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?

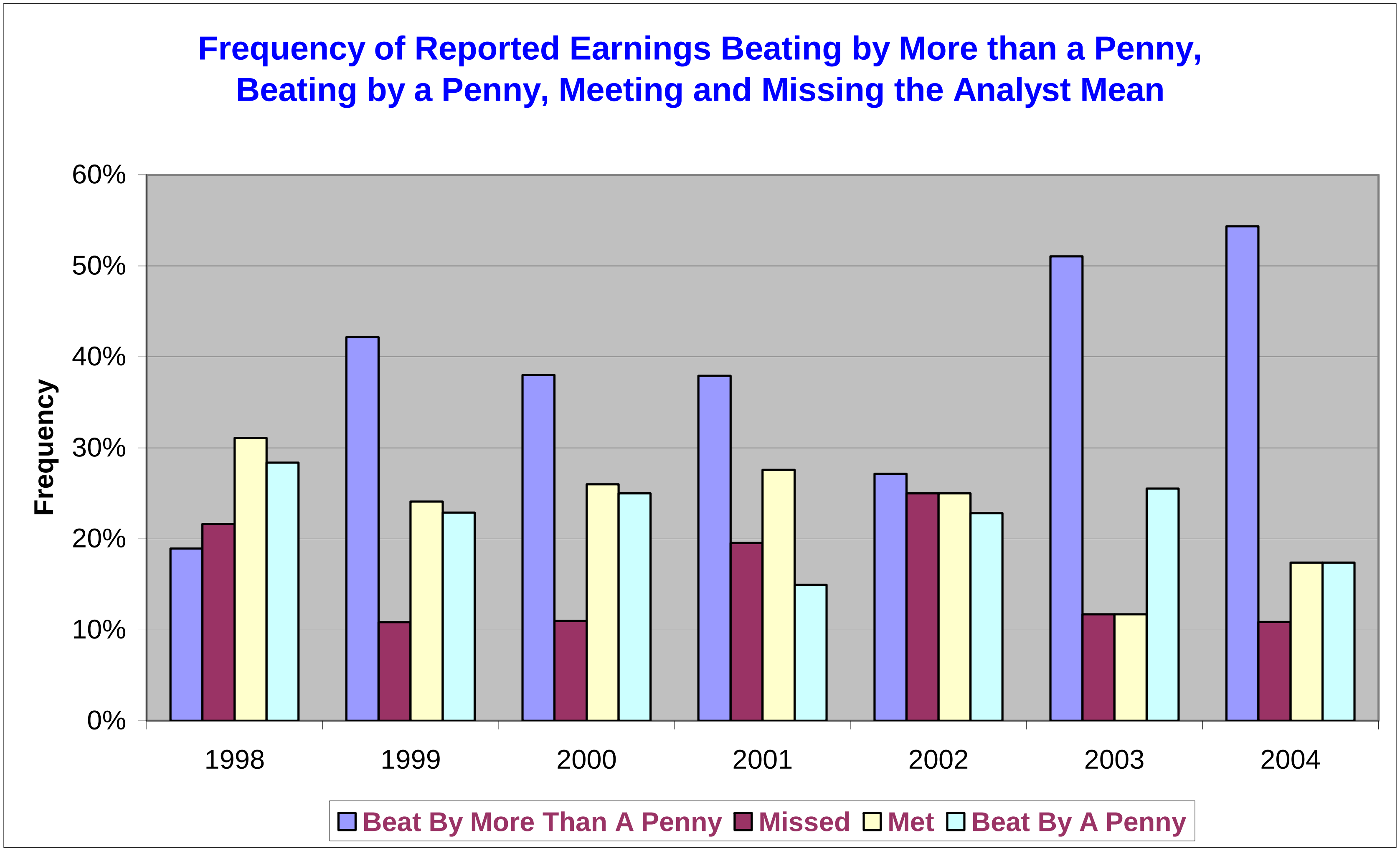
- **Maybe nothing on the average!**

- 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 1: Frequency of Reported Earnings Beating by More than a Penny, Beating by a Penny, Meeting and Missing the Analyst Mean
(at the time of earnings announcement since 1998 for current DJIA Stocks)

	1998	1999	2000	2001	2002	2003	2004	Overall Average
Beat By More Than A Penny	18.9%	42.2%	38.0%	37.9%	27.2%	51.1%	54.3%	**37.8%**
Missed	21.6%	10.8%	11.0%	19.5%	25.0%	11.7%	10.9%	**16.0%**
Met	31.1%	24.1%	26.0%	27.6%	25.0%	11.7%	17.4%	**23.4%**
Beat By A Penny	28.4%	22.9%	25.0%	14.9%	22.8%	25.5%	17.4%	**22.7%**



Frequency of Reported Earnings Beating by More than a Penny,
Beating by a Penny, Meeting and Missing the Analyst Mean
Frequency
60%
50%
40%
30%
20%
10%
0%
1998
1999
2000
2001
2002
2003
2004
Beat By More Than A Penny
Missed
Met
Beat By A Penny

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 2: Event Return*	1998	1999	2000	2001	2002	2003	2004	Overall Average
Beat By More Than A Penny	-0.22%	1.74%	0.63%	0.73%	1.20%	0.97%	0.64%	**0.91%**
Missed	0.06%	-1.48%	-1.73%	-0.61%	-1.19%	-2.08%	-1.53%	**-1.08%**
Met	-0.48%	-1.08%	-0.20%	0.62%	-0.55%	0.15%	-0.35%	**-0.27%**
Beat By A Penny	0.78%	-0.33%	0.05%	-0.53%	0.17%	0.30%	0.15%	**0.12%**

Table 3: Five-Day Return**	1998	1999	2000	2001	2002	2003	2004	Overall Average
Beat By More Than A Penny	1.69%	2.45%	1.55%	2.02%	0.18%	1.88%	1.91%	**1.73%**
Missed	-0.96%	-0.19%	-1.27%	0.22%	-3.05%	-3.32%	-2.51%	**-1.59%**
Met	-0.56%	-1.09%	-0.86%	1.00%	-1.78%	0.34%	-1.00%	**-0.58%**
Beat By A Penny	-0.09%	-1.80%	1.22%	-0.62%	2.48%	0.28%	-1.42%	**0.26%**

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.