Corporate Guidance and Earnings Announcements: Are Companies Gaming the System to Beat the Analyst Mean when Announcing Earnings?

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Earnings Guidance

- Companies are required to make announcements when significant new information becomes available.

- It is an announcement by a company that it expects to have sales, earnings per share and/or a particular growth rate for the next quarter, year or other period.

- For retailers, may include same store sales expectations.
Earnings Guidance - Continued

• Often given for next quarter when announcing current quarter’s results.

• Numbers are often given as a range such as “we expect to earn between $1.00 and $1.05 per share.”

• Companies do not have to give guidance or may state that they are “comfortable with analyst estimates.”

• On the average, negative guidance occurs around twice as often as positive guidance.
Analyst Estimates

• Analysts work for investment banks (sell-side).

• They estimate financial numbers such as sales, earnings per share, etc.

• Financial information providers such as Thomson Financial (First Call) aggregate the estimates and supply means and standard deviations.
Gaming the Mean Estimate

- When analyst estimates and their means are too high, companies often guide them lower.

- By putting in a range such as $1.00 and $1.05 per share, analysts may end up around $1.03 or $1.04.

- The company can then announce $1.05, “beat the mean” and still be within their predicted range.
So what does “beating the mean” really mean?

• **Maybe nothing on the average!**

• Table #1 shows how often DJIA companies beat the mean by a penny as well as hitting the mean, beating by more than a penny and falling short.

• As can be seen, they beat by a penny nearly a quarter of the time and more than a penny nearly 40% of the time. Also, the trend is to beat the mean more frequently over time!
<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Overall Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beat By More Than A Penny</td>
<td>18.9%</td>
<td>42.2%</td>
<td>38.0%</td>
<td>37.9%</td>
<td>27.2%</td>
<td>51.1%</td>
<td>54.3%</td>
<td>37.8%</td>
</tr>
<tr>
<td>Missed</td>
<td>21.6%</td>
<td>10.8%</td>
<td>11.0%</td>
<td>19.5%</td>
<td>25.0%</td>
<td>11.7%</td>
<td>10.9%</td>
<td>16.0%</td>
</tr>
<tr>
<td>Met</td>
<td>31.1%</td>
<td>24.1%</td>
<td>26.0%</td>
<td>27.6%</td>
<td>25.0%</td>
<td>11.7%</td>
<td>17.4%</td>
<td>23.4%</td>
</tr>
<tr>
<td>Beat By A Penny</td>
<td>28.4%</td>
<td>22.9%</td>
<td>25.0%</td>
<td>14.9%</td>
<td>22.8%</td>
<td>25.5%</td>
<td>17.4%</td>
<td>22.7%</td>
</tr>
</tbody>
</table>
Frequency of Reported Earnings Beating by More than a Penny, Beating by a Penny, Meeting and Missing the Analyst Mean

Beat By More Than A Penny
Missed
Met
Beat By A Penny

Frequency

1998 1999 2000 2001 2002 2003 2004
Is the Market Fooled?

• Tables #2 and #3 look at the stock market returns of companies around earnings reports.

• Table #2 examines the returns from before the announcement to after (close to open or open to close).

• Table #3 examines the returns from before the announcement to the close of the fifth day after.
What do the returns look like?

- Beating the mean estimate results in positive returns.
- Falling short or equaling the mean results in negative returns.
- Beating by more than a penny or missing are statistically significant.
- Meeting or beating by a penny are statistically insignificant!
<table>
<thead>
<tr>
<th>Event</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Overall Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beat By More Than A Penny</td>
<td>-0.22%</td>
<td>1.74%</td>
<td>0.63%</td>
<td>0.73%</td>
<td>1.20%</td>
<td>0.97%</td>
<td>0.64%</td>
<td>0.91%</td>
</tr>
<tr>
<td>Missed</td>
<td>0.06%</td>
<td>-1.48%</td>
<td>-1.73%</td>
<td>-0.61%</td>
<td>-1.19%</td>
<td>-2.08%</td>
<td>-1.53%</td>
<td>-1.08%</td>
</tr>
<tr>
<td>Met</td>
<td>-0.48%</td>
<td>-1.08%</td>
<td>-0.20%</td>
<td>0.62%</td>
<td>-0.55%</td>
<td>0.15%</td>
<td>-0.35%</td>
<td>-0.27%</td>
</tr>
<tr>
<td>Beat By A Penny</td>
<td>0.78%</td>
<td>-0.33%</td>
<td>0.05%</td>
<td>-0.53%</td>
<td>0.17%</td>
<td>0.30%</td>
<td>0.15%</td>
<td>0.12%</td>
</tr>
<tr>
<td>Table 3: Five-Day Return**</td>
<td>1998</td>
<td>1999</td>
<td>2000</td>
<td>2001</td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
<td>Overall Average</td>
</tr>
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<td>---------------------------</td>
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</tr>
<tr>
<td>Beat By More Than A Penny</td>
<td>1.69%</td>
<td>2.45%</td>
<td>1.55%</td>
<td>2.02%</td>
<td>0.18%</td>
<td>1.88%</td>
<td>1.91%</td>
<td><strong>1.73%</strong></td>
</tr>
<tr>
<td>Missed</td>
<td>-0.96%</td>
<td>-0.19%</td>
<td>-1.27%</td>
<td>0.22%</td>
<td>-3.05%</td>
<td>-3.32%</td>
<td>-2.51%</td>
<td><strong>-1.59%</strong></td>
</tr>
<tr>
<td>Met</td>
<td>-0.56%</td>
<td>-1.09%</td>
<td>-0.86%</td>
<td>1.00%</td>
<td>-1.78%</td>
<td>0.34%</td>
<td>-1.00%</td>
<td><strong>-0.58%</strong></td>
</tr>
<tr>
<td>Beat By A Penny</td>
<td>-0.09%</td>
<td>-1.80%</td>
<td>1.22%</td>
<td>-0.62%</td>
<td>2.48%</td>
<td>0.28%</td>
<td>-1.42%</td>
<td><strong>0.26%</strong></td>
</tr>
</tbody>
</table>
Conclusions

• Companies can “have their cake and eat it too!”

• But, maybe the cake doesn’t really taste so good since beating by a penny does not lead to significant positive returns.

• And finally, when guiding analysts’ estimates lower, the stock often falls at that time. So maybe later gains offset earlier losses.