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CAPITAL MARKET CONSEQUENCES OF EXPECTATIONS MANAGEMENT IN THE POST-REGULATION FAIR DISCLOSURE PERIOD

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ABSTRACT

This paper investigates the capital market consequences of expectations management in the post-Regulation Fair Disclosure period. Results show that investors "punish" firms that deliberately issue pessimistic public guidance to dampen analysts' expectations to a beatable level in the post-Regulation Fair Disclosure Era. I find that on average, the negative stock price effects caused by management's pessimistic guidance dominate the positive stock price effects associated with the positive earnings surprises. Furthermore, both the short-term stock return over the combined guidance plus earnings announcement window and the long-term total period return are more negative for guidance firms than for firms that do not guide and thus miss financial analysts' expectations.

JEL: M41, M48

KEYWORDS: Expectations Management, Earnings Guidance, Managerial Guidance, Regulation Fair Disclosure, Analysts' Expectations, Capital Market

INTRODUCTION

Expectations management refers to the phenomenon that management finds ways to influence financial analysts' expectations to avoid negative earnings surprises at the earnings announcement day. There is ample anecdotal evidence indicating that the expectations management game has been played, and successfully played for many years. For example, an article in the Chicago Sun-Times states, "Essentially, chief executives and chief financial officers have learned that the secret to spinning earnings is to under-promise and over-deliver. The first step is to provide conservative earnings guidance to the market, causing analysts to lower their earnings expectations. This is done through press releases, interviews with financial media and meetings with analysts in groups. Next, the company reports earnings that are better than analysts' lowered earnings estimates." (Zacks, 2003). This paper is one of a series of studies dedicated to exploring how market participates (e.g., financial analysts, investors, regulators) react to expectations management in the post Regulation Fair Disclosure (FD) period. The primary objective of Regulation FD, which was adopted by the Securities and Exchange Commission (SEC) in October 2000, is to address selective disclosure of information to certain market participants. Prior to Regulation FD, management could provide private earnings guidance to financial analysts to influence their forecasts, but after the passage of this regulation, they are not allowed to do so. If management intends to disclose certain nonpublic information to certain information users, they must make public disclosure of that information.

Regulation FD has greatly changed the way that the expectations management game is played. In the new regulatory environment, management has to give up private communications with analysts and switch to providing *public* guidance if they still intend to manage analysts' expectations, making it possible to *directly* capture expectations management activities and measure market participants' reactions to such activities. Several studies have reported positive stock price effects when firms meet or beat analysts' forecasts at the

date of the official earnings announcement, even if it is achieved through expectations management (Bartov et al., 2002, Skinner and Sloan, 2002). However, issuing pessimistic guidance prior to the earnings announcement in order to generate a positive earnings surprise may result in a drop in stock price at the guidance date. Whether the positive announcement period return can offset the negative price effect related to the earnings guidance activity is still an empirical question. There are ample articles on the popular press reporting that firms' stock prices drop sharply after they issued disclosures indicating their earnings would fall short of analysts' expectations. The results of my stock return tests show that the average three-day cumulative abnormal return around the pessimistic guidance release date is -10.2 percent, while the average three-day cumulative abnormal return around the earnings announcement is only 1.7 percent. It appears that the positive stock return associated with the positive earnings surprise is not large enough to offset the negative stock return as a result of pessimistic guidance. Furthermore, using a control sample of matched firms, I find that both the short-term stock return over the combined guidance plus earnings announcement window and the long-term total period return are more *negative* for firms that beat analysts' forecasts through managerial guidance than for firms that do not engage in expectations management and therefore miss the analysts' forecasts. Overall, my results indicate that firms are "punished" by the investors for issuing pessimistic guidance to achieve positive earnings surprises.

