Should Managers Provide Forecasts of Earnings?

A Review of the Empirical Literature and Normative Policy Recommendations

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September 2009

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OVERVIEW

The issue of whether managers should provide forecasts of earnings has received a large amount of attention in the last few years. While the debate has had input from a variety of sources, the discussion has not drawn on the large amount of empirical research examining management forecasts of earnings. This paper provides a review of that literature, first discussing the benefits of forecasting including a more informed capital market, current returns that are more reflective of future performance and reduced information asymmetry. However, the paper also points out some potential costs such as managerial opportunism. On balance, the review concludes forecasting creates a net benefit. I then review the literature regarding effectiveness of forecasting. That literature indicates that variance in forecasting practices can have a strong influence on whether firms achieve the benefits of forecasting. I conclude with a normative discussion of some suggested practices.

INTRODUCTION AND EXECUTIVE SUMMARY

Recent years have seen a growing debate regarding the role management forecasts of earnings (MFE) should play in investor communications. Some players in the market argue that an increasing focus on earnings guidance, particularly quarterly guidance, has created a myopic environment in both investment markets and operating companies. Proponents of this view come from a wide range of backgrounds, including managers, capital market investors, regulators and academics. However, there is an equally diverse group of individuals who have argued that MFE are a crucial part of the management communication process. Arguments from both sides have been passionate yet reasoned. However, they have generally relied on impressions or anecdotal evidence. The goal of this paper is to draw on the large body of empirical research regarding MFE to provide insights into the merits of these arguments.

The debate on MFE's has focused heavily on shorter term guidance—particularly the practice of providing quarterly guidance. However, it has also called for a general reduction in providing earnings related guidance, including at the annual level. The academic literature has investigated MFE of varying time periods. In some studies a single type of MFE is used, at times quarterly at other times annual or even broader, longer term forecasts. More often, multiple MFE horizons are included in a single study and research design is used to deal with differences across the horizons. In order to be complete in representing the literature, this review includes studies that examine MFE over all forecasts horizons. That is, I do not limit the discussion to quarterly or annual MFE. Rather, the important issue is that the managers were forecasting a bottom line earnings number. Throughout the paper I will point out the horizons used in various studies and, where appropriate, differences in findings across the horizons.

The review of this literature shows that MFEs have long been an important source of information for market participants. They allow managers to align both investor and analysts' expectations with those of the manager while reducing information asymmetry across traders. They also increase the degree to which current market returns reflect longer term operating performance. Additionally, MFEs allow managers to mitigate well documented returns anomalies such as post-announcement drift. In total, the evidence indicates that MFEs offer many benefits for managers attempting to develop a well informed investor and analyst base.

However, the literature also shows that the response to MFEs varies—suggesting there are ways to optimize the value of MFEs. In particular, the market values more precise forecasts supported by numerical details. They highly value managerial reputation, which is built by a record of frequently providing accurate MFEs. While the market seems to appreciate MFEs for varying horizons, short term MFEs generate the greatest response. Interestingly, these MFEs appear to help the market understand longer term performance.

Despite these benefits, MFEs also impose costs. In particular, it appears managers may act opportunistically by taking advantage of their private information to favorably time stock transactions around MFEs. Additionally, they may strategically issue MFEs to obtain favorable option terms. However, the empirical literature generally does not support the recent allegations that MFEs led to value destroying myopic behavior. In particular, the literature shows that the market responds to short term performance even in the absences of prior guidance. Further, firms' which curtail guidance show no evidence of increased long term investment policy nor do they demonstrate a reduction in "myopic" behavior.

There is no way to sum the benefits and costs of MFE's to create a quantitative measure of the net impact of forecasting. Further, the benefits and costs would differ across firms and types of MFE. Additionally, as discussed in the text of this review, some costs cannot be quantified by large sample research and thus this cannot be considered in this study. Keeping these caveats in mind, it appears that for many firms the benefits of MFEs outweigh their costs – particularly since there are techniques available to both maximize the benefits and minimize the costs.

Thus, I conclude by discussing some suggestions for developing an effective MFE policy that maximizes gains while minimizing costs. These suggestions center on the adoption of a written policy detailing when MFEs will be provided, what form they will take and how they relate to the company's overall disclosure package. This document would commit managers to a policy and provide a framework for discussing this policy with outsiders, thus allowing the market to more fully understand why a given policy is correct for a specific firm. It also would reduce managers' ability to undertake opportunistic timing of MFEs.

In addition to calling for a written policy, I suggest managers design their MFEs to provide forecasts over multiple horizons at a single time. The MFE should be more precise for shorter horizons and get less precise as the time period expands. It should be supported by sufficient detail and provided on a regular basis in order to build a reliable history of guidance. I also suggest managers commit to providing an ex-post explanation of why actual results differed from the MFE (or why longer term expectations are being adjusted).

The paper proceeds as follows: Section 2 discusses evidence regarding whether MFEs are informative to market participants, Section 3 discusses the benefits of providing MFEs, Section 4 discusses evidence regarding the costs of MFEs, Section 5 discusses empirical evidence regarding what makes MFEs effective and Section 6 consist of normative suggestions based on my review of the literature.

Do Managers Forecasts of Earnings Contain Information?

A. The Market Response to Management Forecasts of Earnings

Participants in the current debate regarding MFEs assume that people respond to MFEs and worry about a fixation. However, the early accounting literature focused on the question of whether the market would respond to these forecasts at all. This literature was motivated by two underlying issues. First, the generally unregulated nature of MFE combined with managerial incentives to mislead created a very real question of whether market participants would view the forecasts as being credible (Foster, 1973; Patel, 1976). Second, in the early 1970's the U.S. Securities and Exchange Commission (SEC) was considering various forms of mandating that companies provide MFEs and academics undertook studies in order to provide information to normative policy makers (Patel, 1976; Imhoff, 1978).[1]

The earliest papers generally limited themselves to point or specific range MFEs. Although most studies limited their analyses to MFE of annual earnings, the horizon prior to the annual earnings announcement varied greatly. For example, Foster (1973) studied forecasts of earnings provided subsequent to the firm's fiscal year end, but prior to the actual earnings announcement. In contrast, Patel (1976) requires the MFE to have been made prior to the end of the third quarter and Jaggi (1978) requires MFE to have been made at least 8 months prior to the fiscal year end (i.e., by the end of the first quarter). Thus, while the majority of early studies focused on annual MFE, the variance in horizon effectively results in studying both short and longer term forecasts.

