Do Managers Use Earnings Guidance to Influence Street Earnings Exclusions?

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A Tale of Two Companies' Guidance

Company A

- Fortune 500
- Followed by 23 analysts
- SIC Code 59**
- Earnings guidance treats amortization and stock-compensation expense consistent with GAAP

Company B

- Fortune 500
- Followed by 23 analysts
- SIC Code 59**
- Earnings guidance makes a strong case for not including amortization and stock-compensation expense in computing earnings (non-GAAP or pro forma guidance)

How did Analysts React?

- Analysts' consensus earnings estimates followed the guidance provided by the two companies.
  - Street vs. GAAP for Co. A -- $0.32 vs. $0.32
  - Street vs. GAAP for Co. B -- $0.37 vs. $0.25
- So, what is the point?
  - Managers *sometimes* exclude specific line items from earnings guidance.
  - Analysts *sometimes* appear to buy these exclusions.
  - Analysts treat the same items idiosyncratically for different companies, even in the same industry.

Is this Common?

- Another example:
  - Apple vs. Dell (SIC Code 3571)
  - Apple provides GAAP guidance
  - Dell provides pro forma guidance

Company	Y.E.	First Call Street EPS	GAAP EPS
Apple	9/30/2009	$6.29	$6.29
Dell	1/31/2009	$1.31	$1.25