This paper contributes to the literature by addressing the *costs*, in terms of the stock price effects, of expectations management in the post-Regulation FD period. Several studies have documented the benefits of taking actions to meet or beat analysts' forecasts (Bartov et al., 2002, Skinner and Sloan, 2002). However, little research has been done to measure the *costs* of expectations management. Examining the costs of expectations management is crucial to understanding the net rewards, and furthermore, the motivations for managers to dampen analysts' forecasts. My results suggest that it does not pay (in terms of stock performance) for managers to alter analysts' expectations through pessimistic public guidance. It shows that on average, the guidance firms' stock performance worsens in both short and long run. This finding appears to be inconsistent with prior research which usually suggests that the major reason for managers to achieve positive earnings surprises is to maintain or increase the firms' stock prices (e.g. Graham et al., 2005, Brown and Caylor, 2005). The remainder of the paper is organized as follows: In the next section, I provide background information and review the related literature. I then present the sample selection procedures and the data sources. In the results section I document the capital market consequences of expectations management. In the last section, I provide concluding comments and discuss possible future research questions.

LITERATURE REVIEW AND BACKGROUND

In recent years, a large portion of accounting research (e.g. DeGeorge et al. 1999, Richardson et al. 2004, Brown 2001, Matsumoto 2002, McVay et al. 2006, Bhojraj et al. 2009, Doylea et al. 2013, Kasznik, R. and M. McNichols 2002) has been dedicated to documenting and understanding the phenomenon that managers take actions to meet or beat financial analysts' expectations (MBE, hereafter). For example, Degeorge et al. (1999) find unusually low frequencies of negative forecast errors and unusually high frequencies of positive forecast errors in the cross-sectional empirical distribution of analysts' forecast errors. Richardson et al. (2004) and Brown (2001) document a disproportional number of cases where earnings per share are exactly equal to or slightly above analysts' forecasts based on I/B/E/S data. Matsumoto (2002) finds similar results using the Zack's earnings surprise file.

Both anecdotal and academic evidence has shown that expectations management is an effective mechanism to achieve MBE (e.g. Matsumoto 2002, Bartov et al. 2002, Cotter et al. 2006). More recent research that specifically focuses on the post-Regulation FD period finds that expectations management game is still played, although decreasing, and management has changed to issuing pessimistic *public* guidance to dampen analysts' forecasts (Li et al., 2014, Li, 2019). Using a uniquely hand-collected dataset, Li et al. (2014) explore how *analysts* react to expectations management and find that they responded to earnings guidance activities in the way that management desired. They revised their forecasts downward immediately to a beatable level

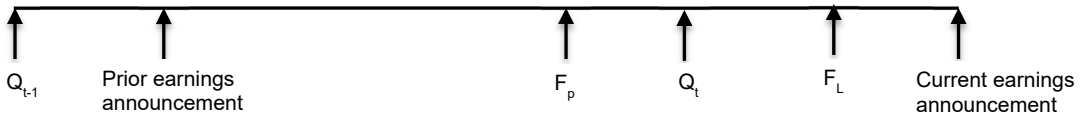
after the issuance of a pessimistic public guidance. This study extends Li (2019) and Li et al. (2014) by investigating how *investors* react to expectations management activities in the post-Regulation FD period. Prior studies suggest that an important incentive to MBE is to improve stock performance. It is no secret that investors penalize firms for failing to MBE. Stock market reactions to negative earnings surprises tend to be large and asymmetric, suggesting a high cost to missing analysts' forecasts (Skinner and Sloan, 2002).

It is also no secret that investors reward firms for MBE. For example, Bartov et al. (2002) report that MBE firms enjoy a higher return over the quarter than non-MBE firms with similar quarterly earnings forecast errors. Further, such a premium to MBE, although somewhat smaller, exists even when MBE is likely to have been achieved through expectations management. However, whether the *net* reward to MBE through expectations management strategy is positive is questionable, because management's earnings guidance activities likely result in negative price effects around the release of the guidance, possibly leaving the total return for the period negative or unchanged. Kasznik and Lev (1995) find that firms do not improve their stock price performance by issuing warnings before large negative earnings surprises. However, they did not address whether the stock price performance would have been improved by a firm's decision to issue pessimistic guidance that successfully switches a negative earnings surprise to a positive earnings surprise. This paper addresses this issue using a uniquely hand-collected dataset described in the next section.