The findings in this literature are important to our current debate for at least two reasons. First, and most importantly, the findings in this literature consistently show that forecasts provide important value relevant information to the markets. The earliest studies tended to use event-study methodology and limited their scope to investigating the market response to the MFEs. These studies found a strong price reaction at the time the MFE was issued, suggesting it provides new information to the markets (Foster, 1973; Patel, 1978; Jaggi, 1978). Further examination indicated that prior to the forecast the market was drifting in a direction consistent with the news in the MFE, but that the majority of the returns occurred around the release date of the MFE (Nichols and Tsay, 1979). This indicates that the market was able to develop some expectations of earnings, either via prior leakage from managers or independent sources, but also shows that the

[1] It is interesting to note that we have gone from a situation in which the government was considering compelling MFEs, through a period where market forces have made the provision of MFEs relatively common and now to a debate where a large group of stakeholders are calling for companies to cease providing MFE.

eventual release by management is a strong input to market expectations.[2] Subsequent work replicated the general findings after applying more rigorous methodology and earnings expectations models (Penman, 1980; Waymire, 1984).

The subsequent work also expanded on prior results by demonstrating that managers issued forecasts which adjusted expectations both up and down, suggesting symmetry both in their use and in the market credibility (Ajinkya and Gift, 1984; Waymire, 1984). Finally, some subsequent work has shown that the market also responds to MFE that confirm current expectations, indicating that the market values the level of certainty gained by seeing that managements' views are consistent with their own (Clement, Frankel and Miller, 2003). As a group, early tests of the market response to MFEs demonstrated high information content for both good and bad news forecasts—a result which has been replicated as a starting point for many subsequent studies including those using very current data.[3]

Second, the early studies drew on MFEs from the 60's or early 70's, which indicates that MFE as a practice has been around long before concerns of rampant myopia. While many of these studies focused on "annual forecasts", they often included or even focused exclusively on annual MFE provided late in the year, which were essentially short term forecasts. Further, some authors noted that during the 60's and 70's shorter term MFE appeared to be more common than long range MFE (Nichols and Tsay, 1979). Overall, this indicates that forecasting does not de facto lead to myopic view points.

B. Other Evidence of Management Forecasts of Earnings Containing Information

The majority of the literature has taken a direct approach by examining the change in a firm's market price in a short window around the provision of a MFE. While this is a clean and obvious way to examine the information content of MFE, several papers have provided information in complementary ways.

[2] Nichols and Tsay, 1979 only examined long term forecasts of earnings. Thus, it is possible that even the drift they found prior to the long term forecasts were due to shorter term forecasts provided in previous periods.

[3] As Imhoff (1978) points out, these studies were designed in part to provide normative implications to regulators but the reliance on firms that voluntarily forecast makes it difficult to validly generalize to non-forecasting firms. This caveat should be borne in mind during my review as well. However, the limitations for the purpose of this study are less severe since much of the current discussion centers around curtailing forecasting of firms currently providing the information—firms which likely were included in these prior studies.

The first complementary method focuses on a phenomenon called "information transfer". In the MFE literature test of information transfer examine whether MFE by one firm in an industry result in market adjustments for other firms in the industry. Several papers find evidence consistent with information transfers due to MFE (Baginski, 1987; Han, Wild and Ramesh, 1989; Pownall and Waymire, 1989). While the magnitude of the information transfer impact is much less than the impact on the firm providing the MFE, in some ways this is even more compelling evidence that MFEs provide important information to the markets. That is, this evidence suggests that the MFEs are informing the market about industry wide information that managers possess but that has not yet been ascertained by market participants.

In a related paper, Anilowski, Feng and Skinner (2007) show that aggregate MFE impact aggregate analysts forecasts of earnings as well as providing (somewhat weaker) evidence of the MFE impacting market returns. This evidence again indicates that important market participants, both investors and analysts, are deriving a fuller understanding of the market as a whole from MFEs.[4]

Overall, the evidence from the literatures examining both direct and indirect impacts of MFEs indicates that they provide new information to market participants. This evidence indicates a benefit of MFE for the market participants.

What are the Benefits to Managerial Forecast of Earnings?

In this section I discuss research on the benefits derived by providing MFEs. A maintained assumption in these discussions is that managers prefer to have market perceptions of their firms and industries set in a manner consistent with the managerial view of the current and future economic conditions. The alternative would be for managers to leave an "information gap" allowing outsiders to set the expectations regarding performance for their firms. As the evidence discussed in section 2 has shown, MFEs impact the market's perception of the firm, implying that absent the MFEs market expectations would be misaligned with those of the firm. Thus, to the extent that managers wish to minimize an information gap, the evidence in section 2 provides insights into some benefits managers derive from providing MFE. In this section I discuss papers that have further explored the major benefits of providing MFE.

[4] It should be noted that any evidence of information transfer or an aggregate response is impressive given that researchers have often struggled to find evidence of information transfer even in more regulated disclosures such as earnings announcements (Frost, 1989; Lang and Lundholm, 1996).

A. Returns Based Benefits of Providing Management Forecasts of Earnings

The previous discussion has shown that MFEs can result in price adjustments consistent with the news contained in the MFE. While this implies managers can use MFEs as a tool to reflect their beliefs, Ajinkya and Gift (1984) formalize this by proposing an "expectations hypothesis" that argues managers use MFE to move market expectations towards their own beliefs in cases where expectations differ greatly. They test the theory using analyst expectations, MFEs and market returns. Their findings support the expectation hypothesis, providing more formal support for the idea that a primary benefit of forecasting is to align managerial and market expectations.

Das, Kim and Patro (2008) further explore the ability of MFE to align market and managerial expectations by examining returns patterns in periods after the MFE are forecasted. They document a drift following an MFE that suggests the market does not correctly impute the information at the time of the forecasts. However, they find strong evidence that the MFEs were effective at reducing the market response to the earnings "surprise" that occurs at the time of the earnings announcement.[5] Combined with the Skinner and Sloan (2002) evidence of large negative market reactions around earnings surprises, this study indicates MFE can help managers to avoid market penalties.

Coller and Yohn (1997) also focus on the period following issuance of an MFE, but their study investigates information asymmetry using bid-ask spreads. They find that spreads increase for up to two days following the MFE, but then drop and remain lower until the related earnings announcement. Thus, in addition to changing mean expectations, MFEs appear to reduce asymmetry across market participants.

Several other studies also examine how MFE can change the patterns of future returns or other returns related attributes. These studies attempt to build on the previously discussed literatures by examining previously identified returns phenomena and then showing specific ways in which MFE can impact the information environment and thus the pattern of returns. Choi, Myers, Zang and Ziebart (2008) show that the current period market returns are more reflective of future performance for firms that provide MFE. Importantly, they find this relation is stronger for firms that provide short-term/quarterly forecasts even after conditioning on providing longer term forecasts. Thus, not only can MFEs "pull understanding forward" but we can see that providing a broader range of MFEs over various horizons seems to create a deeper understanding for the market.

