Book Reviews

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Even though all three authors of this manuscript are recognized for their seminal contributions to the research on sell-side analysts and the properties and impact of these analysts’ research and forecasts, the manuscript is not a review of this rich literature. Rather, it focuses on the evidence pertinent to the questions of “whether, how, and under which circumstances sell-side research contributes to the functioning of capital markets” (p. 3). The authors propose that, despite the vast body of empirical research on the information produced by financial analysts and their role in the capital markets, there are important unanswered questions. The authors provide numerous suggestions for future research to address these questions, but at the same time are careful to alert researchers to potential pitfalls and difficulties in dealing with them.

The manuscript contains 11 relatively brief chapters. The introductory chapter provides a review of the players in the capital markets and a roadmap of the manuscript, and the last chapter contains a summary. Each of the other nine chapters provides the reader with a different aspect of the work of sell-side analysts, ranging from the institutional and regulatory environment in which the analysts operate, through the information sources they use and the products they generate, to their role in the capital markets and the effect of recent regulatory changes on their activities.

The authors add their own insights to the discussions and further highlight areas in which the empirical evidence is scant as having potential for future research. For example, in Chapter 4 (“Information Sources”), after describing the diversified sources of information used by analysts, the authors discuss the evidence on the effect of the extent of information about the firm on the “supply” of analysts’ coverage and products. They point to the reverse effect, namely, the effect of the “demand” by analysts for information and a firm’s propensity to supply it, and suggest the examination of “more linkages among analyst coverage, information, and benefits to firms and capital markets” (see p. 24) as an area of promising future research. Another example from this chapter is the discussion of how analysts are monitored and evaluated by the market and by their employers. Direct evidence for this question is difficult to obtain. There is, however, an extensive body of empirical studies that address the question indirectly. The conclusions reached by this research are inferred from associations between analysts’ performance measures and an assortment of explanatory variables (e.g., between accuracy and turnover [see Mikhail, Walther, and Willis 1999]), between achieving all-star status and stability and consistency in the forecast error [see Hilary and Hsu 2013], or between success in being hired by a prestigious brokerage house and forecast accuracy and bias [see Hong and Kubik 2003]). The authors note some direct evidence regarding how banks evaluate their analysts’ performance (which is based, in part, on the number of downloads of their research by clients [see p. 17]). Even though this evidence is merely anecdotal, it adds to our understanding of how analysts’ performance is evaluated. More anecdotal evidence of this nature as well as evidence in the form of survey results, which is arguably more powerful, are needed to supplement the archival research. Below, I review selected chapters of the manuscript.

A chapter that I particularly like is Chapter 3, “Day-to-Day Responsibilities and Career Trajectory.” It is not directly related to the main theme of the manuscript (the role of analysts in making the capital market efficient) but rather to the “workplace scene” of sell-side analysts. In this chapter, the authors describe the daily routine and schedule of sell-side analysts, their typical career path, their compensation structure, the hierarchy of their potential employers, the different ranks of seniority in this position, and the career of sell-side analysts after they depart this profession. Even though I have conducted research on sell-side analysts, some of the information in this chapter was new to me. For example, I did not know that the typical analysts’ weekly workload does not consist of five “9 to 5” working days but rather of six to seven working days that often extend from...
7 a.m. to 9 p.m., for a work week of 60–70 hours (see p. 12). Clearly, familiarity with this background information is very helpful to anyone conducting research on analysts and their incentives.

Chapter 5, “Nature of the Information Analysts Generate,” deals with two topics—the importance of qualitative information (e.g., assessment of management capabilities, opinions about industry developments) contained in analysts’ reports as opposed to the quantitative information that they produce (e.g., earnings forecasts or target prices) and the manner in which analysts’ research reports and products are disseminated. Both issues are of interest to researchers, but they do not appear to be directly related so I found that lumping their discussion within one chapter to be a bit confusing.

In Chapter 5, the authors discuss a number of papers (Asquith, Mikhail and Au 2005; Huang, Zang and Zheng 2014; Tweedt and Rees 2012) that innovatively use textual analysis to assess the extent to which analysts’ reports convey qualitative information and how this type of information affects investors’ reactions to the reports. The authors provide a list of intriguing research questions that are left open for future research.

The chapter also highlights two aspects that relate to the dissemination of analysts’ research. One is the timing of the research releases, which is not identical across all users: preferred clients receive the information earlier than others (including I/B/E/S). The authors call for further research on the hierarchy or “pecking order” of the consumers of analysts’ work. Another dissemination issue addressed in the chapter is seldom recognized by researcher—the fact that the I/B/E/S database does not completely represent the full research production by analysts. This occurs because some analysts do not contribute their research or their full research output to I/B/E/S. The authors further mention the possibility that was raised by Ljungqvist, Mallory, and Marston (2009) of a more sinister reason for the incompleteness of I/B/E/S data—it’s censoring by its own data provider.

