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Financial Distress and the Credibility of Management Earnings Forecasts

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Abstract

This study examines the relation between financial distress, bias in forecasting, and the credibility of voluntary earnings forecasts made by management. Prior research suggests that penalties to misreporting are, in general, sufficient to deter management from issuing intentionally biased forecasts. I examine the special case of distressed firms and develop the prediction that managers of distressed firms perceive a greater incentive to release upwardly biased forecasts because the firm, or their position at that firm, may not last long enough for them to face the institutional penalties for inaccurate disclosures. Given these incentives to misreport, I also predict that disclosures made by firms exhibiting signs of financial distress will be met with skepticism. Empirical evidence supports my hypotheses that management earnings forecasts issued by distressed firms exhibit greater upward bias and are viewed as less credible than similar forecasts made by non-distressed firms. For management earnings forecasts in excess of analysts' existing expectations, I find that the degree of over-optimism in management earnings forecasts increases as financial distress intensifies. In addition, an examination of revisions in analyst forecasts suggests that the financial community views forecasts made by firms in financial distress with skepticism. Analysts essentially ignore good news forecasts made by distressed firms, while there is actually an exaggerated negative analyst reaction to bad news forecasts made by distressed firms.

Keywords: financial distress, credibility, management forecast, voluntary disclosure

JEL Classification: M41, M45, G29, G33

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