Li and Tse (2008) take a slightly different approach by examining whether MFE can impact the returns pattern created by the well documented "post-earnings

[5] Surprise is measured based on expectations prior to the MFE.

announcement drift". They find that providing MFE contemporaneous with announcing earnings significantly reduces the drift—particularly if the firm has a history of prior accurate forecasts. MFE provided on a stand-alone basis are less effective and actually create an earnings drift themselves, leading the authors to conclude that the way MFEs are combined with other information makes an important difference in their impact on returns drift.

Finally, Pownall and Waymire (1989) show the firms that provide MFEs incur less information transfer from information events of other firms in their industry. This indicates that providing MFEs allows managers to focus the market more clearly on the information specific to their firm, rather than to have the firm treated as a homogenous member of the industry.

In total, these returns based papers show that MFE can have a wide ranging impact on how investors perceive the firm. These impacts are consistent with MFEs helping the market to understand the longer range implications of current firm performance and at reducing disagreement across investors. Obviously, these capabilities suggest the MFEs can provide important benefits for managers attempting to develop an informed set of investors.

Despite this strong evidence, it is important to point out that not all returns based studies find a positive impact for MFEs. For example, Rogers, Skinner and Van Buskirk (2008) examine the impact on implied options volatility. They find that in general there is little or no impact, but that for MFEs that contain negative news volatility can increase—consistent with the MFE actually creating market uncertainty.[6] This is consistent with Bushee and Noe (2000) who study the impact of disclosure in general (not just MFE) and find that increased levels are correlated with higher subsequent volatility and with attracting investors who frequently churn the stock.[7]

[6] The findings of increased volatility occur mostly for firms that are infrequent forecasters. Thus, it is likely that when these firms undertake the atypical act of providing an MFE it is due to some underlying atypical issues at the firm. It is very possible that the increased volatility is due to that underlying issue.

[7] Specifically, Bushee and Noe indicate that increased disclosure may attract a larger number of "transient" investors who trade in and out of the stock on speculative information. Their paper uses a categorization for investors based on Bushee (1998) that shows investor composition can impact managerial decisions of whether to take value destroying decisions in order to meet current earnings expectations. It is clearly important to understand the impact of investor composition, but generally this approach has been inconclusive in large sample research. Bushee and Goodman (2007) point out that it is likely more fruitful to consider the specific relations between a given investor and the firm, rather than drawing on the more general investment approach of the institution. With this caveat, Bushee (2004) provides an excellent review of the literature on investor composition through the date of that paper.

B. Analyst Related Benefits of Providing Management Forecasts of Earnings

While most papers have focused on examining MFEs impact on stock prices, there is also a literature that examines the relation between MFEs and analyst forecast errors. Given the important role of analysts in setting market expectations and as an audience for disclosure in general, it is useful to develop an understanding of how MFEs impact managers' relations with analysts.[8]

Cotter, Tuna and Wysocki (2006) show that managers are more likely to provide MFE when analyst are optimistic and when the analyst forecast dispersion is low. That is, MFEs are used to break a strong analyst consensus of higher performance than management anticipates. They find that analyst respond by quickly revising their earnings expectations downward. Similar to several of the returns based studies; this is another example that shows how MFEs can be used to assist managers in correcting ill informed market perceptions—but it shows that MFEs can provide an additional lever via also impacting analysts perceptions.

In a related study, Hutton (2005) compares firms that give analysts performance guidance to those that do not.[9] She finds that there are several reasons managers provide such guidance, such as an earnings process that is inherently complex or a large degree of analyst attention. All of the reasons are consistent with managers feeling the need to take control of the firms expectations when there is a group of interested individuals and the information is difficult to predict—consistent with a managerial attempt to successful control the firm's information environment.

Analyst expectations are more accurate for firms that guide, suggesting that overall the process results in better information in the market. The expectations are also more pessimistic, indicating managers may be purposely biasing the guidance to increase the likelihood that they will meet or exceed analysts' forecasts. While such bias is less than desirable from the sense of a fully informed market, it is likely a rationale managerial response to the large penalty to missing earnings forecasts (Skinner and Sloan, 2002). Again, this evidence shows managers effectively using MFEs to take

[8] A large number of MFE studies use analyst forecasts as a proxy for market expectations. However, in this section I am only considering papers that are investigating the impact on analysts directly.

[9] Most papers discussed in this review identified firms that provide MFEs by directly observing MFEs (either by hand collection or through a data base of MFEs created by others). Hutton (2005) is an exception as it uses survey evidence of firms that indicate they provide earnings model guidance to analysts. The advantage of this approach is that it can capture private guidance as well—which was common pre Reg FD. The disadvantage is that I cannot say for certain that all of these firms were providing MFEs—it is possible their interpretation of the word guidance includes a broader range of activities.

control of the firm's information environment.[10] However, the finding of bias does suggest some gaming. If this gaming skews expectations or encourages value destroying actions by managers this suggests a cost to forecasting as well.

C. Litigation Related Benefits to Disclosure

MFEs often are viewed as a potential cause of litigation and practitioners frequently argue that their legal counsel advise against providing any MFEs. Consistent with these anecdotal arguments, the literature has found that MFEs are more likely in environments with a lower litigation risk (Johnson, Kasznik and Nelson, 2001; Baginski, Hassell and Kimbrough, 2002).

Despite the evidence of litigation risk deterring MFE, studies specifically examining the role of litigation and MFE find the MFEs can be an effective tool in managing litigation risk. Managers are likely to provide short term forecast to preempt bad earnings news (Skinner, 1994; Soffer, Thiagarajan, and Walther, 2000). While there is mixed evidence regarding whether the disclosures lessen the likelihood of being named in a lawsuit (Francis, Philbrick and Schipper, 1994; Field, Lowry and Shu, 2005)) they do lessen the amount and likelihood of a payout when there is litigation (Skinner, 1997). Combined, these studies suggest MFEs play an important role in litigation. They are also further evidence of managers using MFEs to take control of the firm's information environment and of its related economic consequences.

Further, practitioner research performed by Cornerstone Research suggests that litigation is driven by large stock price drops (Cornerstone, 2008). Anecdotal discussions with practicing attorneys support this argument. The discussion of MFE research in prior sections of this paper has shown it can lead to more informed and orderly market expectations of performance. This suggests that MFE's may also deter litigation by reducing the probability of a large stock decline.

What are the Costs of Providing Managerial Forecasts of Earnings?

The proceeding section has provided a wide range of benefits for providing MFEs. These benefits show that managers can use MFEs to align market and analysts expectations, mitigate well known factors causing returns distortions and to generally make the returns pattern consistent with a more informed investor base. In addition, MFEs can reduce the potential costs of litigation. Despite these benefits, a large number

[10] Several other papers that examine the impact of MFE on analyst forecasts are discussed in the section on the arguments against providing MFEs. Those papers also find that MFEs have a positive impact on analysts accuracy and dispersion of beliefs.

of practitioners and practitioner bodies have argued that the costs exceed the benefits and called for companies to cease providing MFEs (Krehmeyer, Orsagh and Schact, 2006; Donaldson, 2008; Krehmeyer 2008a, 2008b). In the following sections I will briefly review the major arguments put forth, providing a summary of the empirical literature that most directly addresses these arguments and then discuss some potential costs that were not highlighted in these pieces arguing against MFE.