Sample Selection and Data Source

I first select a sample of firms that are *more likely* to have beaten analysts' expectations through expectations guidance game. Firm-quarters that meet the following criteria are selected: (1) The last available I/B/E/S analyst median consensus forecast (denoted as F_L) before the actual earnings announcement is pessimistic (relative to the actual earnings); (2) The last available I/B/E/S analysts' median consensus forecast (denoted as F_P) prior to F_L is optimistic (relative to the actual earnings). I choose consensus forecast instead of individual forecast (e.g. Bartov et al., 2002) as the proxy for analysts' earnings expectations because managers are more likely concerned with whether the actual earnings can meet or beat the consensus forecast (as reported in company press releases), rather than any individual forecast. Furthermore, stale forecasts that have not been updated since the previous quarter's earnings announcement are excluded from the consensus forecast computation. Figure 1 presents the timeline of events. Since I/B/E/S publishes consensus forecasts on the third Thursday every month, F_L is about 30 days after F_P. The median number of days between F_L and the subsequent earnings announcement is 11 days. This initial sample includes firm-quarters where analysts revised their initially optimistic forecast (F_P) down and turned a negative forecast error (measured as the actual earnings minus F_P) into a positive earnings surprise (measured as the actual earnings minus F_L) at the earnings announcement day.

Figure 1: Timeline of Events



F_L: the last available I/B/E/S analysts' consensus forecast before the actual earnings announcement.
F_P: the last available analysts' consensus forecast before F_L.
Q_{t-1}: the previous quarter end.
Q_t: the current quarter end.

Next I hand-collect *all* the public disclosures (both quantitative and qualitative) with implications for quarterly earnings issued between F_P and F_L by the sample firm-quarters. I focus on these disclosures instead of disclosures made at the beginning of the quarter because the latter are more likely to be issued to purely correct analysts' optimism instead of managing their expectations to a beatable level, as suggested by many previous studies (e.g. Tse and Tucker 2007, Li et al.2014, Li 2019). I then classify these disclosures as

pessimistic/neutral/optimistic guidance if they indicate that earnings will be worse/the same/better. The public disclosures were obtained from the Lexis/Nexis News Wires File, the StreetEvents database, company website and other sources. I exclude firms in regulated industries from the study, as they are likely to have different incentives to meet or beat analysts' forecasts than those in non-regulated industries (Matsumoto, 2002). Specifically, I exclude financial institutions (SIC codes 6000-6999), utilities (SIC codes 4800-4999), and other quasi-regulated industries (SIC codes 4000-4499, and 8000 and higher). The analyst forecast-related data are from the 2005 I/B/E/S Summary History File, stock return-related data are from CRSP and other accounting data are collected from 2005 Compustat Research Insight.

The sample period is from January 2001 to December 2004, after Regulation FD was officially adopted. The initial sample is composed of 955 firms with 1,073 firm-quarter observations with required data available. Table 1 shows the types of public guidance issued by the initial sample. 58.4% of the sample (627 firm-quarters) issued pessimistic guidance, 0.5% made neutral guidance (five firm-quarters), 0.7% made optimistic guidance (seven firm-quarters), and 40.4% (434 firm-quarters) made no disclosures at all.