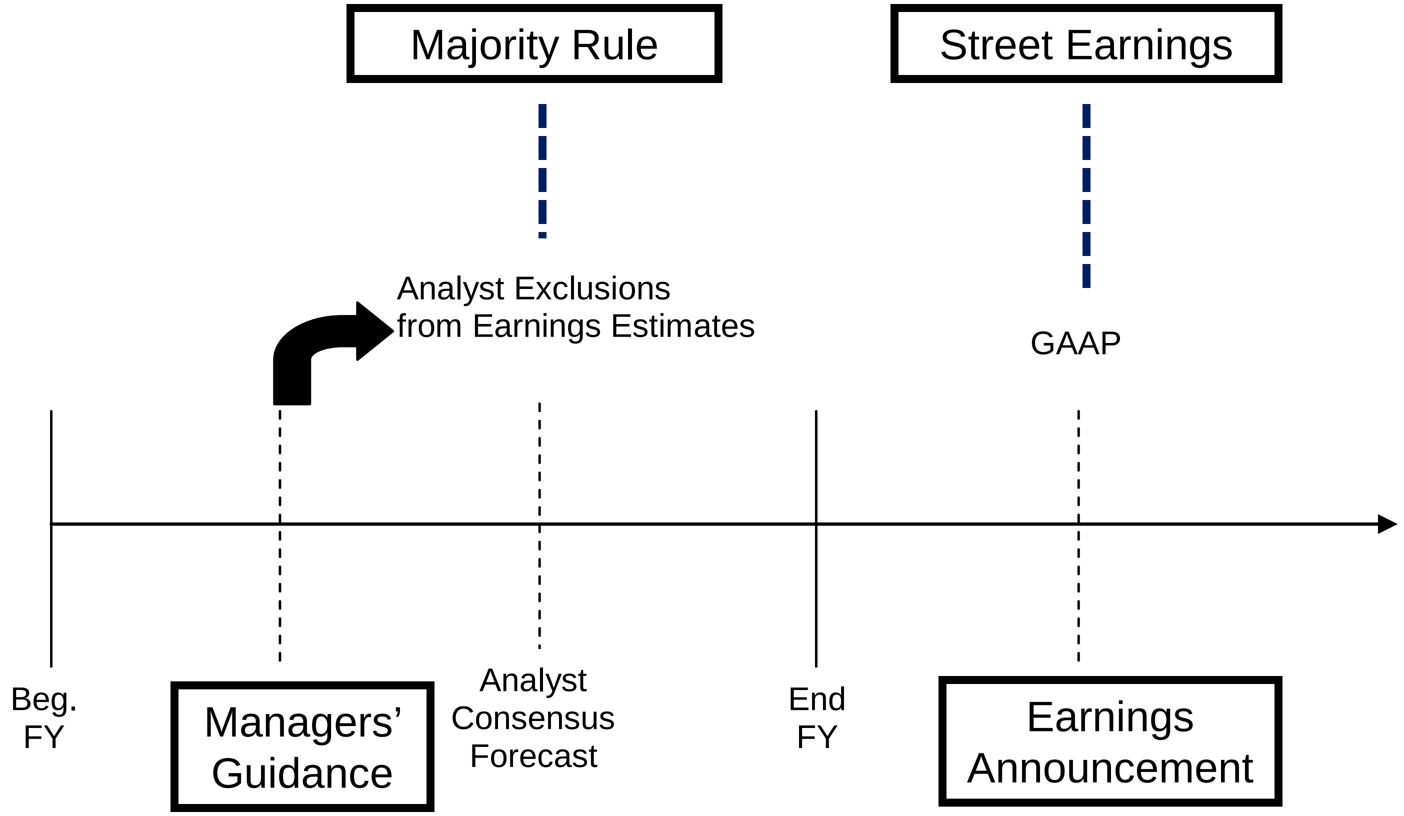
Research Question

- Do Managers Use Earnings Guidance to Influence Analysts’ Street Earnings Exclusions?

Why is this an Interesting Question?

- Prior research tells us that investors care about street earnings more than they do about GAAP earnings (Bradshaw & Sloan 2002, Doyle et al. 2003, Brown & Sivakumar 2003).
- Yet, we know relatively little about **<u>who</u>** determines the composition of street earnings.

Who Determines the Composition of Street Earnings? Managers or Analysts?



Prior Research on Street Earnings: Focus is on Analysts

- **Analyst ability** decides what components get excluded from street earnings (Gu and Chen 2004) Analysts exclude items that are less persistent .
- **Analyst incentives** decides exclusions (Baik, Farber and Petroni 2009) Analysts make more income increasing exclusions for glamour stocks.
- The role of managers is acknowledged, but not tested.

Lambert (2004)

- *"…..we do not know enough yet about who is making these inclusion decisions to know whether we should give the credit to analysts."*