A. Business Roundtable, CFA Institute and Related Arguments

Recently, the Business Roundtable Institute for Corporate Ethics and CFA Institute Centre for Financial Market Integrity combined forces to undertake a discussion of the pros and cons of MFEs as well as the broader issue of myopic behavior by managers and investors. Their findings and conclusions were summarized in Krehmeyer, Orsagh and Schacht (2006) (KOS). It argued MFE, particularly those with quarterly horizons, were a primary contributor to a high perceived level of myopia in company and market operations.[11] The underlying argument essentially stated that by providing short term MFE the managers were focusing market participants on those results and thus contributing to myopia.

In response to their findings, the white paper produced by these institutes called for the vast majority of firms to discontinue quarterly guidance and to greatly curtail (or even cease) annual guidance. Instead, the authors suggest firms focus their discussions on long term objectives and strategies of the firm. Their recommendations also included a call for managers to increase the amount of disclosure regarding these longer term objectives, though not necessarily as forecasts. These suggestions have been reiterated in papers and speeches that the two institutes have sponsored or supported in some way over the last several years (Donaldson, 2008; Krehmeyer 2008a, 2008b). The underlying implication is that managers can shift the discussion, and thus the focus of the market, away from short term performance. Essentially, this argument suggests that the market will not respond as strongly to short term performance if managers do not create expectations for that performance. Thus, it assumes the market will not adopt the alternative of simply creating its own short term expectations and placing a similar focus on that expectation.[12] The KOS arguments also suggest that a market short term

[11] They also indentified other issues, such as incentives and board training, MFEs were the first item discussed and the one which received the largest amount of attention. However, it is important to note that KOS did not argue that MFE were the sole or even sufficient cause of myopia.

[12] Members of the panel indicate that their expectation is that the market will attempt to provide its own short term expectations, but that increased managerial disclosure of long term information along with changes they recommend in other parts of the financial markets (such as investors adjusting their process) will combine to reduce the weight placed on these short term expectations.

focus will translate into managerial myopia in practice—that is short term investment practices and other actions that decrease longer term value.

Most of the support for the conclusions reached relies on the experience of the diverse panel of people involved in the panel, focus groups and other interactions within the groups' memberships. As such, it is difficult to comment on the specific process or findings. The primary academic paper cited was Graham, Harvey and Rajgopal (2005), an influential survey of managers performed primarily at a business conference in New York City in November of 2003. The results in that paper find that startling high numbers of managers say they will sacrifice real economic growth in order to meet short term earnings goals. This certainly provides enough evidence to cause readers to pause and consider whether short-term thinking has resulted in market wide losses of long term value. However, it does not necessarily follow that managers would feel less pressure if they did not provide MFEs or in fact that MFEs contribute to the focus on short term numbers.[13] Further, it provides no evidence that an absence of MFE's would lead the market to curtail its focus on short term performance. In fact, the text and several of the responses in the paper suggest that managers feel they are responding to the preexisting market fixation on short term performance—indicating that focus exists regardless of the MFE practice of managers.

Although they were not cited in KOS, there are several papers that provide more direct evidence regarding the assertions in KOS (that is, MFEs foster short-termism and if they are halted managers can and will fill any new information gap with other long term disclosure).[14] Before discussion of those papers, it is important to point out the difficulty of directly testing the underlying assertion that MFE create (or exacerbate) a short term focus and, the necessary corollary, that the market would not simply create its own expectations absent MFE. From an empirical perspective, we can only observe the actions managers have taken—thus it is impossible to observe what would have occurred had the managers used an alternative MFE policy. The MFE policy in place is likely a result of strategic choices made by managers, thus introducing a strong component of self selection into the distribution observed by the researcher. While researchers employ various research design and statistical methods in an attempt to mitigate this bias, it is difficult to completely overcome this self selection. However, as

[13] The study was designed to cover a large area of questions in a short amount of time in order to develop broad insights with a high response rate. Unfortunately, this creates the classical trade off pitting breadth against depth. For example, the authors were not able to ask each question in various ways in order to use statistical methods to validate the underlying response variable. This is not meant as a criticism of the study, but rather to point out that its goal was not to provide an in-depth answer to the specific question of interest in the KOS paper.

[14] Several of these papers appear to have been written in order to investigate the assertions made in KOS. Thus, it is possible they did not exist at the time of the KOS paper.

the set of studies use various methods, it is possible to use these studies to create a more informed understanding than would be developed via purely anecdotal analysis.

While the prior sections have cited many studies that indicate MFE's impact the markets' perception of upcoming performance, those papers did not examine whether the total response to that performance was impacted by the decision to provide an MFE. Tucker (2007) examines this issue by investigating the market response to poor quarterly earnings performance. After adjusting for managerial selection bias (more extreme bad news is more likely to be preempted via a MFE), she finds that the market response is greater when firms fail to provide a MFE. Thus, contrary to the concerns in KOS, it appears the MFE mitigate the markets focus on short term performance. Of course, this paper is subject to the caveat that the findings are highly dependent on the effectiveness of the statistical method used to control for the high degree of managerial self selection.

In a similar vein, Mergenthaler, Rajgopal and Srinivasan (2008) examine whether managers are likely to be terminated following poor performance. They find managers are more likely to lose their jobs if they have recently failed to meet the market's earnings expectations. The association holds regardless of whether the firm provided MFEs, but the probability of a termination is slightly higher if the managers had provided an MFE for the period. The authors are unable to determine if the higher probability of termination is purely punitive or if it is in response to a belief that the unexpected negative outcomes indicate the managers who provided the MFEs have a fundamental misunderstanding of their business (i.e., it has uncovered manager type).[15] In addition, it is unclear whether firms that provide MFEs do so in response to a greater interest in their current earnings performance. If so, the MFE may simply indicate that the market is very sensitive to current performance for these firms—suggesting the managers would have lost their job regardless of whether an MFE is provided. Despite these caveats, this paper provides mixed support for KOS. On the one hand, forecasting increases the possibility of managerial termination—thus potentially skewing managerial incentives towards myopia. On the other hand, it appears managers are almost as likely to lose their jobs regardless of forecasting; suggesting the underlying issue of myopia is driven by something beyond MFEs.

In addition to the market response to short term performance, KOS make an argument that managers take value destroying actions due to short term fears. They tie this pressure to the use of MFE's. Several papers investigate this possibility.

[15] Kasznik (1999) provides evidence that once managers provide an MFE target they will manipulate accruals in order to meet that target. This provides further evidence that managers feel there are negative impacts to missing their own forecasts—though it still does not identify whether those impacts are purely punitive or based on a market using the information to assess managerial talent.