Table 1: Types of Public Guidance Issued by the Initial Sample Firm-Quaters[1]

	N	Percent
Pessimistic guidance	627	58.4
Neutral guidance	5	0.5
Optimistic guidance	7	0.7
No disclosures	434	40.4
Total	1073	100

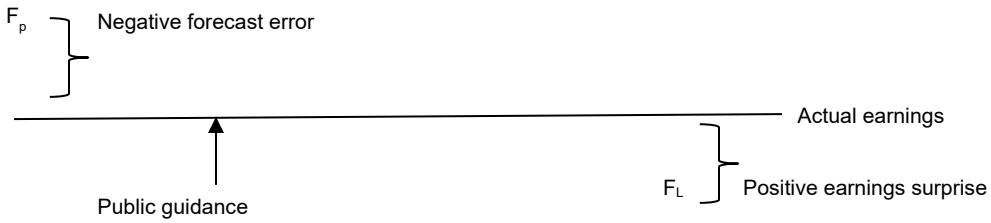
[1] *The initial sample is composed of 1073 firm-quarters where analysts revised their initially optimistic forecasts downward to turn a negative forecast error into a positive earnings surprise.*

I denote the 627 pessimistic guidance cases as the *Guidance-Beat* sample, which represents firm-quarters that issued pessimistic public disclosures and successfully guided analysts' forecasts down to avoid a disappointment at the earnings release day. I then select a control sample, denoted as the *Nonguidance-Miss* sample, according to the following criteria: (1) The initial analyst consensus forecast (F_P) is optimistic (relative to the actual earnings); (2) The last available analyst consensus forecast before the actual earnings announcement (F_L) is also optimistic (relative to the actual earnings); (3) There are no public managerial disclosures with implications for earnings between F_P and F_L.

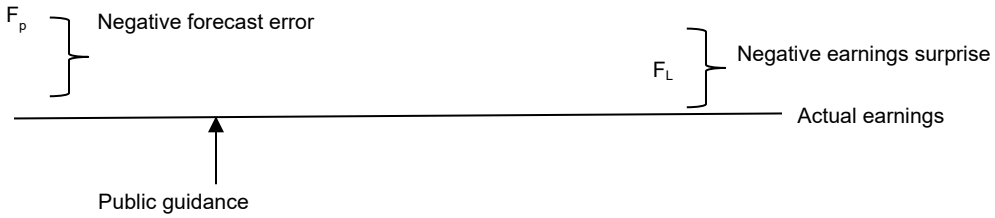
Figure 2 shows the criteria. The first two criteria select firm-quarters that are faced with the same incentives as the *Guidance-Beat* firm-quarters to manage expectations (F_P is higher than the actual earnings), but fail to beat analysts' expectations at the earnings announcement date (F_L is higher than the actual earnings as well). The third criterion ensures that the *Nonguidance-Miss* firm-quarters were not involved in public expectations guidance activities. Thus the *Nonguidance-Miss* sample represents firm-quarters that did not guide expectations and thus missed the analysts' forecasts. Figure 2 presents the sample selection criteria for the *Guidance-Beat* sample and the *Nonguidance-Miss* sample.

Figure 2: Sample Selection Criteria: Guidance-Beat Sample vs. Nonguidance-Miss Sample

Guidance-Beat Sample: firm-quarters that beat analysts' forecasts through expectations management



Nonguidance-Miss Sample: firm-quarters that do not manage expectations and fail to beat analysts' forecasts



F_L: the last available analyst consensus earnings forecast before the actual earnings announcement.
F_P: the last available analyst consensus earnings forecast prior to F_L.
Forecast error is measured as the actual earnings minus F_P.
Earnings surprise is measured as the actual earnings minus F_L.

Each *Guidance-Beat* firm-quarter is then matched with a *Nonguidance-Miss* firm-quarter by two criteria: industry membership (2-digit SIC code) and calendar quarter. I further excluded seven firm-quarters that do not have stock return data in CRSP from the original *Guidance-Beat* sample (627 firm-quarters). With the matched-sample design, both *Guidance-Beat* and *Nonguidance-Miss* final samples contain 620 firm-quarters.

