Tracking Analysts Forecasts Over the Annual Earnings Horizon

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Working paper

This paper examines the dynamic behavior of analyst earnings forecasts in the 12 months leading up to announcements of annual earnings. We find that forecast errors were more pessimistic in the 1990s and that the pessimism increased as the earnings announcement approached.

This evidence is consistent with media allegations and concerns expressed by policymakers that analysts are allowing firms to guide their forecasts and are increasingly more prone to provide “beatable” forecasts.

We find that forecast pessimism is strongest for firms with the highest incentives to avoid earnings disappointments. These firms include high market-to-book firms, high-market-capitalization firms and firms about to issue new equity. We also find that pessimistic forecasts are more frequent in years when firms report positive special items, high cash flows from operations and high working capital accruals.

We suggest that the observed pattern of earnings forecasts is attributable to the incentives faced by analysts. Analysts are evaluated on their ability to generate accurate earnings forecasts, but they obtain much of their information about earnings prospects directly from firm managers. Therefore, analysts must balance generating accurate forecasts with maintaining good relations with the firm’s managers.

At the beginning of the fiscal year, analysts generally focus more on pleasing management and less on accuracy, and so report optimistic initial forecasts. Later, they tend to reduce their forecast with guidance from the firm’s managers. Given the incentives to avoid an earnings disappointment, we believe management guides the analyst toward a final forecast that is just “beatable.”
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