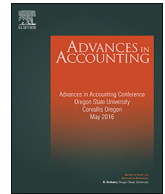




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Price momentum and the premium for meeting or beating analysts' forecasts of earnings[☆]

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ABSTRACT

This study provides a theoretical rationale and empirical support that relates the existence and magnitude of the premium for meeting/beating analysts' EPS forecasts to the existence of preannouncement price momentum. The study is based on the theoretical work that suggests that extreme levels of price momentum can cause security prices to deviate from fundamental values even in the presence of well-informed and well-financed rational arbitrageurs. Differences of opinion regarding the extent of mispricing and/or optimal exit time to exit the position allow this mispricing to persist (Abreu and Brunnermeir 2002, 2003). To correct mispricing, a news event, like an earnings announcement, is necessary to synchronize investors' exit strategy beliefs (Abreu and Brunnermeir 2002, 2003). In the case of an earnings announcement, this synchronization of beliefs triggers a price reaction of such magnitude that it cannot be explained by unexpected earnings. Instead, we hypothesize and show that the abnormal price reaction is largely captured in what empirical researchers have identified as the meet/beat market premium. Our findings provide a cohesive argument for the temporal variation in meet/beat premiums documented by Koh, Matsumoto and Rajgopal (2008).

1. Introduction

Prior research has documented the existence of a stock return premium for meeting or beating analyst forecasts of earnings¹ even after controlling for unexpected earnings (Bartov et al. 2002; Kasznik and McNichols, 2002). Despite the empirical evidence of its existence, the basis of the meet/beat premium remains a largely unexplained phenomenon in the literature. The motivation behind our paper is to extend

the existing literature by providing a theoretical rationale and related empirical support for the existence and magnitude of the meet/beat premium. To that end, we relate the meet/beat premium to the degree of pre-announcement stock price momentum.²

The foundation of our study is based on the idea that price momentum is linked to investor disagreement³ over the extent of temporary mispricing caused by a prior market misreaction to news about a security.⁴ That is, disagreement over any such misreaction and the re-

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¹ Hereafter, this is referred to as the meet/beat premium. The meet/beat premium in our context is the differential stock return for firms that just meet (beat) the consensus analyst forecast of earnings relative to firms that miss the consensus forecast.

² Consistent with prior research we define positive and negative momentum, respectively, on the basis of past stock market “winners” (highest returns) and “losers” (lowest returns). As discussed later, we measure momentum on a residual basis, after controlling for changes in fundamental information during the measurement period.

³ Disagreement among investors not only manifests in abnormal trading volume but also can lead to security prices to deviate from their intrinsic values and generate price momentum. See Hong and Stein (1999) for a complete discussion of disagreement theories.

⁴ Prior literature has linked market misreactions (e.g., both over- and under-reactions) to news events, to price momentum (Daniel, et al., 1998; Debondt and Thaler, 1995; Barberis, 1998; Hong Stein, 1999)

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lated price momentum will result in the belief among a subset of investors that a security is temporarily mispriced (e.g., [Barberis 1998](#); [Hong and Stein 1999](#); [Lee and Swaminathan 2000](#)).⁵ Differences of opinion concerning the timing of the market correction ([Abreu and Brunnermeier, 2002, 2003](#)) allow this momentum / mispricing to persist.⁶ To correct any mispricing, a sufficient number of investors must be synchronized in the belief that the security is indeed mispriced. Therefore, a news event, such as an earnings announcement, is necessary to synchronize investors' beliefs ([Abreu and Brunnermeier 2002, 2003](#)). In the case of an earnings announcement, the synchronization of beliefs triggers a price reaction of such magnitude that it cannot be explained by unexpected earnings. Instead, we argue that the abnormal price reaction is largely captured in what empirical researchers have identified as the meet/beat premium. In this vein, we argue that the meet/beat premium is a consequence of resolving investor disagreement over the existence and magnitude of a prior misreaction.

Given the above arguments, we hypothesize that the magnitude of the meet/beat premium should be positively related to the magnitude of disagreement over mispricing in the preannouncement period.⁷ Unfortunately, it is extremely difficult to identify the degree of disagreement over market misreactions within specific securities. Instead, we utilize preannouncement price momentum portfolios as a tangible measure to identify securities where a disagreement over a misreaction is more likely. To strengthen the measure we develop the portfolios using momentum that is adjusted for the release of any fundamental information (i.e. momentum unrelated to fundamental news released during the preannouncement period).⁸

Our findings are consistent with a strong positive association between the magnitude of the meet/beat premiums and the magnitude of the pre-announcement price momentum. For example, firms in the top decile of preannouncement price momentum have meet/beat premiums that are approximately 5 times larger than the premiums for firms in the bottom decile. Additionally, our results are consistent with the meet/beat signals varying temporally with pre-announcement price momentum, and we find larger premiums in periods of extreme pre-announcement price momentum (i.e. dot-com period and the more recent 2007–2008 financial crisis period).

