The Ability of Analysts’ Recommendations to Predict Optimistic and Pessimistic Forecasts

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Abstract

Previous researches show that buy (growth) companies conduct income increasing earnings management in order to meet forecasts and generate positive forecast errors (FEs). This behavior however, is not inherent in sell (non-growth) companies. Using the aforementioned background, this research hypothesizes that since sell companies are pressured to avoid income increasing earnings management, they are capable, and in fact more inclined, to pursue income decreasing Forecast Management (FM) with the purpose of generating positive FEs. Using a sample of 6553 firm-years of companies that are listed in the NYSE between the years 2005–2010, the study determines that sell companies conduct income decreasing FM to generate positive FEs. However, the frequency of positive FEs of sell companies does not exceed that of buy companies. Using the efficiency perspective, the study suggests that even though buy and sell companies have immense motivation in avoiding negative FEs, they exploit different but efficient strategies, respectively, in order to meet forecasts. Furthermore, the findings illuminated the complexities behind informative and opportunistic forecasts that falls under the efficiency versus opportunistic theories in literature.

Introduction

Dutta and Gigler [2] suggest that companies have strong incentives to avoid negative Forecast Errors (FEs) or/and generate positive FEs. They propose a contractual model where the management utility is mainly based on whether the reported earnings meet or miss the forecasts. Their theoretical model assumes that both earnings forecasts and earnings management generate positive FEs. It explains and integrates both pessimistic (opportunistic) and optimistic (efficiency) forecasts behavior of companies by illuminating the effect of earnings forecasts on the earnings management.

Abarbanell and Leahy [1] indicated that the companies’ ability to manipulate earnings influences the extent of earnings management. They argue that companies with higher growth rates are more capable in manipulating profits. Abarbanell and Leahy [1] assume that the companies are recommended by analysts to be bought (hereafter buy companies) are classified as growth type companies that will enjoy high profitability. They show that these companies conduct income increasing earnings management in order to meet forecasts and generate positive FEs.

However Abarbanell and Leahy [1] discovered that the companies recommended by analysts to be sold (hereafter sell companies) are unable to conduct earnings management. Among the reasons for this are that firstly, the sell companies’ stock prices are less susceptible to earnings news, which may render their earnings management ineffective with regards to influencing investors’ decisions. In other words, sell companies cannot effectively manipulate and increase their low profit to boost their stock prices. Secondly, sell companies possess insufficient sums of available accounting reserves and pre-managed earnings for them to achieve any relevant earning target.

According to Dutta and Gigler [2], sell companies might also suffer from communication restrictions. This seems most logical, as the lack of resources will render sell companies unable to communicate the full scope of their rich information set to investors via the manipulation of reported earnings. Therefore, communication restrictions are binding upon sell companies.

It seems that since sell companies eschew income increasing earnings management, they are both capable and more inclined to pursue income decreasing Forecast Management (FM) to generate positive forecast errors. Thus, the aim of this research is to examine the effects of the analysts’ recommendations representing the buy and sell companies on the managers’ decisions towards FM.

This research enriches the literature by examining whether sell (non-growth) companies engage in negative FM to realize positive FEs. The importance of the research is that it shows whether analysts’ recommendations in terms of buying or selling of the stocks have informational value that can be used by individual investors to assess the optimism or pessimism of management forecasts. Additionally, the findings obtained here would be useful for future theoretical developments.

The rest of this article is organized as follows: Section 2 reviews the literature and highlights the problem. Section 3 develops the hypothesis, while the research methodology is explained in section 4. Section 5 describes the findings, and section 6 presents the