

Economic Incentives for Analysts Play Role in Determining Street Earnings

November 6 2008

Even though investors use street earnings as a key valuation measure, little is known about analysts' rationale when determining street earnings. Street earnings are an adapted version of earnings based on modifications that are decided on a firm-by-firm basis and reflect analysts' decisions to include or exclude certain expenses. In a new study, a University of Missouri researcher found that analysts' self-interests often influence the value of street earnings, which makes street earnings less useful for predicting future earnings of high-growth stocks.

“Decisions when calculating street earnings are quite subjective,” said David B. Farber, assistant professor of accountancy in the MU Robert J. Trulaske, Sr. College of Business. “We found that analysts' economic incentives are associated with the adjustments made when deciding street earnings. When analysts are more optimistic toward glamour stocks, more trade and investment banking business is generated.”

Using detailed data on analysts' inclusion and exclusion decisions on nonrecurring expense items, Farber found that street earnings for glamour stocks (stocks that appear to have high-growth potential) were more upwardly biased than street earnings for values stocks (stocks that tend to trade at a low price relative to their fundamentals). Expenses for glamour stocks that should be included in street earnings were, instead, excluded.

“Analysts are more likely to exclude expense items when determining street earnings for glamour stocks than for value stocks,” Farber said.

“Although we argue that analysts have an economic incentive to be biased toward street earnings of glamour stocks, we cannot establish whether the observed bias is intentional. Also, several agents play roles in the determination of street earnings, so we cannot attribute all of the bias to analysts.”

The study, “Analysts’ Incentives and Street Earnings,” has been accepted for publication in the Journal of Accounting Research and is co-authored by Bok Baik of Seoul National University and Kathy Petroni of Michigan State University.

Provided by University of Missouri

Citation: Economic Incentives for Analysts Play Role in Determining Street Earnings (2008, November 6) retrieved 26 April 2024 from <https://phys.org/news/2008-11-economic-incentives-analysts-role-street.html>

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