RESULTS

I perform two sets of tests to explore the investors' reactions to expectations management in the post-Regulation FD period. First, if it does pay (in terms of stock performance) for a firm to dampen analysts' expectations through pessimistic public guidance to achieve a positive earnings surprise, the positive stock price effects around the actual earnings announcement should be large enough to offset any negative stock price effects resulting from management's pessimistic guidance. Table 2 Panel A presents the distributions of the three-day (-1,+1) cumulative market-adjusted returns (the firm's raw return minus the corresponding CRSP value-weighted market return) around the earnings announcement date and the guidance release date for all the *Guidance-Beat* sample firm-quarters. The average three-day cumulative market-adjusted return around the earnings announcement *(CAR_EA)* is 1.7 percent ($p<.0001$). However, the average three-day cumulative market-adjusted return around the pessimistic guidance release date *(CAR_Guidance)* is -10.2 percent ($p<.0001$), indicating that management's pessimistic guidance results in a much stronger negative stock price effect. The average combined market-adjusted return over the three-day guidance window plus the subsequent three-day earnings announcement window *(CAR_Combined)* is -8.5 percent ($p<.0001$), suggesting that the net reward to dampening analyst forecast through pessimistic guidance is negative. I also computed alternative measures of returns over the analysis window: the cumulative raw return over the period, the cumulative CRSP equal-weighted market-adjusted return over the period, and the period's size-adjusted return. The results presented in this section are not sensitive to different return measures.

For the *Guidance-Beat* firm-quarters that issued multiple guidance during the interval examined (less than 3%), I measured the three-day return around each of the guidance events to capture the investors' reactions to all the guidance activities. I also performed three robustness tests on these multiple guidance firm-quarters (results unreported): (1) exclude the firm-quarters with multiple disclosures from the sample; (2) only consider the market reactions to the "primary disclosure" and ignore other disclosures, as in Kasznik and Lev (1995) where the primary disclosure is the most quantitative, earnings-related disclosure; (3) only consider the market reactions to the most current disclosure. The three robustness tests lead to essentially the same inferences as reported in this section.

Table 2 Panel A shows that firms bear high costs (negative stock price effects caused by management's pessimistic guidance) for managing expectations to avoid negative earnings surprises. However, such costs may still be smaller than the penalty of missing analysts' forecasts. Plenty of anecdotal and academic evidence indicates that investors penalize firms for failing to meet or beat analysts' projections (e.g., Skinner and Sloan 2002, Bartov et al. 2002). Therefore, in the second set of tests, I apply a matched-sample design to investigate the differential stock returns to firms that beat analysts' estimates through pessimistic guidance (the *Guidance-Beat* firms) and firms that do not guide expectations and thus miss the analysts' forecasts (the *Nonguidance-Miss* firms).

Table 2: Three-Day Cumulative Market-Adjusted Returns Around the Earnings Announcement Date and the Guidance Release Date

Panel A: Guidance-Beat Sample					
Variable	**Mean**	**S.D.**	**1st Quartile**	**Median**	**3rd Quartile**
CAR_EA	0.017*	0.093	-0.027	0.011	0.058
CAR_Guidance	-0.102*	0.136	-0.167	-0.073	-0.015
CAR_Combined	-0.085*	0.165	-0.171	-0.067	0.016
Panel B: Nonguidance-Mill Sample					
Variable	**Mean**	**S.D.**	**1st Quartile**	**Median**	**3rd Quartile**
CAR_EA	-0.031*	0.118	-0.081	-0.020	0.020
CAR _Average	-0.005	0.023	-0.014	-0.002	0.007
CAR_Combined	-0.035*	0.119	-0.082	-0.024	0.021