Cheng, Subramanyam and Zhang (2005) compares firms that consistently provide MFEs with those that only periodically provide MFEs. They find that the "dedicated" MFE firms invest less in longer term activities such as R&D and that the dedicated guiders have a lower growth rate over the long run. These associations are consistent with the arguments in KOS. However, it is difficult to provide direct attribution to the act of providing MFEs as each set of firms have selected their communication process for a reason. For example, the firms that provide regular short term forecast may do so because they are facing unclear situations or know they are in an industry where longer term outlook is less positive (Miller, 2002). In either case, there may be an increased demand for (or supply of) short term information in these industries due to the underlying feature that causes the lower long term growth. Despite this caveat, it does appear that some association exists.

Two other recent studies get around some of these research limitations by examining firms that have stopped providing MFEs (that is, they once used MFEs, but now either explicitly or implicitly have discontinued the practice). This "changes" methodology reduces some of the issues of self selection as they allow the firm to be used as its own control. Further, they create the experiment most consistent with firms following the KOS recommendations (in fact, many of these firms may have directly relied on those recommendations).

Chen, Matsumoto and Rajgopal (2006) study a sample of firms that publicly announced they were ceasing quarterly MFEs. They find that the firms generally make such announcements following a period of poor performance, suggesting it may be an attempt to curtail communications with the market. More importantly, they find that current market returns are less correlated with future earnings performance and that analyst forecast accuracy is reduced while dispersion is increased. As a whole, this paper essentially finds that once firms discontinue quarterly guidance they lose the benefits of guidance discussed in section 3 above.

In a related study, Houston, Lev and Tucker (2008) also examine firms that stopped providing MFEs.[16] They find similar adverse impacts on analysts' forecasts. In addition, they find that the firms do not increase long term investment nor do they provide increased other information to help fill the information gap left by the discontinuance of MFEs. In fact, in general they find the firms curtail other information as well. Combined, the two studies on firms that cease MFEs cast serious doubts on the assertions in KOS and related papers. In fact, they show a general reduction of information quality with no gains from reducing the level of myopia.

[16] Houston, Lev and Tucker (2008) did not require the firms to provide a public announcement that they were ceasing guidance. Rather, they used empirical data of MFEs to find firms that had discontinued the practice during the period of their study.

As previously mentioned, direct empirical evidence regarding the assertions in KOS is problematic due to the managerial self selection regarding MFEs. However, the bulk of the evidence indicates the market will focus on short term performance regardless of the managerial decision to provide MFE's. Further, the markets' expectations of upcoming performance is adversely impacted when MFE's are not provided, suggesting the market will now be focusing on a less informed benchmark. The evidence on managerial investment is mixed, but the most direct evidence indicates it is not impacted by the MFE policy.

B. Managerial Opportunism and Managerial Forecasts of Earnings

While KOS and the related papers primarily focus on MFEs impact on myopia, the empirical literature has also examined whether managers use MFEs as a tool for self enrichment either through strategic trading or impacting options values. Overall, that literature suggests there are issues of managerial opportunism around MFEs.

Insider trading likely presents the largest potential for managerial opportunism. Consistent with this, Penman (1982) finds that managers time their trades around forecasts in a manner that is consistent with attempting to benefit from their private information regarding the upcoming disclosure. Using larger samples with more recent data, studies have been able to refine this understanding to show that managerial opportunism is most likely to occur via strategically timing trades to follow an MFE and that managers are more likely to be involved in purchases that appear opportunistic than in opportunistic sales (Noe, 1999; Cheng and Lo, 2006).[17]

In addition to direct trading in the market, some studies provide evidence that managers also may use their ability to time when a MFE occurs in a self-serving manner. Aboody and Kasznik (2000) find that bad news MFEs are provided prior to option grant dates while good news MFEs are often withheld until the grant has occurred. Obviously, such timing would increase the eventual expected value the option will provide for the manager. In a similar manner, managers appear to increase the use of good news MFEs if they are participating sellers in a secondary stock offering even though there is no evidence of increased use of MFEs to support secondary offerings in general (Frankel, McNichols and Wilson, 1995; Marquardt and Wiedman, 1998).

[17] The legality of insider trading around MFE's is questionable. If managers traded in advance of an MFE that contained "material information" they would be subject to insider trading litigation. However, to the best of my knowledge, managers who chose to withhold a trade until after an MFE would not be subject to such litigation. That is, managers cannot be held responsible for failing to trade on material information. The results in the literature generally support such a pattern—the findings are much stronger for trading after an MFE than in the period prior to an MFE (see for example, Noe, 1999).

C. Fraud and Managerial Forecasts of Earnings

The KOS papers and a large number of observers point out the potential role of extreme market expectations driving managers towards fraud. These observers point out that if such a relation exists and if MFE further increase the focus on short term market expectations, then MFE may contribute to these large frauds. Many of these people argue that the high costs of frauds such as Enron or WorldCom, essentially wipe out any of the on average gains from MFE discussed in the previous portions of the paper.

Unfortunately, the academic literature can add little hard evidence to this debate. Thankfully, these massive frauds are relatively infrequent in numbers (though obviously their large costs results in such frauds being very important). Further, each fraud has unique aspects that make it different from prior frauds. As such, we cannot build up a large data set that provides a clear research design. Further, even after the fact we often cannot agree on what caused a fraud or even the actual extent of the fraud. For example, while there were many books on Enron and much discussion, the extent and causes are still a matter of debate (see for example, Salter, 2008).

The most pertinent large sample empirical evidence that can be provided is Kasznik (1999) which shows that managers are likely to manipulate earnings (via accruals) in order to meet the expectations set in a managerial forecast of earnings. While these firms have not undertaken the massive frauds discussed above, they certainly have headed down a slippery slope that is not beneficial for anyone involved in the markets. Again, we are faced with the caveat that these managers may be responding to an ex-ante market focus on short term performance for their firms, and thus would manipulate to some sort of benchmark anyway.

Beyond academic evidence, one can also consider the counter argument that MFE allow managers to take better control of expectations regarding their firm and thus may serve to reduce the pressure to meet some external market expectations. Literature previously discussed in this paper shows that managers can adjust market expectations via the use of MFE's. This expectations adjustment provides an alternative to financial manipulation (Matsumoto, 2002).

In the end, large sample research can provide little insight into the role MFE played in recent (or not so recent) massive frauds. It is an interesting issue to consider and individual case studies may be more fruitful in providing further context regarding this issue. Unfortunately, the massive litigation and varying incentives of parties following such frauds lead to very unclear understandings of the frauds even during ex post analyses. To some extent, governance and other issues discussed in the subsequent

sections of the paper may speak to some of the concerns regarding massive frauds. However, I am unable to provide any conclusive evidence in this paper and readers should keep this caveat in mind when relying on the paper.[18]

What Makes Managerial Forecasts of Earnings Effective?