Chapter 6, “Research on Analyst Roles in Capital Markets,” centers on the main theme of the manuscript and, appropriately, it is the longest chapter in the manuscript. In this chapter, the evidence on the relative weight of the contribution of analysts to the market efficiency of each of their three functions—as interpreters, generators (or discoverers), and disseminators of information—is discussed. The authors describe a number of studies that use innovative and clever empirical designs to produce evidence on that issue. Among those studies are Daniel, Lee, and Naveen (2016) and Huang, Lehavy, Zang, and Zheng (2017) who use textual analysis, and Francis, Schipper, and Vincent (2002), Ivkovic and Jegadeesh (2004), and Livnat and Zhang (2012) who examine the market responses to earnings announcements or analysts’ revisions.

I would add another open and interesting research question: To what extent are analysts able to detect earnings management and alert investors to it? The scant evidence available suggests that, like the market as a whole, analysts are unable to detect earnings management (or perhaps unwilling to share such detection publicly). The evidence that points to this conclusion includes Bradshaw, Richardson, and Sloan (2001) and Givoly, Hayn, and Yoder (2011). Bradshaw et al.’s (2001) results show that analysts do not incorporate in their earnings forecasts the predictable reversal of high accruals in future earnings. This finding suggests analysts’ failure to detect earnings management, at least through accruals. Givoly et al. (2011) provide more direct evidence, which shows that analysts’ forecasts and stock recommendations for firms that subsequently restate their currently reported earnings do not appear to consider the presence in current earnings of a managed earnings component, that is, the component of currently reported earnings that would be erased by a subsequent restatement. Extending this research, either by analyzing analysts’ research reports and communication in the periods preceding the discovery of accounting shenanigans or by conducting a survey among analysts about their skills in, and perceived role in, identifying instances of earnings management, would contribute to our understanding of the interpretational and discovery roles of analysts.

The fact that very few, if any, of the many accounting irregularities are detected and exposed publicly by sell-side analysts may be a reflection of career concerns by these analysts, which brings me to the discussion in Chapter 7 on the “Classic Arguments about Conflicts of Interest.” The evidence on apparent conflicts of interests summarized by the authors include the well-documented optimistic bias in earnings forecasts made early in the forecast period, the walk-down of these forecasts as the period progresses, the greater optimism regarding stock-issuing firms by analysts of brokerage houses affiliated with the stock issuer (Lin and McNichols 1998), and the greater timeliness in upgrades than downgrades in analyst recommendations (O’Brien, McNichols, and Lin 2005). The authors rightly point to the issue of endogeneity (e.g., the brokerage houses associated with the underwriting of stock issues may be genuinely optimistic about the future of the issuing firms). While it is difficult to completely rule out such endogeneity as a driver of the results, the preponderance of the evidence as well as the fact that most studies try to address this issue (within the limitations of the data) render the conclusion that sell-side analysts are inherently conflicted as fairly compelling.

Several recent studies, which are not mentioned in this chapter, provide further evidence suggesting that, due to career concerns, analysts who are eying an upward move in their careers are optimistically biased toward their future employees. Lourie (2017) documents instances in which analysts who accept positions with one of the firms that they have been recently covering do not disclose their career moves in the period during which they were likely negotiating these moves. Further, using this sample of “revolving door” analysts, he finds that during this pre-move period, analysts issue research reports on their soon-to-be employing firms that are optimistic relative to their peer analysts, optimistic relative to their own past assessments of
the firms, and optimistic relative to their assessments of other firms in the same industry. J. Cornaggia, K. Cornaggia, and Xia (2016) examine a sample of “revolving door” credit analysts who left their positions to join firms that are, primarily, in the financial services industry. They find that the rating agencies that employed these analysts issued credit ratings that were more favorable in the year before the analysts’ departures relative to the ratings issued by other credit rating agencies. Horton, Serafeim, and Wu (2017) find that throughout their careers, analysts who cover banks employed by low- and mid-tier brokerage houses “walk-down” their earnings forecasts for more prestigious employers: banks that have sell-side equity departments.

Do sell-side analysts, despite their shortcomings and biases, add value to the capital markets? This is the subject of the discussion in Chapter 10. The evidence brought to bear on this question is primarily in the form of the effect of the extent of analysts’ coverage on the amount of firm-unique information, the firm’s cost of capital, and the asymmetry of information. This evidence shows that initiation of analysts’ coverage is associated with a decreased stock price synchronicity (Crawford, Roulstone, and So 2012), and that termination of coverage results is associated with negative consequences (such as higher bid-ask spreads and a decrease in the trading volume by institutional owners [see Mola, Rau, and Khorana 2013]). Similar to other topics of research on analysts discussed in the manuscript, the authors highlight the need for (and opportunities to undertake) further research to resolve conflicting results and address the pervasive problem of endogeneity that arises in this setting because the initiation and termination of analysts’ coverage is likely associated with other concurrent changes in the fundamentals of the firm.

In summary, this thoughtful manuscript provides useful content for accounting and finance researchers, investors, regulators of the capital markets, and particularly of market intermediaries. It is, further, indispensable reading for serious researchers of analysts’ products or those who use analysts’ research (forecasts, recommendations, target prices) in conducting their own research.

REFERENCES


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