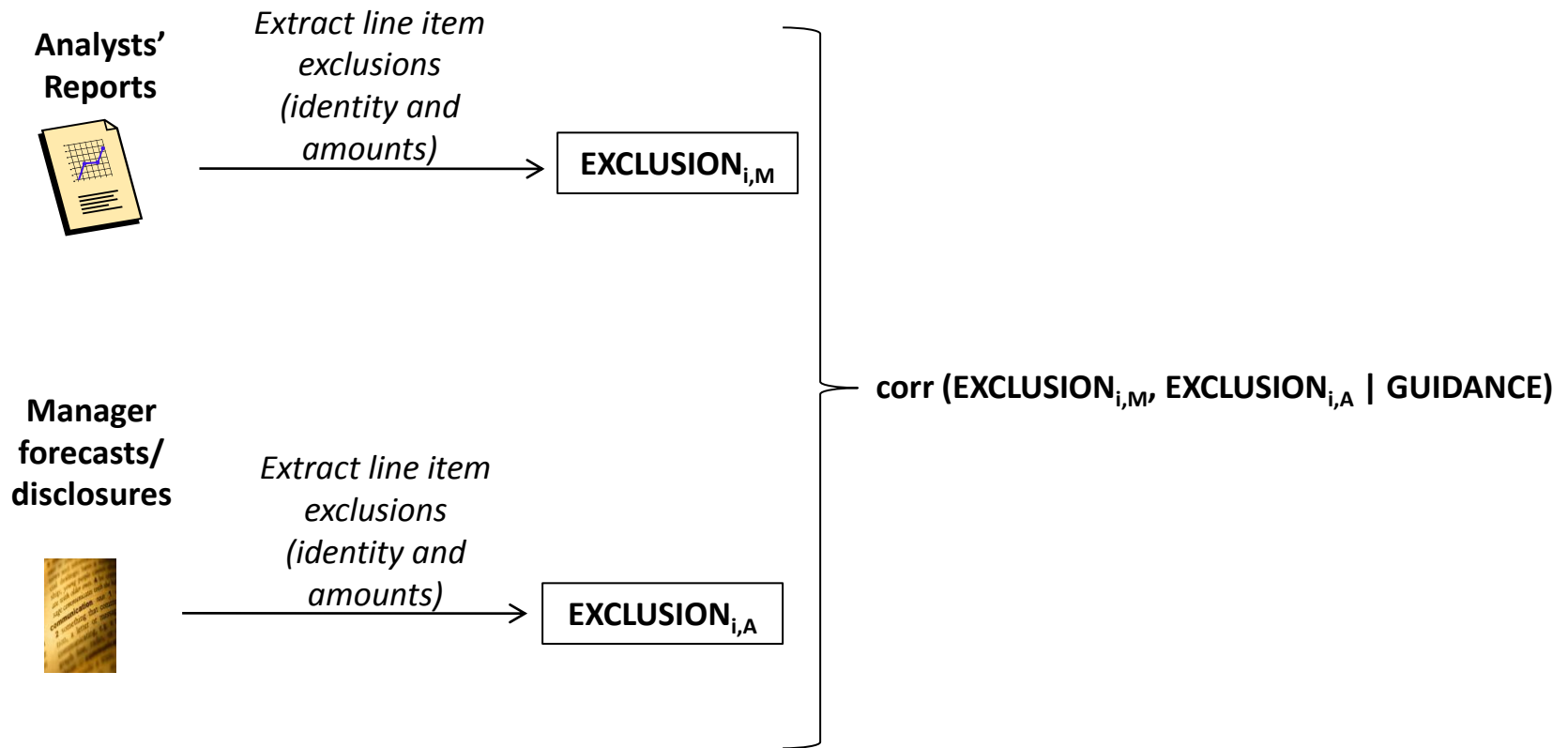
- *Ex ante*, I'm not optimistic that CMTV can overcome this either

- **Aquinas phenomenon:**
 - No matter when their timeline starts, there was always a mover before then
 - There are no “unmoved movers” in the authors’ data

- **Objective is to conclude from rejection of null that “managers use earnings guidance to influence street earnings exclusions”**
 - However, the analysts could be the ones prompting the disclosures by the managers
 - e.g., Matsumoto, Pronk and Roelofsen (2007): Information content higher during Q&A vs. presentation portions of conference calls
 - *Repeated game*;

5. Ideal vs. Implemented Research Design

Ideal:

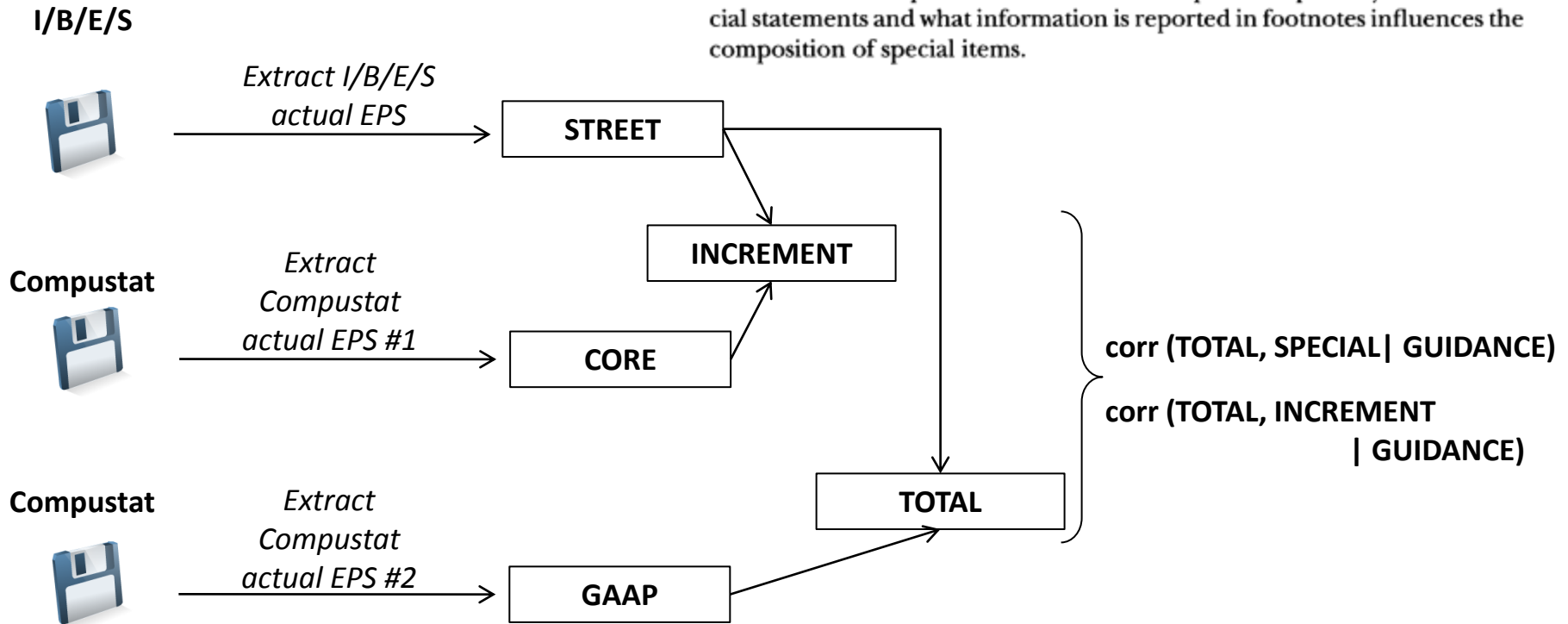


* Timing would be important

5. Ideal vs. Implemented Research Design (cont.)

Implemented:

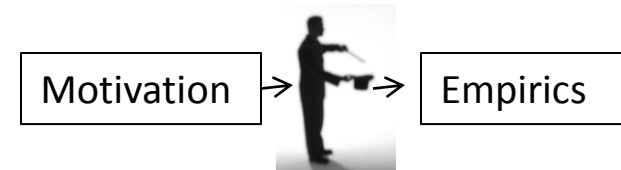
Professional standards influence, but do not completely determine, the composition of special items because (1) components of earnings reported separately on the income statement are frequently, but not always, included in the Compustat data item "Special Items" and (2) the Compustat data item "Special Items" sometimes includes items reported in the footnotes but not shown separately on the income statement.⁶ Similarly, management discretion with respect to which items are reported separately in the financial statements and what information is reported in footnotes influences the composition of special items.



5. Ideal vs. Implemented Research Design (cont.)

■ SUMMARY

- Want: $\text{EXCLUSION}_{i,M}$ and $\text{EXCLUSION}_{i,A}$
- Get: TOTAL and INCREMENT



- Assumption is that $\sum \text{EXCLUSION}_{i,A}$ maps into TOTAL ($\text{EXCLUSION}_{i,M}$ can be free form)
 - Some potential validity threats
 - *If managers identify no exclusions* (whether they guide or not), positive correlations (between TOTAL and SPECIAL/INCREMENT) could still obtain
 - If managers do guide specific exclusions, their exclusions could be *orthogonal* to analysts', but if totals are similar (in cross-section), positive correlations (between TOTAL and SPECIAL/INCREMENT) could still obtain
 - The *mapping of guidance* to exclusions is unclear

(at any time)

6. GUIDE

- **GUIDE = 0 if no earnings guidance during the fiscal year**
= 1 if any earnings guidance during the fiscal year

- **Focus is on *annual* analyst forecasts**
 - Not clear if GUIDE is measured relative to *annual* guidance only
 - Even if so, not convinced annual is the way to go
 - Quarterly earnings announcements are actually guidance for annual earnings
 - Which would seem to work *against* the authors' results
 - BUT, if $\text{pr}(\text{guidance}) \uparrow$ with special items in earlier quarters, both GUIDE and SPECIAL might load

- **Other things reflected by GUIDE**
 - Update a prior forecast
 - Visibility
 - Routine
 - Manipulation
 - Bundle with earnings announcement
 - Narcissism

7. Empirical wish list, conclusion

- **Document and explain some evidence that guidance is actual guidance of components**

- **Address quarterly earnings announcements as effective guidance**
 - e.g., Rogers and Van Buskirk (2009) ~ 70% management forecasts bundled within earnings announcements

- **Examine off-diagonals (i.e., managers guide, no exclusions and vice versa)**
- **Key takeaway (imo)**
 - **Authors move towards understanding street earnings DURING year**
 - **Move towards simultaneous examination of analysts and managers**

- **Do managers influence analysts' exclusion decisions DURING the year?**
 - **Probably**

The end