The discussion in sections 3 and 4 show that MFE lead to many positive benefits related to the firm controlling its information environment and creating a more informed market. Further, while the academic literature shows some costs exists to forecasting, the evidence of a casual relation with myopia is weak. There is, however, some evidence of managerial self dealing. On balance, the evidence in this survey indicates the MFEs are a net benefit to the firm and the markets. Thus, the remainder of the paper turns towards understanding how managers can better use MFEs as a portion of their disclosure program. In this section of the paper I will review the empirical evidence regarding what makes MFEs most effective.

A. Precision, Horizon and Venue of Management Forecasts of Earnings

Managers preparing an MFE face many decisions regarding the form, horizon and timing of the MFE. Early MFE literature was focused primarily on showing whether MFEs had any impact on the market or analysts. As such, they tended to limit their analysis to a single type of forecast and horizon, generally requiring a specific point or range forecast and focusing on annual forecasts. This reduced heterogeneity in the samples being studied allowing the researchers to focus on the broad issue of whether MFEs had information content. However, as researchers developed more knowledge in the field they began to observe a large degree of diversity in these choices and thus turned to examining differences in impact on the market and analysts. These subsequent studies can provide useful insights into what makes MFEs most effective. However, it is important to note that this literature faces a large selection issue. That is, managers likely design their MFE to be most effective in their specific situation. Thus, there are some risk in generalizing to other situations.

Several papers have examined the impact of MFE specificity. These papers most frequently compare specific point forecasts, ranges with specific numbers, minimum or maximums and directional (higher or lower than some benchmark). Studies in this area have unambiguously found that the greater the precision of the forecasts the greater the

[18] Anecdotal evidence has suggested that in several frauds, such as World Com, management has been very aware of the need to meet the MFE that they have supplied. It is possible that the process of providing a forecast creates a greater psychological incentive to meet the target. I have been unable to identify any work that directly examines this question, but it would be an interesting area for future research.

market and analyst response (Baginski, Conrad and Hassell, 1993; Pownall, Wasley and Waymire, 1993, Bamber and Cheon, 1998). This result has been replicated across many subsequent studies that use a broad range of MFEs. The robustness of this finding across time, firm composition and situations suggests it can be relatively broadly generalized.

The literature on horizon is slightly more difficult to interpret. Most studies find that shorter horizon MFEs result in a greater market response (see, for example, Pownall, Wasley and Waymire, 1993). However, shorter horizon MFEs are highly skewed towards bad news forecasts, which also have been shown to result in generally higher price responses (Skinner, 1994; Soffer, Thiagarajan, and Walther, 2000; Hutton, Miller and Skinner, 2003). In fact, there is some evidence that on the day of announcement the market may over respond to these short horizon bad news MFEs and then correct with a drift over the following quarter (Das, Kim and Patro, 2007)—which indicates that the event study methodology may be overstating the informativeness of these MFEs.

While these caveats should be kept in mind, many studies compare returns within news type and/or control for the underlying news. In almost all situations, shorter term MFEs are found to have a greater impact on the market. In addition to the price movement, short term MFEs also increase the relation between current returns and longer horizon accounting performance, suggesting that shorter horizon MFEs play a role in developing the markets longer term understanding of the firm (Choi, Myers, Zang and Ziebart, 2008).

MFE venue faces similar selection issues and has received much less attention in the literature (Miller, 2002). However, in the few studies that specifically address venue the findings suggests that MFEs are more effective if they are provided as the primary item in the disclosure and if they are presented directly to analysts (Pownall, Wasley and Waymire, 1993, Bamber and Cheon, 1998).

B. Using Additional Information to Support Management Forecasts of Earnings

Building off the forecast specificity literature, several relatively recent studies have examined the role of supporting information provided within the disclosure of the MFE. These studies have found that supporting information can play an important role in impacting the markets response to an MFE. The response to good news MFEs is enhanced by the inclusion of forecasts of other components of the income statement, such as revenues or expenses (Hutton, Miller and Skinner, 2003). This response is consistent with the market using the additional information to understand the MFE and to assess its credibility. Consistent with a role for credibility, the response to bad news MFEs is not impacted by the inclusion of a forecast of another component of the income statement.

While bad news MFEs are not impacted by further details on the income statement, managers issuing bad news MFEs are more likely to provide an explanation of how internal and external forces have created the current performance expectations. These explanations generally increase the price response to the MFE, on average in a downwards manner (Baginski, Hassell and Kimbrough, 2003). Thus, while such support is treated as informative, it appears the market generally views the explanations as bad news. It is unclear whether this is due to managers providing explanations when the news is worse than indicated by the numerical estimate alone or if the market views the attempts at external attribution of the problem as being a signal of weak management unable to operate in the current environment.

Both of these papers suggest that supporting information plays an important role in supporting the informativness of the MFE. In fact, in some situations the market may treat the supporting forecast as being more informative than the MFE (Han and Wild, 1991). As a set, these studies suggest that supporting information is an important component in an MFE. Consistent with this, the supply and demand for supporting information has increased as the analyst community has become more developed, suggesting the MFE is used as a way to communicate both specific expectations and to enhance the markets understanding of the firm's current position (Baginski, Hassell and Kimbrough, 2007). It also suggests a growing role for high quality MFEs within today's sophisticated market.

C. Credibility of Management Forecasts of Earnings

Not surprisingly, credibility is a major factor in determining the market impact of an MFE. Jennings (1987) shows the market and analysts responses to MFE are highly correlated. That is, when analysts adjust their own forecasts to be consistent with an MFE, the market is also more likely to respond as if the MFE is credible. This suggests some consistent, systematic process for determining the underlying credibility of a MFE.

Mercer (2004) proposes a model of disclosure credibility based on a review of the literature that investigates credibility of management disclosures in general. She shows that the literature indicates there are four attributes to disclosure credibility 1) situational incentives 2) management credibility 3) external and internal assurance and 4) characteristics of the disclosure. This section applies Mercer's framework to the literature on MFEs, showing support for all of these characteristics impacting credibility.

Managers issue MFEs when they are facing a wide range of issues and the market is likely aware of the firm's situation when they receive the MFE. These situational incentives may be as simple as the type of news being forecasted. That is, managers likely face incentives to provide optimistic news in many situations—leading investors to be skeptical of good news MFE. On the other hand, bad news MFE should be intrinsically credible given the lack of managerial incentives. These speculations are

borne out by the empirical findings in several studies (McNichols, 1989; Skinner, 1994; Hutton, Miller and Skinner, 2003; Ng, Tuna and Verdi, 2008).

