Implications of Past Forecasting Errors Often Underestimated

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(PhysOrg.com) -- When managers issue a forecast of their firm's earnings, they do not always take into account prior forecasting errors, according to research in the current issue of the Journal of Business Finance & Accounting.

Weihong Xu, assistant professor of accounting in the University at Buffalo School of Management, analyzed more than 11,000 firm-quarter observations. She found that managers often underestimate the implications of their past forecasting errors when forecasting earnings.

This underestimation of past errors can affect how the market responds to a new earnings forecast. Specifically, it can contribute to "post-earnings announcement drift;" that is, stock prices continue to drift in the direction of the initial price response to an earnings announcement.

"Managers underestimate the information in their prior forecast errors to a greater extent when they make earnings forecasts with a longer horizon," Xu says.

A copy of the study is available here.

She notes that further study is needed to see if the underestimation is intentional on the part of management in order to provide biased forecasts.

Provided by University at Buffalo (news : web)