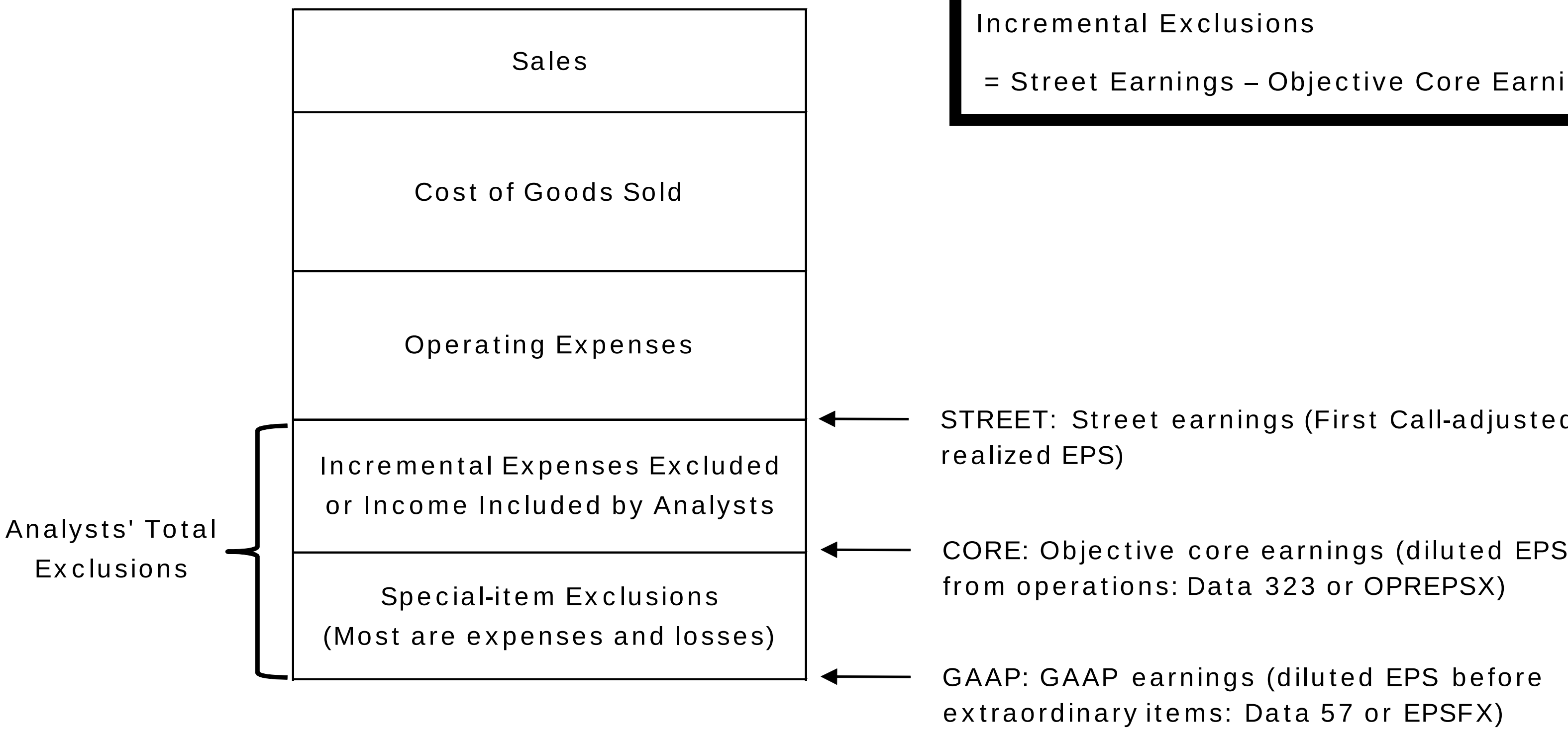
Terminology

Total Exclusions

= Street Earnings – GAAP Earnings

Incremental Exclusions

= Street Earnings – Objective Core Earnings



H1

- **Analysts are more likely to exclude the full amount of special items when managers guide than when they do not guide.**

- $TOTAL = a_0 + a_1\, SPECIAL \times GUIDE + a_2\, SPECIAL + a_3\, GUIDE + a_4\, VSPECIAL + a_5\, TURNOVER + a_6\, E/P + a_7\, MOMENTUM + a_8\, \Delta SALE + e$

H2

- **Incremental exclusions are higher for firms that issue earnings guidance than for those that do not.**

- $INCREMENT = b_0 + b_1 GUIDE + b_2 VSPECIAL + b_3 TURNOVER + b_4 E/P + b_5 MOMENTUM + b_6 \Delta SALE + e$

Sample

- Period: 2003-2007 after Reg. FD
- Financial statement data from Compustat
- Stock returns data from CRSP
- Earnings guidance from First Call CIG
- 15,209 firm-year observations
- Descriptive statistics – largely consistent with prior research

Results: H1: Total Exclusions

			Special items in prior year? No	Special items in prior year? Yes
Intercept	0.004*** (5.35)	0.005*** (5.97)	0.005*** (5.07)	0.004*** (4.10)
GUIDE x SPECIAL		-0.110 (-1.62)	-0.347*** (-2.78)	-0.067 (-0.87)
GUIDE	0.003*** (4.50)	0.002*** (3.22)	0.002** (2.18)	0.002*** (2.60)
SPECIAL	-0.817*** (-26.92)	-0.787*** (-22.05)	-0.667*** (-7.99)	-0.807*** (-20.52)
VSPECIAL	0.020** (2.18)	0.020** (2.16)	-0.007 (-0.41)	0.019** (2.00)
TURNOVER	0.005** (1.96)	0.005** (1.96)	-0.000 (-0.11)	0.008** (2.02)
E/P	-0.084*** (-7.61)	-0.086*** (-7.90)	-0.079*** (-5.01)	-0.091*** (-6.61)
MOMENTUM	-0.000 (-0.41)	-0.000 (-0.29)	0.000 (0.85)	-0.000 (-0.60)
ΔSALE	-0.001 (-1.43)	-0.001 (-1.53)	-0.001 (-0.96)	-0.001 (-0.77)
Model-fit F statistic	135.50***	118.97***	28.63***	99.38***
Adjusted R^2	50.9%	51.0%	37.2%	54.1%
Observations	14,674	14,674	5,938	8,736

Results: H2: Incremental Exclusions

			Guided in Prior Year?			
			Yes		No	
Intercept	0.003	***	0.006	***	0.002	***
	(4.26)		(3.66)		(3.01)	
GUIDE	0.003	***	0.004	***	0.003	***
	(4.82)		(3.29)		(3.22)	
VSPECIAL	0.018	**	0.006		0.022	***
	(2.54)		(0.42)		(2.75)	
TURNOVER	0.005	*	-0.004		0.008	**
	(1.89)		(-1.05)		(2.45)	
E/P	-0.076	***	-0.140	***	-0.062	***
	(-8.37)		(-6.22)		(-6.60)	
MOMENTUM	0.000		0.001		0.000	
	(0.79)		(1.08)		(-0.02)	
ΔSALE	-0.001		0.004	**	-0.001	
	(-0.88)		(2.08)		(-1.62)	
Model-fit F statistic	17.26	***	8.16	***	13.95	***
Adjusted R^2	7.1%		13.8%		6.3%	
Observations	14,674		5,241		9,433	

Supplementary Analysis

- Do we know:
  - How common is pro forma guidance?
  - What do managers exclude in their guidance?

