Management Earnings Forecasts - Does Corporate Governance Matter?

*Presented by*

Thu Phuong Truong

Victoria University of Wellington
Corporate Governance & Corporate Disclosure

- Regulatory perspective:
  - Higher quality corporate governance → higher quality corporate disclosure in terms of timeliness and balance of disclosures

- Finance and economic theories:
  - Higher quality corporate governance structure → an optimal corporate disclosure policy (Shleifer and Vishny, 1997; Core, 2001)

- Empirical evidence:
  - Mixed evidence
  - Depending on what types of disclosures are examined

Does corporate governance make any difference to corporate disclosure behaviour?
Corporate Governance & MEF

- Management earnings forecasts (MEF) are regarded as an important part of corporate disclosure policy
  - Especially in New Zealand where few firms are followed by analysts
- Investigate the impact of corporate governance on corporate decision to issue MEF, their characteristics and consequences
A Framework for MEF

- Forecast Antecedents
- Decision to issue forecast
- Forecast Characteristics
- Forecast Consequences

(Hirst et al., 2008)
Forecast Antecedents

- **External corporate governance mechanisms**
  - Legal and regulatory environment
  - Analyst following
  - Block and institutional ownership

- **Internal corporate governance mechanisms**
  - Board characteristics (size, independence, expertise, committee structure, CEO/chairman duality, ownership and compensation)
  - Managerial incentives (ownership and compensation)

- **Other firm-specific characteristics**
  - Information asymmetry between firms and the market
  - Firm-specific litigation risk (size, return variability, earnings news and industry membership)
  - Proprietary costs of information
  - Prior forecasting behaviour
Forecast Characteristics

- Frequency
- Good news vs. Bad news
- Precision
- Accuracy and Bias
- Stand-alone vs. Bundled
- Timing
Forecast Consequences

- Share price reaction
- Analyst reaction
Legal and Regulatory Environment

- MEF characteristics are different in high litigation environments
  - Baginski et al., 2002

- Changes in regulation are found to impact on MEF characteristics and consequences

- However, the results vary depending on firm-specific characteristics
  - Johnson et al., 2001 (U.S. PSLRA 1996)
  - Bailey et al., 2003; Heflin et al., 2003; Wang, 2007 (U.S. Reg FD 2000)
  - Chan et al., 2007 (Australian CD regime 1994)
  - Truong et al., 2008a-c (New Zealand CD regime 2002)
Analyst Following

- MEF characteristics and consequences are different for firms followed by analysts.
- Number of analysts following does matter.
- However, results vary for individual MEF characteristics and consequences.
  - Ajinkya et al., 2005
  - Karamanou and Vafeas, 2005
  - Truong et al., 2008a-c
Block and Institutional Ownership

- Block ownership and institutional ownership influence MEF characteristics and consequences differently.

- Results vary depending what MEF characteristics and consequences are examined.
  - Bamber and Cheon, 1998
  - Truong et al., 2008d
  - Ajinkya et al., 2005
  - Karamanou and Vafeas, 2005
Board Characteristics

Mixed evidence obtained for the impact of board characteristics on MEF characteristics and consequences, depending on:

- Individual board characteristics
- Individual MEF characteristics and consequences
- Different legal environment
  - Ajinkya et al., 2005
  - Karamanou and Vafeas, 2005
  - Chan et al., 2008
  - Truong et al., 2008d
Managerial Incentives

- Firm-specific managerial incentives significantly impact on the decision to issue and determine the news content of MEF
- Firms issue MEF for reasons consistent with managers’ self-interest or incentives
  - Nagar et al., 2003
  - Aboody and Kasznik, 2000
Other Firm-specific Characteristics

- Firms with higher information asymmetry are more likely to issue MEF
- Firm-specific litigation risk does influence the decision to issue MEF
- The impact of proprietary costs on MEF characteristics is mixed
- Firms’ prior forecasting behaviour is found to influence MEF characteristics and consequences
A Framework for MEF

Forecast Antecedents

Decision to issue forecast

Forecast Characteristics

Forecast Consequences

(Hirst et al., 2008)
Conclusion

- Academic research provide support for the role of both external and internal corporate governance mechanisms in determining corporate decision to issue MEF, their characteristics and consequences.

- The evidence that external corporate governance mechanisms such as increase in regulation and litigation risk play a role is more consistent.

- However, it is difficult to conclude at this stage that external corporate governance mechanisms are better given the limitation of both research design and data availability.