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Endogenous entry/exit as an alternative explanation for the disciplining role of independent analysts

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Abstract

Gu and Xue [2008. The superiority and disciplining role of independent analysts. Journal of Accounting and Economics, this issue, doi:10.1016/j.jacceco.2008.02.002] study the disciplining effect of independent analysts on the accuracy and forecast relevance of the forecasts of non-independent analysts. One of the intriguing results is that while independent analysts issue inferior forecasts, their presence appears to reduce the forecast bias, improve the forecast accuracy and increase the forecast relevance of forecasts issued by non-independent analysts. We explore alternative explanations for the Gu–Xue results. Our evidence of endogenous entry and exit of independent analysts provides a more compelling explanation for the reported results.

JEL classification: G28; G29; M41; M43

Keywords: Endogenous entry; Disciplining; Independent

1. A straight-forward hypothesis with intriguing results

Gu and Xue (2008, hereafter GX) study the role of independent analysts (i.e., analysts with no ties to companies whose earnings are being forecasted) in improving the quality of forecasts of non-independent analyst (i.e., analyst with potential conflicts of interest, for example investment banking relations). The basic premise of the paper is that independent analysts should, all else equal, issue less-biased and more precise forecasts. More importantly, the presence of independent analysts should have a disciplining effect on non-independent analysts, resulting in less-biased and more accurate forecasts by non-independent analysts as well.

The importance of GX's research is highlighted by recent regulatory initiatives, culminating in the Global Research Settlement, which aim to address issues relating to the lack of independence of equity research analysts. While these regulatory initiatives by and large focus on stock recommendations, they are based on the assumption that lack of analyst independence impedes the quality of equity research. Therefore, GX set out to examine whether independent analysts are superior forecasters of earnings and whether their presence disciplines non-independent analysts following the same company.

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Several papers have compared the quality of research of independent analysts with non-independent analysts. GX adds to this stream of literature in a novel manner by studying the interaction between these two groups of analysts. This basic thesis is both simple and intuitive. Further, despite the richness of the equity research industry for addressing fundamental questions relating to the dynamics of competition, there is little prior research that examines the role of competition and GX take a first step in that direction.

GX ask two questions. First, are independent analysts' forecasts less-biased and more precise than those of non-independent analysts? Second, does the presence of independent analysts *discipline* non-independent analysts following the same firm by reducing bias, increasing precision, and increasing the credibility of forecasts of the latter group? GX address these issues by comparing the accuracy, bias, and earnings response coefficient (ERC) of earnings forecasts for firms that were followed by only non-independent analysts in some quarters to forecasts for the same firms when they were followed by both independent and non-independent analyst in other quarters.

At first, the hypothesis tested by GX seems straight-forward: introducing independent analysts who compete with incumbent non-independent analysts increases competition and ought to improve the quality of the forecasts of the non-independent analysts. And indeed, GX report that, in general, the presence of independent analysts reduces the bias, increases the accuracy, and increases the ERC of forecasts issued by non-independent analysts. What makes their research intriguing is the result that, forecasts issued by independent analysts while less-biased, is significantly less precise than forecasts issued by non-independent analysts. Thus, GX document a puzzling phenomenon, namely that introducing an otherwise inferior competitor induces superior competitors to increase the quality of their output and become more credible.

2. Evidence and interpretation of results

2.1. Findings

Using absolute forecast errors as a measure of forecast accuracy, GX find that independent analysts are less accurate than non-independent analysts.[1] Moreover, using average forecast error as a measure of forecast bias, while both groups of analysts are on average pessimistically biased, independent analysts are less pessimistic than non-independent analysts.

The accuracy results suggest that forecasts issued by independent analysts are in fact inferior to forecasts issued by non-independent analysts. As indicated in the introduction, GX main result, however, is that forecast accuracy of non-independent analysts is higher and their forecasts are less pessimistically biased in periods when independent analysts are also issuing forecasts compared to periods when independent analysts are not issuing forecasts. GX interpret this as the disciplining effect of independent analysts.

With respect to credibility, GX find that the ERC for independent analysts is higher, particularly when the earnings news is bad, than the ERC of non-independent analysts. Moreover, GX find that the ERCs of non-independent analysts are higher in the presence of an independent analyst following the same firm compared to the ERC of non-independent analysts when independent analysts are absent. This result is further evidence of the disciplining role of independent analysts. Based on these results, GX conclude that the presence of independent analysts has a disciplining effect on the non-independent analysts and therefore suggest that improving analyst independence enhances the quality of analyst research.

With respect to the superiority of independent analysts, GX find mixed results with forecasts of independent analysts being less accurate but being more credible (having higher ERCs). However, GX argue that higher ERCs imply better quality forecasts since it suggests that the forecasts are better aligned with market expectations.

The mixed evidence with respect to the superiority of independent analysts raises some interesting puzzles. How is it that the ERC of independent analysts is higher even though their forecast accuracy is lower than that of non-independent analysts? Further, how can the independent analysts discipline the non-independent analysts while their forecasts have lower forecast accuracy? We address the puzzling results using two

[1]This is consistent with evidence on forecast accuracy in other recent papers such as Jacob, Rock and Weber (2005) and Ertimur, Sunder and Sunder (2007).