Are Benchmark Beaters Doing Anything Wrong?

April 10, 2000

Working paper

We investigate two samples of firms that just beat benchmarks — “benchmark beaters” — and compare them to the distribution of all other firms. It is often assumed that firms “manage” earnings to beat expectations, but little evidence exists on how benchmarks are beaten or why firms do so.

Research has documented that publicly traded companies seem to avoid reporting small losses. Specifically, the earnings distribution suggests that managers attempt to report small positive earnings. This result holds for earnings levels as well as earnings changes, and appears to be pervasive in all earnings based data.

The first sample of benchmark beaters we investigate consists of firms reporting small positive earnings. The second consists of firms that have zero forecast errors. We investigate how and why these firms beat benchmarks. Specifically, we see whether firms boost accruals or strategically use special and extraordinary items to beat benchmarks.

We do find that benchmark beaters are smaller, more recently listed firms. We also find that firms that just beat the zero earnings benchmark tend to be delaying bad news, and tend to have lower earnings and stock returns over the following year. In addition, we find this underperformance is almost entirely due to high accrual firms. Thus conditioning on both the firm having high accruals and small positive profits provides a more negative return than conditioning on high accruals alone.