Analysts, Lies, and Statistics
Cutting Through the Hype in Corporate Earnings Announcements

Introduction

It is the customary fate of new truths to begin as heresies and to end as superstitions.
Thomas Henry Huxley

The time is right for a book that addresses the use of earnings and earnings estimate data in picking stocks. The number of people using estimate data has grown over the past 15 years from a small group of fanatics to mainstream America. Ten years ago, did anyone know what earnings surprise was? Turn on CNBC during earnings season and you will hear the term used several times per hour. The speed at which this topic has moved from the fringe to the mainstream is nothing short of amazing. With all of the newfound emphasis on earnings estimates, the lack of a book covering this topic is an obvious gap in the literature of finance. This book will cover all of the topics necessary to understand the use of earnings estimate data. It starts with an overview section, which contains needed background material. The second section covers popular issues regarding the earnings and estimates. The final section shows how to utilize this information in picking stocks for your portfolio.

The book begins with an introductory section that discusses the history of earnings estimates and the roles they play. Chapter 2, 'The history of earnings estimates', discusses expectations of earnings. In this chapter, there is a brief stroll down memory lane, highlighting how earnings estimates have been collected and disseminated over the years. Understanding the basic process involved sets the stage for being able to understand how this data has been used and misused over the years, and provides insights into the best ways to utilize this valuable information.

In Chapter 3 there is an examination of the role that analysts play. Based on the recent accounting scandals, a reasonable investor might ask 'What role do analysts serve? Why can't we get rid of them? At the very least, let's replace them with independent research firms and not rely on analysts tied to brokerage firms.' This chapter shows the critical function that analysts play in the flow of information from companies to investors, and subsequent chapters show how to properly utilize information provided by analysts despite their limited accuracy. This chapter examines the role of those analysts, their motivations, and the amount of useful information they provide.

Chapter 4, 'Analysts' conflicts of interests', discusses sell-side analysts as a source of a number of primary pieces of information relevant to those wishing to effectively invest in common stocks. The analysts provide projections of earnings growth, purchase recommendations, target prices, and commentary on the possible risks and rewards of owning a particular stock. These analysts provide a critical link in the information flow between company and investor. It is examined how much faith you should place in the research reports and recommendations of analysts, given that they are essentially paid by the firms they are evaluating.

The book then focuses on all of the various topics which are part of the field. Chapter 5 focuses on various estimates of earnings growth. First, analysts forecast the level of earnings growth over longer term horizons. Second, they provide target prices, which are forecasts of actual price levels. Finally, they issue stock recommendations to buy or sell securities.

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Moving forward, they are starting to estimate sales and other income statement information that may be less likely to be involved in the generally accepted accounting principles (GAAP) versus Pro Forma earnings discussion (which is covered in the following chapter). In this chapter, these other items are considered, and we discuss how useful these metrics are to investor stock-selection models.

In Chapter 6, the focus changes from looking at the various estimates being made, and moves into that of which those estimates are comprised. For years, investors have focused their attention on earnings calculated in accordance with GAAP established by the regulatory organizations and their predecessors (GAAP). However, recently companies have been reporting an ever widening array of alternatively calculated earnings figures, and Wall Street has embraced these definitions of earnings, although these are not explicitly defined or sanctioned by any of the regulatory overseers. These definitions are known by such names as ‘pro forma,’ ‘normalized,’ ‘cash earnings,’ and a host of other such names. In this chapter, there is an examination of this trend, and we provide two sides of the argument for and against the use of pro forma accounting numbers. The chapter looks at whether investors should pay attention to these numbers, or should they view them as an attempt by managers to hoodwink them into believing earnings are rosier than they are?

After looking at estimates and what makes them up, Chapter 7, ‘Earnings management’, addresses the question ‘Do managers manipulate earnings?’ Almost anyone familiar with the financial reporting process would not hesitate to answer the question posed above. Most people would respond, ‘Yes, of course managers manage earnings’. However, what does it mean, to ‘manage’ earnings? Most observers would agree that any deliberate intervention in the accounting process aimed at affecting reported financial numbers would fall under the definition of earnings management. However, there seems to be no accepted definition of earnings management. Nevertheless, there seems to be a general consensus among academics, regulators, and the investment community that earnings manipulation is characterized by managerial intent to paint a picture of firm performance that is not accurate. Additionally, most believe that earnings management is widespread. However, is there hard evidence to support this claim? Why would managers care so much about managing earnings? How can it be measured whether earnings have been managed? What has been documented regarding the pervasiveness of earnings management? In this chapter, there is a very brief description of how researchers have viewed earnings management, and we summarize a small but representative sampling of the evidence.