*CAR_EA is the three-day (-1,+1) cumulative market-adjusted return (raw return minus the corresponding CRSP value-weighted market return) around the earnings announcement date; CAR_Guidance is the three-day (-1,+1) cumulative market-adjusted return around the pessimistic guidance release date; CAR _Average is measured as the three-day average cumulative market-adjusted return between F_P and F_L for Nonguidance-Miss firm-quarters; For Guidance-Beat Sample, CAR_Combined is the combined cumulative market-adjusted return over the three-day guidance release window plus the three-day earnings announcement window. For Nonguidance-Miss Sample, CAR_Combined is the three-day average cumulative market-adjusted return between F_P and F_L plus the three-day cumulative market-adjusted return around the subsequent earnings announcement. * significant at the .01 level.*

I perform the following regression to examine whether investors react differently to *Guidance-Beat* firm-quarters and *Nonguidance-Miss* firm-quarters:

$$CAR = \lambda_0 + \lambda_1 Guide_{it} + \lambda_2 ForeError_{it} + \lambda_3 Size_{it} + \lambda_4 GrowthProspect_{it} + \lambda_5 Day_{it} + \varepsilon_{it} \quad (1)$$

where *CAR* is the cumulative market-adjusted return and is measured over two windows:

(1) *The combined guidance plus earnings announcement window (denoted as CAR_Combined)*: for *Guidance-Beat* firm-quarters, *CAR* is measured as the three-day return around the release of the pessimistic guidance, plus the three-day return around the following official earnings announcement. *Nonguidance-Miss* firm-quarters do not have a guidance event. In order to compare an equivalent six-day return window, I add three-day average return between F_P and F_L to the three-day return around the subsequent earnings announcement for the *Nonguidance-Miss* firm-quarters.

(2) *The long window (denoted as CAR_LongWindow)*: spanning from the last trading day before the date of F_P through the second trading day after the actual earnings announcement.

Guide is a dummy variable, equal to 1 for *Guidance-Beat* firm-quarters and equal to 0 for *Nonguidance-Miss* firm-quarters. *ForeError* refers to the forecast error, measured as the actual earnings minus the initial analyst consensus forecast F_P, and deflated by the price at the end of the same quarter in the prior year. *ForeError* is included to control for the total earnings news. Firm size (*Size*) is included as a proxy for risk factors that may affect stock return. In addition, a firm's growth prospects (*Growth Prospect,* measured as firms' long-term growth forecasts made at the F_P date by I/B/E/S) is included to control for the well-established phenomenon that the realized returns of growth stocks have been lower than other stocks (Skinner and Sloan, 2002). As a robustness test, I also used the book-to-market ratio as a proxy for future growth expectations as in Koh et al. (2008). The regression results reported later are not sensitive to different growth measures. In the long-window regression specification, firm-quarters have different return interval lengths. Therefore, when *CAR* is measured over the long window, I include the variable *Day* to control for the number of days included in the cumulative market-adjusted return computation.

Table 2 Panel B reports some descriptive information on the *Nonguidance-Miss* sample. Compared to the average three-day return around the earnings announcement for the *Guidance-Beat* sample in Panel A (mean *CAR_EA* =1.7 percent), the average three-day return over the same window for the *Nonguidance-Miss* sample is asymmetrically large (mean *CAR_EA* = -3.1 percent). This confirms the well-documented large asymmetric negative market reactions to negative earnings surprises. The mean three-day average return (*CAR_Average)* is not significantly different from 0, while the average combined return over the six-day window *(CAR_Combined)* is significantly negative (p<.0001) for the *Nonguidance-Miss* sample.

Table 3: Attributes of the Guidance-Beat Sample and the Nonguidance-Miss Sample[1]

