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MANAGEMENT FORECASTS AND THE PERSISTENCE OF REPORTED EARNINGS

Abstract:

We investigate the relation of voluntary management earnings forecasts (guidance) on the persistence and quality of reported earnings figures. We specifically explore if the existence (or not) of management earnings forecasts is related with the persistence of reported earnings; that is the ability of earnings and its components i.e. cash flows from operating activities and accruals to predict one year ahead earnings. We further test if there is a relation between pessimistic versus optimistic management forecast disclosures (i.e. the forecast error direction) and the persistence of reported earnings. The empirical evidence supports the intuition that the existence of management earnings forecasts disclosures implies reported earnings figures of higher quality relative to firms' that decide to provide no earnings guidance. On that end we further provide evidence that firms' management that provide pessimistic earnings forecast disclosures generate more persistent reported earnings than firms' management that provide optimistic earnings forecast disclosures. The difference in the persistence of reported earnings derives from the accrual component and we do not notice any significance difference in the persistence of the cash flow component. Moreover, management providing pessimistic earnings forecast disclosures provide more accurate estimates. Finally, additional evidence supports a mispricing of the information content of forecast error direction, by generating positive and significant excess returns, when investing on firms' providing pessimistic management earnings forecasts relative to firms' providing optimistic management earnings forecasts.

Keywords:

Management Forecasts; Earnings Persistence; Reporting Quality

JEL Classification: G11, G14, M41