We also find larger meet/beat premiums in negative momentum stocks, which we attribute to slower information diffusion rates in negative news firms. Slow rates of information diffusion have also been positively associated with market misreactions ([Hong and Stein 1999](#)). Overall, our findings are consistent with meet/beat signal resolving disagreement concerning whether a prior price movement was a

misreaction.

Finally, given that momentum is an observable phenomenon, we investigate whether managers' incentive to just meet (beat by 1 cent or less) analysts' expectations increases when momentum is present. Our results are consistent with managers' being more likely to just meet in the presence of preannouncement momentum. As stated earlier, despite an extensive body of research that documents firms receive a market equity premium for meeting/beating analysts' earnings expectations,⁹ the basis for the meet/beat premium remains largely unexplained. Our findings provide some insight as to why firms receive premiums (penalties) for meeting/beating (missing) market expectations even after controlling for the unexpected news in earnings.

Our study also has implications for findings reported in [Koh et al. \(2008\)](#) that the market premium for meeting or just beating (by one penny or less) forecasted EPS completely disappeared, and the premium for beating forecasted EPS by more than a penny greatly diminished following the accounting scandals in 2001–2002.¹⁰ [Koh et al. \(2008\)](#) demonstrate empirically that the diminished premiums after the accounting scandals are not related to declining earnings quality and thus conclude that the decline was possibly the result of unwarranted skepticism of earnings reported by just meet and beat firms. We document that these premiums returned in the presence of strong pre-announcement price momentum during 2007 and 2008. Further, we show that the disappearance and reappearance of the just meet premium is strongly associated with the level of pre-announcement price momentum, suggesting an additional explanation for its disappearance.

The findings in this paper should appeal to a wide audience. The just meet and beat premiums are important given that they offer managers a strong incentive to avoid missing analysts' expectations ([Graham et al. 2005](#)). Further, scholars have suggested that the premium was the primary driver behind the accounting scandals of the early 2000s ([Jensen et al. 2004](#)). We provide evidence consistent with larger premiums in the presence of pre-announcement price momentum and managers being aware of the importance of meeting/beating expectations when these market conditions exist. Our findings should therefore be of interest to auditors, regulators, investors, academics, or anyone else interested in understanding how market conditions affect investors' reactions to earnings announcements and managers' incentives to manipulate reported accounting numbers.

Finally, our study should also appeal to academics interested in the intersection of behavioral finance theory and accounting information events. This area of research has received less attention in the academic literature as research focused on security valuation has generally operated under the assumption that accounting events provide useful information to investors from a purely fundamental perspective (i.e. predicting future earnings and assessing risk). However, given the extreme market volatility and frequency of asset bubbles in the last decade, an investigation into how mispricing can affect the interpretation of accounting events may serve as a fruitful avenue for future research.

The remainder of the paper is organized as follows. [Section 2](#) provides background, theoretical development, and related empirical predictions. The research design related to the primary analysis is outlined in [Section 3](#). Data and descriptive statistics are presented in [Section 4](#). Results related to the primary analysis are presented in [Section 5](#) with [Section 6](#) providing a temporal analysis of the meet/beat premiums. [Section 7](#) investigates managers' incentives to meet or just meet analysts' expectations when momentum is present. [Section 8](#)

⁵ The idea of why momentum moves security prices away from their intrinsic values is expressed simply in [Keynes' \(1936\)](#) famed beauty contest analogy, where judges are more focused on the beliefs of the other judges than the actual beauty of the contestants. As such, the judges are most interested in picking the winner instead of the most beautiful contestant. Keynes applies this analogy to financial markets arguing that individuals do not pick a stock based on what they think it is worth, but rather on what they think other people think it is worth.

⁶ Accounts from hedge fund managers during the technology bubble clearly portray this exit-timing problem. For example, Stanley Druckenmiller, manager of George Soros's 8.2 billion Quantum fund, was asked why he didn't get out of technology stocks despite knowing that the sector was overvalued, he replied "We thought it was the eighth inning, and it was the ninth". Mounting losses forced Druckenmiller to step down as fund manager in April 2000. However, not playing in this irrational market is not always a solution. Julian Roberts, manager of the legendary Tiger Hedge Fund, refused to invest in the technology sector because he believed that it was overvalued. The Tiger Fund was dissolved in 1999 because its returns underperformed the returns generated by dot-com stocks. *New York Times*, April 29, 2000, "Another Technology Victim; Top Soros Fund Manager Says He 'Overplayed' Hand."

⁷ A more severe misreaction will lead to a more severe correction and thus a larger meet/beat premium.

⁸ This method is discussed in [Section 3.2](#).

⁹ For examples see [Barth et al. \(1999\)](#); [DeFond and Park \(2001\)](#); [Bartov et al. \(2002\)](#), [Givoly, and Hayn \(2002\)](#); [Kasznik and McNichols \(2002\)](#); [Lopez and Rees \(2002\)](#), [Skinner and Sloan \(2002\)](#).

¹⁰ Examples of major accounting scandals during this period include Enron, WorldCom, Adelphia, HealthSouth, McKesson, Tyco, and Qwest.

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