Chapter 7 also examines the impact of pre-announcements. In the ancient times before earnings surprise (any time before 1995) was discussed on CNBC and available on web sites, there was little violent one day reaction of stock prices to earnings news. In the modern days since those times, 25% one day price movements in reaction to earnings announcements occur regularly. As corporate management does not enjoy large negative price movements, the practice of pre-announcements has become prevalent. Management hopes that by sharing potential negative news the price reaction to announcements would be more restrained. Pre-announcements have quickly become part of the landscape. First Call has started collecting data on pre-announcements and research is being done on the data.

Chapter 8 looks at the topic which is the focus of the most cutting edge research today, ‘Accruals and earnings quality’. In the chapters preceding this one, there is a consideration of the uses of estimates of earnings. This chapter looks in-depth at the earnings being estimated. It starts by looking at earnings quality, and then earnings management and pro forma

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earnings. This analysis should give investors a better idea of which earnings estimates have a greater likelihood of occurring, and which do not. Let's start with quality. Analysts forecast earnings, but it is cash flows that ultimately matter. There is a lot of misunderstanding about the link between earnings and cash flows. Simply stated, the difference between earnings and cash flows reflects accounting accruals. In this chapter, there is a brief consideration of this link. Then, there is a discussion of how investors can take advantage of an understanding of this link to identify stocks that will likely report earnings reversals.

Up to this point, this book has focused on the estimates made by analysts that are sent to the data collectors. What about estimates of future earnings that are generated but are not collected by the data services? Does finding them and using them provide any informational advantage? Chapter 9 examines this question by analyzing 'Whisper estimates'. Whisper estimates became popular in the 1990s. They are the natural outgrowth of the behavioral adjustments that continually occur in the earnings estimate cycle. When estimates were first collected by I/B/E/S, there was no need to whisper. People barely paid attention to the published estimates. By the mid 1980s, use of estimates in managing institutional money began to proliferate. So when the technology bubble hit in the late 1990s, estimate data was so popular that it appeared on websites aimed at individual investors. When published estimates become common knowledge, the next step in the behavioral cycle is to try to get better or faster information than the estimate. This led to the growth of whisper estimates, which are examined in depth.

In Chapter 10, there is an examination of the question 'Are there superior analysts?' Do analysts at large firms or who are 'Institutional Investor All-Americans' predict earnings any better than the average? In this chapter, the evidence is considered on the existence of superior analysts. As it turns out, depending on how you measure 'superior,' there do seem to be certain analysts who are better than others. There is also a consideration of research that concludes that not only does the market believe that there are superior analysts, but that the market gives more weight to forecasts, recommendations, and target prices of superior analysts, resulting in stronger market reactions to their announcements.

The book then looks at the tools used by portfolio managers, and the integration of those tools into an equity process. So far, there has been an examination of the history of earnings estimates, the role of analysts, and the use of estimate data in looking at earnings surprises. Chapter 11 focuses on a tool utilized by professional money managers: earnings revisions. The ability to use a large number of estimates by professional money managers in a formal way has led to the creation of the earnings revision model. This model was the first structured use of expectational data. In fact, the earnings revision model was the first successful use of behavioral finance concepts in portfolio management (although, at the time these models were created, behavioral finance did not exist as a field of study).

In Chapter 12 there is an examination of what 'earnings surprise' is. It is an earnings announcement that differs from what analysts were expecting. Earnings surprise often causes a substantial movement in the stock's price. In the 1960s, the concept of earnings surprise was limited to a few academics doing research on an effect that was not known to many sophisticated investors. Now there is an examination of why it seems to be covered everywhere.

Up to this point, the book has discussed many facets of earnings and estimates of earnings. Chapter 13 is the appropriate close to this book, showing how to integrate earnings into a portfolio management strategy. One of the most difficult tasks a portfolio manager faces is making his or her product unique. This requires lots of creativity, as so many people utilize a

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small number of ideas. How do you make your process unique while not discussing the sources of your inspiration? In this case, the sources include the hundreds of academic papers that have been written on this subject. Other sources are the dozens of fabulous speakers who have appeared over the years at the Corporate Earnings Analysis Seminar (www.Investment research.org). Additional sources are all of the portfolio managers who have tried to use this data over the years.

Finally, in Chapter 14, some final thoughts on the subject are provided. This is a rich and ever-changing field. There can be no real conclusion, just a current summary of where we are in understanding the effects of earnings on stock prices. Hopefully, this volume will help with your understanding of how to use earnings in evaluating companies for investment.

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