Economic crisis and market rewards to meeting or beating analysts’ earnings forecasts: Evidence from Korea

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Abstract

We examine whether the market premium to meeting or beating analysts’ earnings forecasts vary according to the economic conditions. Using a sample of Korean firms that suffered the Asian Crisis in 1997-98 as well as the worldwide Financial Crisis in 2008, we find that the market rewards to meeting or beating earnings expectations is higher for economic crisis periods compared to those for other periods, thereby indicating that investors react more positively to good news in bad times.

Keywords: Market premium, Meeting or beating earnings expectations, Analysts’ earnings forecasts, Economic crisis

1. Introduction

Prior studies support the view that corporate management has strong incentives to meet or beat analysts’ earnings forecasts as a key performance benchmark, because meeting or beating earnings expectations (hereinafter MBE) have a disproportionately large impact on investors’ perceptions of firm performance [1, 2, 3, 4]. Bartov et al. (2002) and Kasznik and McNichols (2002) directly investigate the magnitude of the market premium to MBE; as a result, they conclude that MBE is positively associated with stock returns and that the MBE premium reflects higher future performance. Bartov et al. (2002) also document that MBE premium still exists despite the MBE results from earnings or expectations management, indicating that investors perceive MBE itself as a strong signal of good performance.

In this study, we examine how the economic conditions affect investors’ perception on MBE. Specifically, we conjecture that the magnitude of MBE premium could be different during periods of economic crisis. Korea had experienced a severe economic crisis twice in the last 15 years: the Asian Crisis in 1997-98 and the Financial Crisis in 2008. On the one hand, MBE premium may be lower during periods of economic crisis, simply because the overall investment sentiment shrinks back in shock and consequently, investors may not trust the integrity of the accounting information [7]. On the other hand, investors may have a larger reaction to good news in bad times than good news in good times, because a positive earnings surprise may be more surprising in bad times. Thus, this is an empirical question to explore in the study using the following non-directional hypothesis. Hypothesis: The market premium to