Situational incentives may also be related to the economic condition of the firm. Again, it appears that the market is aware of these situations and responds to the MFE accordingly. For example, Koch (2002) shows that managers facing financial distress are likely to upward bias their forecasts. Financial analysts respond to these incentives by ignoring any good news forecasts but (at times over) responding to bad news forecasts. Similarly, the market response is consistent with an awareness of financial distress as well as some understanding of insider trading, litigation impacts and competitive pressures (Rogers and Stocken 2005).

While situational incentives are important, management credibility may be the most important attribute of MFE credibility. A portion of this credibility is linked to the general reputation of the management team (Ng, Tuna and Verdi, 2008). However, it appears managers may build MFE specific reputations that are even more important. Thus, the market responds more strongly if the firm has a history of providing accurate MFE (Hutton and Stocken, 2007; Ng, Tuna and Verdi, 2008). Further, the market response is greater for firms that have a history of providing frequent and regular MFEs (Hutton and Stocken, 2007; Ng, Tuna and Verdi, 2008). In fact, firms that have built strong managerial reputations often have such strong responses to the MFE that there is no response to the actual earnings release. Further, strong reputation firms are able to influence the market even if their MFEs are extreme relative to prior expectations (Hutton and Stocken, 2007). Combined, this evidence indicates a strong value for firms that make it a practice to follow a consistent policy of providing high quality MFEs.

There is also evidence that external and internal validity matter. That is, the governance mechanisms of the firm impact both the quality of the MFE and the markets response. From the internal perspective, higher quality boards, for example those with more independent members, elicit more frequent and more accurate MFEs . Additionally, the market responds more to forecasts from these firms (Ajinkya, Bhojraj and Sengupta, 2005; Karamanou and Vafeas 2005). A high quality audit committee magnifies these results (Karamanou and Vafeas 2005). Externally, firms with a high level of institutional investment are also more likely to provide MFEs and provide higher quality. They also receive a strong response to MFEs (Ajinkya, Bhojraj and Sengupta, 2005). However, concentrated ownership, even by institutions, results in lower quality MFEs and a muted response—showing that external influences can be

positive or negative. Overall, this evidence supports the idea that good governance leads to good information.[19]

Finally the studies discussed in prior sections and studies specifically focused on MFE credibility show strong support for the credibility of MFE being impacted by the characteristics of the disclosure (see for example Ng, Tuna and Verdi, 2008). Given the previous discussion on these factors in this paper, I do not reiterate the findings here. However, it is important for readers to recall that credibility is impacted by these management decisions.

Normative Prescriptions for Forecasting Policies

The prior sections have focused on providing an overview of research insights from empirical studies. They have demonstrated a net benefit to disclosures, but they have shown that some costs remain. The reviews in the prior section have also pointed out specific characteristics that make MFEs effective. In this section I will combine the research insights from the prior sections in an attempt to provide guidance for developing a MFE strategy that will maximize the benefits received while minimizing the costs.[20] As an important caveat, these extrapolations to a specific strategy draw from various findings in the empirical literature, but the strategy itself has not been empirically tested or validated. Further, many of my suggestions include insights gained via discussion with practitioners which help to tie together the result found in the empirical literature.

A. Developing and Communicating a Management Forecasting Policy

Managers need to think and act systematically to generate the greatest net benefit from MFEs. That suggests that managers should develop an ex-ante policy regarding the use and content of MFEs. While some firms may have such policies, the process of making it a written, formal and publicly disclosed policy would have several benefits.

First, the need to commit to a policy would create an incentive for managers to spend sufficient time considering the optimal use of MFEs for their company. This planning process is likely to result in a more fruitful way to use MFEs.

[19] This also provides indirect support for the signaling value of forecasting. That is, if high quality forecasting is related to observable high quality business practices, even firms without those practices may be able to signal similar quality by providing equivalent forecasts.

[20] Given the detailed discussions of research in the prior sections and a desire to keep this section concise, I do repeat research cites in this section.

Second, the goal of any policy would be to create long term benefits for the firm. That would force managers to consider how MFEs should be used in a steady state, rather than adopting ad hoc responses to the issues being faced at the current point in time. As such, it is more likely to result in a consistent strategy over time and in a strategy that helps to focus the overall information environment on the long term value creation process of the firm.

Third, a written policy would allow managers to communicate the appropriate use of MFEs to external stakeholders, such as investors or analysts. Many of the discussions regarding use of MFEs in the current press indicate their role is not clear to external stakeholders. In fact, the creation of a written document would allow stakeholders an opportunity to enter into a two way discussion regarding the optimal use of MFEs. For example, management may suggest a policy and find that large shareholders or analysts argue their needs would be met more fully by some other combination of disclosures and MFEs. In the end, this would help external stakeholders to more effectively use the MFEs, benefiting managers and the external stakeholders.

Fourth, the MFE policy could be used as a tool to help outside stakeholders learn about the firm in general. For example, as managers explain why they would use a certain level of detail over a specific horizon they are also helping investors to understand how the structure of the firm and industry impacts the managerial ability to predict future performance. Discussions about how MFE are used in conjunction with other disclosure would create a further opportunity to help outside stakeholders understand the long term operating and competitive environment for the firm.

Fifth, the public commitment to providing MFEs in a certain time and way should increase their credibility by reducing the impression (and opportunity) that managers are being opportunistic in the decision to provide or withhold an MFE at a certain time. Of course, any thorough policy would include the ability to provide MFEs outside of a regularly scheduled period, but the policy would also clearly explain when such MFEs would be needed and managers would be able to refer to the policy at the time the MFE was provided to help the market understand how to view the MFE.

Sixth, the MFE policy could be combined with the firm's policy on managerial stock trading and options grants to minimize the opportunity for managers to time trades or MFEs in a way that would increase the managers' personal wealth. For example, the company could impose a policy of that forbids managerial trading in the two weeks prior to and following a prescheduled MFE. Similarly, option grant dates could be scheduled to immediately follow or precede an MFE to assure managers do not choose the timing of the MFE to favorably impact their options terms.

To derive these benefits, managers will have to assure that their policy is of sufficient quality and detail to make the policy effective. Thus, it will need to consider what types of forecasts are provided, when they are provided and in what venue. In addition for maximum benefit the policy will have to be widely available to external

stakeholders so they can refer to it at any time they are considering the firm and its disclosure choices. Accordingly, I would make the policy a permanent document on the firm's investor relations web page.