	Guidance-Beat Sample (N=620)			Nonguidance-Miss Sample (N=620)			Test of Difference of Means[3]	Test of Difference of Medians[4]
Variable[2]	**Mean**	**S.D.**	**Median**	**Mean**	**S.D.**	**Median**	**p-value**	**p-value**
MV	2653.5	10918.0	560.2	3396.2	15620.0	439.3	0.361	0.072
Coverage	8.000	6.136	6.000	8.000	5.423	5.000	0.281	0.056
Growth Prospect	19.055	10.923	15.000	21.392	13.659	17.500	0.002***	0.016**
Loss	0.197	0.398	0.000	0.309	0.463	0.000	<0.0001***	<0.0001***
HighTech	0.336	0.473	0.000	0.335	0.471	0.000	0.831	0.831
Dispersion	0.263	0.556	0.100	0.244	0.622	0.095	0.599	0.172
Optimism	1.151	2.167	0.444	0.796	1.883	0.286	0.004***	<0.0001***
Salesgrowth	-0.056	0.249	-0.058	-0.041	0.844	-0.011	0.179	0.201
ROA	-0.015	0.077	0.002	-0.021	0.087	0.002	0.215	0.501
ROE	-0.018	0.157	0.004	-0.022	0.313	0.004	0.792	0.318
CAR_Combined	-0.086	0.165	-0.068	-0.035	0.119	-0.024	<0.0001***	<0.0001***
CAR_LongWindow	-0.112	0.226	-0.089	-0.096	0.256	-0.076	0.280	0.251

[1]Guidance-Beat sample includes 620 firm-quarters that beat the analysts' forecasts through management's public guidance. Nonguidance-Miss sample includes 620 firm-quarters that are not involved in public expectations management activities, and thus miss the analysts' forecasts.

[2]MV is the market value of equity; Coverage is the number of analyst forecasts for a firm-quarter at the F_P date; Growth Prospect is measured as firms' long-term growth forecasts made at the F_P date by I/B/E/S; Loss is a dummy variable, =1 if analyst initial consensus forecast F_P is a loss, =0 otherwise; HighTech is a dummy variable, which equals to 1 if the sample firm belongs to: Drugs (SIC code 2833-2836), Programming (SIC code 7371-7379), Computers (SIC code 3570-3577), Electrics (SIC code 3600-3674); and 0 otherwise; Dispersion is the standard deviation of the initial analyst consensus forecast F_P, deflated by the absolute value of actual earnings; Optimism is measured as the initial analyst consensus forecast F_P minus the actual earnings, deflated by the absolute value of actual earnings; Salesgrowth is the realized growth in sales revenue; ROA is the return on assets, measured as the net income divided by the average total assets; ROE is the return on stockholders' equity, measured as the net income divided by the average book value of equity. For Guidance-Beat Sample, CAR_Combined is the combined cumulative market-adjusted return over the three-day guidance release window plus the three-day earnings announcement window. For Nonguidance-Miss Sample, CAR_Combined is the three-day average cumulative market-adjusted return between F_P and F_L plus the three-day cumulative market-adjusted return around the subsequent earnings announcement; CAR_LongWindow is the combined cumulative market-adjusted return over the period spanning from the last trading day before the date of F_P through the second trading day after the actual earnings announcement.

[3]T-test is performed to assess whether the group means are significantly different.

[4]Wilcoxon z-test is performed to assess whether the group medians are significantly different.

Table 3 presents more descriptive statistics. The *Guidance-Beat* sample and the *Nonguidance-Miss* sample are not significantly different in terms of market value of equity (*MV*), analyst coverage (*Coverage*), percentage of high-tech firms (*HighTech*), analyst forecast dispersion (*Dispersion*) and profitability (*Salegrowth, ROA, ROE*). The *Nonguidance-Miss* firm-quarters tend to have higher growth prospects (*Growth Prospect*, p-value=0.002 for difference in means; p=0.016 for difference in medians), but they also have a higher percentage of predicted loss (*Loss*, p-value<.0001 for difference in means; p=0.000 for difference in medians). The *Guidance-Beat* firm-quarters appear to have a higher level of analyst optimism (*Optimism,* measured as the initial analyst consensus forecast F_P minus the actual earnings, deflated by the absolute value of actual earnings). The difference in sample means (medians) is significant with a p-value of 0.004 (p<.0001). Further, the cumulative market-adjusted abnormal return measured over the combined six-day window is more negative for the *Guidance-Beat* firm-quarters (*CAR_Combined*, p-value<.0001 for both means and medians). The long window return (*CAR_LongWindow*) does not appear to be significantly different across samples.

