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The Effect of Analysts Forecast Distribution on Market Reaction to Earnings Announcements and Forecast Revisions

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ABSTRACT

Previous research has documented that the magnitude of capital market reaction to an earnings announcement is related to the magnitude of earnings surprise, where earnings surprise is defined as the difference between the actual earnings and the consensus analysts' earnings forecast (consensus forecast error). If multiple analysts follow a firm and have differing earnings predictions, and if analysts are viewed as a proxy for the distribution of beliefs in the market about a firm, one would predict that the magnitude of market reaction to an earnings announcement will depend not only on the consensus forecast error but also on the number of individual analysts forecasts the firm beats or misses. For example, if a firm is followed by five analysts with five different earnings forecasts, and if the actual earnings of the firm beats (misses) the consensus forecast, the market reaction to the earnings announcement would be stronger (after controlling for consensus forecast error) if the actual earnings beat (missed) all five forecasts than if the firm beat (missed) only three of the five forecasts. Using data from 1995 to 2010, I find evidence consistent with this prediction. I also find that after controlling for consensus forecast error, the market reacts more strongly to an earnings announcement if a firm beats (misses) more recent forecasts. Furthermore, I find that the consensus forecast revision for the next quarter is positively related to the proportion of forecasts that beat or missed the actual earnings for the current quarter. Finally, I find that the results are stronger in the post Reg-FD period relative to the pre Reg-FD period.