B. Horizon, Precision and Support of Managerial Forecasts of Earnings

The review of the empirical literature showed that current returns are most related to long term future performance when MFEs are provided over various horizons, including shorter horizons. Further, analysts and the market often responded most strongly to short term MFEs. All of this argues for including short term MFEs in the disclosure policy. However, the literature review also showed that many critics of forecasting focus primarily on a perceived relation between MFE and increase myopia. I suggest that firms include both short and long term forecasts in each MFE. Additionally, the MFE should be structured to explain how the short term projections reconcile with the longer term view. Obviously, the exact mix of short and long term discussion will depend on firm and industry characteristics, but such a layered model presents a perfect opportunity for managers to educate external stakeholders about the long term value creation of the firm's strategy. This would allow the firm to obtain all of the benefits of MFEs while reducing myopia. Further, this allows the firm to take control of the discussion regarding its short term performance and the implications for future performance—an opportunity that may reduce the underlying myopia in the market in general as the focus on the discussion will be more under the control of the firm. While critics of MFEs may not like it, the mandatory quarterly reporting model suggests that most firms should provide quarterly MFEs. Those that choose not to provide quarterly MFE need to provide a rationale as to why quarterly reporting is not really informative for their firm.[21]

While the literature shows that investors and the market prefer more precise MFE, the precision of the MFE should be related to the horizon of the forecast. Most firms should be able to be relatively precise about short term MFE (e.g. the current quarter), a little less precise about midterm (e.g., the current fiscal year) and perhaps only directional about the very longest term. By including multiple horizons and precisions in one disclosure the firm should be able to maximize the benefits of creating an informed market—including educating the market about the ability to be precise over various horizons.

[21] Regulators would need to reconsider the mandatory quarterly earnings reporting requirements if a large number of firms provided credible arguments regarding this issue. However, absent such arguments it becomes hard to understand why quarterly reporting would be considered informative for realized earnings performance, but not for MFE.

The literature has also shown that external uses value numerical and verbal explanations of MFEs. A single MFE disclosure with multiple horizons provides an excellent opportunity to give such support as managers use it to explain how their expectations evolve over the various time horizons. These additional supporting items would be particularly important in a situation where expectations differ over the various horizons. For example, if short run expectations are negative due to large investments in R&D that will pay off in the longer run, this provides a perfect opportunity for managers to explain expectations and reduce myopia. Further, supporting ideas and explanations provide an opportunity to tie the MFE into the other disclosures provided by the firm, again increasing the value of the MFE. In general, all of this suggests managers should vigilantly look for opportunities to support and explain their expectations in a structured manner. However, it is important to remember that investors may be overwhelmed by too much detail from any one firm—causing them to fixate on one or two forecasts and thus defeating the purpose of creating such rich support for MFEs. Unfortunately, this limitation makes it difficult for me to provide guidance beyond broad suggestions. However, it further reinforces the need for a carefully thought out long term policy for MFE.

C. Frequency and Venue

Any comprehensive MFE policy will include a clear frequency guideline. Similar to forecast horizons, the current mandatory quarterly reporting framework suggests managers should consider providing MFEs on at least a quarterly basis. Further, the empirical evidence indicates that frequent forecasting is an important component to building credibility providing further support for quarterly forecasting.

Frequency of forecasting is closely related to the venue. If managers adopt a policy of providing quarterly MFE, then earnings announcement are an obvious time to consider forecasting. As an added advantage, the literature has shown that the market processes the information in earnings more efficiently and timely when firms include an MFE in their earnings announcements.

On the other hand, the MFE policies I have suggested include forecasts over several horizons with supporting information and discussions. That will involve a large amount of information, which may be overwhelming if packaged along with all of the information needed to support the announcement of realized earnings. Further, the literature shows that the market responds more to MFE that are provided as the primary item in a disclosure. These arguments suggest the MFE should be provided in some period outside of the earnings announcement—perhaps at the midquarter point.

Managers may want to combine these recommendations by providing a detailed MFE outside of the quarterly earnings announcement. That MFE could be supplemented by a limited MFE to support the earnings announcement (perhaps just quarterly or quarterly and annual) which would be combined with very limited explanatory information. In fact, the MFE bundled with earnings announcements

would often just reaffirm the prior MFE. That would still be useful as prior literature has shown that the market responds to such confirming forecasts.

As another option, managers may consider providing the stand alone detailed MFE twice a year (or even once a year in stable industries) combined with the limited updates within each earnings announcement. That would provide management with a dedicated time to discuss their view of the future without requiring four involved discussions a year. Obviously, the specific choice for a given firm should be dictated by its specific circumstances including items such as stability of earnings, seasonality of business and information demands of its investor base.

Regardless of the specifics of frequency, managers should provide MFEs in a forum that allows for interaction with analysts and investors. This could include a dedicated conference call, a portion of a conference call used for some other method or a conference presentation. Prior research has shown that analysts and the market respond more to forecast provided in a focused venue of this type. Further, this would allow participants to probe the managers about the implications of the MFE, giving managers an opportunity to provide more supporting information without the need to fully anticipate the market's demands. This would increase the informativness and credibility of the forecast.

D. Ex-post Explanations

In addition to providing MFEs for future periods, managers should explain why prior MFEs were inaccurate. This can include reconciling to actual reported earnings and explaining a change in expectations for longer horizon forecasts. This process could help outsiders build an understanding of the company and of management by showing what type of occurrences were not anticipated and by seeing how those occurrences impact earnings over multiple horizons. This greater understanding should result in more informed stakeholders and help to build the credibility of high quality management teams—both of which will result in a stronger and more accurate response to future disclosures (MFE and others) by the firm. Further, the managerial commitment to provide ex post explanations should help restrain any impulse to skew the MFE at the time it is provided as managers will know that they will have to subsequently explain their bias.

E. Costs of Implementing a Management Forecast of Earnings Policy

While I have discussed benefits and costs to providing MFE, it is likely that managers will argue a program such as the one I recommend above would be too costly to implement. However, all of the information I suggest is likely to be a part of any well managed company's internal budgeting process. If it is not, then managers should use their MFE policy to explain why the information is not used internally and to discuss the alternative information used. That alternative information can then be provided in place of the omitted recommended information.

Managers may also suggest that the true costs are related to the time managers would need to use to prepare and present this information. Again, some of these costs should be offset by the fact that the information is likely required for internal budgeting purposes. In addition, these disclosures may take the place of other interactions. Further, when one considers the costs of not communicating to the market (based on the lost benefits), it seems likely to outweigh the costs of these presentations in most situations.

As a final cost, managers may be concerned about competitors using the information (generally termed the proprietary cost argument). In those situations managers should provide a detailed explanation of their concerns as a component of their written MFE schedule. They then may want to find alternative disclosures to make up for the lack of MFEs. For example, they may find that less sensitive information such as monthly actual sales updates can fill at least a portion of the information gap. While such high proprietary cost situations almost certainly exist, it is my belief that they are relatively rare. I conjecture that most managers would find little market support or understanding for their explanation of withholding information for proprietary reasons.

CONCLUSION

This paper has reviewed the empirical literature on MFEs and provides normative suggestions for developing an effective and informative MFE process. The review of the literature shows that MFEs are an important source for building understanding in the market. While there are some documented costs to providing MFEs, the literature clearly suggests a net benefit to forecasting. Thus, the paper provides a survey of the empirical findings regarding relative effectiveness of MFE and then applies this research to suggest a formal, written MFE policy.

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