Table 4 shows the regression results. *Guide* is the primary variable of interest. λ_1 captures the differential returns to *Guidance-Beat* firm-quarters and *Nonguidance-Miss* firm-quarters. If the costs of providing pessimistic managerial guidance are smaller than the penalty to missing analysts' forecasts, and firms can eventually benefit from the expectations management game, λ_1 should be significantly positive.

Table 4: Investors' Reactions to Expectations Management

	Combined Window		**Long Window**	
	Coefficient Estimate	*p-value*	*Coefficient Estimate*	*p-value*
Intercept	-0.023	0.321	-0.010	0.812
Guide	-0.056	<0.0001***	-0.033	0.026**
ForeError	0.017	0.387	0.029	0.358
Size	0.004	0.172	0.008	0.089
Growth Prospect	-0.002	<0.0001***	-0.003	<0.0001*
Day			-0.002	0.019**
R^2	5.16%		3.40%	
Adj. R^2	5.10%		3.38%	

CAR is the cumulative market-adjusted return measured over two windows. The combined window includes three trading days around the release of the guidance, plus three trading days around the following earnings announcement. The long window spans from the last trading day before the date of F_P through the second trading day after the actual earnings announcement. Guide is a dummy variable, which equals 1 for Guidance-Beat firm-quarters; 0 for Nonguidance-Miss firm-quarters. ForeError is the forecast error, measured as the actual earnings minus the initial analyst consensus forecast F_P, and deflated by the price at the end of the same quarter in the prior year. Size is the log of the market value of equity; Growth Prospect is measured as firms' long-term growth forecasts made at the F_P date by I/B/E/S; Day is the number of days included in the long window cumulative market-adjusted return computation.

When *CAR* is measured over the *combined guidance plus earnings announcement window*, λ_1 is -0.056 (p<.0001), suggesting that the combined investors' reactions to management's pessimistic guidance and the subsequent earnings announcement are more *negative* for *Guidance-Beat* firm-quarters than for *Nonguidance-Miss* firm-quarters. In the *long window* regression, λ_1 is -0.033, also significantly different from 0 (p=0.026), suggesting that over the long run, stock returns for *Guidance-Beat* firm-quarters are significantly lower than that of *Nonguidance-Miss* firm-quarters. Overall, the regression results indicate that compared to firms that do not guide analysts' expectations and thus fail to beat analysts' forecasts, the stock performance of firms that achieve positive earnings surprises through pessimistic managerial guidance worsens over both the short and long run.

CONCLUSIONS

This study examines how market participants, specifically, the investors, react to the expectations management game in the post-Regulation FD period. The stock return tests results suggest that firms are "punished" for achieving positive earnings surprises through expectations management. The negative stock

price effect as the result of the pessimistic guidance (-10.2 percent on average) dominates the positive stock price effect (1.7 percent on average) associated with the positive earnings surprise at the earnings announcement. Furthermore, using a matched-sample design, I find that both the short-term stock return over the "combined guidance plus earnings announcement window" and the long-term total period return are more *negative* for guidance firms than for firms that do not guide and thus fail to beat the expectations. One limitation of the study is that I focus only on the capital market consequences of the expectations guidance game. It seems that firms are not better off (in terms of stock performance) by guiding analysts' forecasts to achieve positive earnings surprises. However, other factors, such as management's reputation considerations and stock-based compensation may explain why firms engage in expectations management. Moreover, I do not consider the risk and costs of *unsuccessful* expectations management activities, e.g. investors' reactions to the *Guidance-Miss* firm-quarters (firm-quarters that provide guidance, but still fail to beat the forecasts). I leave these questions to future research.

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