

# Financial Statement Analysis & Valuation: Research, Teaching and Practice

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# How do analysts forecast earnings?

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It depends on the analyst and the situation.

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## A Spectrum of Analysts:

Conscientious

Less than Conscientious

- Use a *granular* approach
- Use all guidance from by mgmt
- Use extensive knowledge of firm, industry & past sales to predict future sales.
- Use extensive knowledge of firm, industry & past expenses to predict future expenses.
- Earnings = Sales – Expenses

- Use *30,000 feet* approach
  - Use all guidance from mgmt
  - (May) Use past earnings & earnings growth rate to predict future earnings
  - Use current price
  - Use all guidance from other analysts (herd!)
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# Why do we still study analysts?

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- **Data availability**
    - I/B/E/S, Value Line, Zacks, FirstCall, others
  - **Distributions to analyze**
    - Forecast accuracy, bias, dispersion, etc.
  - **Correlations to compute**
    - forecasts and prices, forecasts and \_\_\_\_\_, etc.
  - **Our interest in how capital markets operate**
  - **Birth of a new literature**
    - Analysts as an economic agent
    - Incentives, information processing, use of accounting data, etc
  - **We have yet to fully understand**
    - How they forecast earnings
    - What they do with these earnings forecasts
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# Why do I care about analysts?

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# Why I Care About Analysts' Forecasts

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- **Despite their imperfections:**
    - **Yes, they are better than time-series forecasts**
      - More accurate
      - Better surrogate for market (and sophisticated) expectations
    - **The stock market cares about analysts' forecasts**
    - **They are incredibly useful tools for capital markets research**
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# Analysts' Forecasts as a Tool in Capital Markets Research

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- **Do analysts exhibit the (inefficient) behavior of which we accuse investors ?**
    - Accruals (Bradshaw, Richardson, Sloan 2001)
    - PEAD (Mendenhall 1991; Abarbanell & Bernard 1992)
    - Value-Glamour (LaPorta 1996; Dechow & Sloan 1997)
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# Analysts' Forecasts as a Tool in Capital Markets Research

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- **Do price movements convey info about future cash flows or, e.g., about changes in liquidity, changes in investor recognition...?**
  - Exchange Listings
  - Index Listings (Denis et al 2003)
  - Stock Splits (Doran 1994)
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# Analysts' Forecasts as a Tool in Capital Markets Research

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- **Do different investors use different information sets?**
  - Analysts forecasts versus time series models (Bhattacharya 2001; Battalio & Mendenhall 2005)
  - **Open question: Can we identify some investors whose expectations are more sophisticated than those of analysts?**
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# Analysts' Forecasts as a Tool in Capital Markets Research

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- **We are still finding fascinating phenomena that have implications for how capital markets work**
    - Large forecast dispersion  $\Rightarrow$  large optimistic bias  
Large forecast dispersion  $\Rightarrow$  low returns  
(Ackert and Athanasakos 1997; Diether et al 2002)
  - Open questions: What more can we do with dispersion? E.g., can we relate it to the elasticity of demand for stocks?
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# Final Thoughts

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- **If you really want to capture, or control for, earnings surprise, use both analysts' forecasts & a time series model**
  - **Surveys of "analysts" should be viewed with skepticism**
    - Block(1999)—randomly selected AIMR members
  - **Recent regulation changes should make the future interesting**
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