How Common is Pro forma Guidance?

Panel A: GAAP vs. pro forma earnings guidance

Guidance Type	Special-item Firms	Non-special-item Firms	Total
GAAP Guidance Only	52	75	127 (63.5%)
Both GAAP & Pro forma Guidance	37	25	62 (31%)
Pro forma Guidance Only	11	0	11 (5.5%)
Total	100	100	200 (100%)

What Items do Managers Exclude?

Panel B: Number of exclusions in pro forma earnings guidance

Exclusion Type	Special-item Firms	Non-special-item Firms	Total
Below-the-line Items	10	4	14 (8.9%)
Special Items	27	16	43 (27.4%)
Recurring Items	44	32	76 (48.4%)
Other Items	22	2	24 (15.3%)
Total	103	54	157 (100%)

Supplementary Analysis: Stock Compensation

- Do managers use earnings guidance to influence analysts' exclusion of stock compensation expense from street earnings?
- We ask this question for a sample of firms with positive stock compensation expense.

Earnings Guidance and Analysts' Exclusion of Stock-Compensation

Logit Model Dependent Variable = Pr (EXCLUDE = 1)		
	Coefficient	T-Statistic
Intercept	-2.415***	(-15.41)
GUIDE	0.463***	(3.43)
RELEVANCE	-1.605***	(-5.96)
VCOMPX	6.878***	(6.69)
TURNOVER	2.615***	(7.77)
E/P	-0.685	(-0.97)
MOMENTUM	0.128	(1.14)
ΔSALE	-0.401***	(-2.69)
Wald χ^2	205.89***	
Pseudo R^2	10.8%	
Observations	4,758	

Conclusion

- Managers use earnings guidance as a tool to influence analysts' street earnings exclusions.
- Contribution:
  - We extend the street earnings literature by examining managers' role in determining the composition of street earnings.
  - We extend the expectations management literature by examining managers' influence on components, rather than the level of earnings expectations.

Robustness Tests

- Analysts' incremental exclusion decisions & managers' decision to guide may be attributable to some common unobservable factor. Can we account for this?
- Do these results hold for quarterly guidance? Why did we use annual guidance?

Special Case—Stock Based Compensation

Logit Model Dependent Variable = Pr (EXCLUDE = 1)

	GUIDE =1 if:		
	Firm issued Guidance	Pro Forma Guidance Only	Pro Forma or Both types of Guidance
Intercept	-2.456***	-2.357***	-2.474***
	(-14.95)	(-14.98)	(-15.42)
GUIDE	0.545***	1.293***	1.522***
	(3.78)	(5.13)	(8.25)
RELEVANCE	-1.497***	-1.437***	-1.366***
	(-5.26)	(-5.04)	(-4.75)
VCOMPX	6.710***	6.575***	6.627***
	(6.27)	(6.22)	(6.31)
TURNOVER	2.715***	2.652***	2.633***
	(7.82)	(7.63)	(7.33)
E/P	-0.550	-0.224	-0.499
	(-0.76)	(-0.31)	(-0.69)
MOMENTUM	0.133	0.133	0.129
	(1.11)	(1.12)	(1.06)
ΔSALE	-0.461***	-0.456***	-0.462***
	(-2.88)	(-2.89)	(-2.82)
Wald χ^2	208.31***	236.90***	239.12***
Pseudo R^2	11.3%	13.2%	13.2%
Observations	4,121	4,121	4,121

Supplementary analysis: Agreement between managers' and analysts' exclusion of stock-based compensation expense

	n	Include stock-based compensation expense	Exclude stock-based compensation expense	Percentage agreement between managers and analysts
Explicitly includes stock-based compensation expense	253	238	15	94.1%
Explicitly excludes stock-based compensation expense	117	78	39	33.3%
Provide both types of guidance	121	80	41	?
Silent about stock-based compensation	732	676	56	N.A.
Total n =	**1,223**			

Limitations

- Cannot rule out the possibility that managers guidance is responding to analysts' demands.
- Our evidence is indirect because we use managers' earnings guidance as our explanatory variable.
- We cannot draw any conclusions about the appropriateness of managers' (or analysts') exclusions.