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Determinants of the informativeness of analyst research[☆]

Richard Frankel[a], S.P. Kothari[b,*], Joseph Weber[b]

[a]Olin School of Business, Washington University in St. Louis, St. Louis, MO 63130-6431, USA
[b]Sloan School of Management, Massachusetts Institute of Technology, Cambridge, MA 02142, USA

Abstract

We examine cross-sectional determinants of the informativeness of analyst research, i.e., their effect on security prices, controlling for endogeneity among the factors affecting informativeness. Analyst reports are more informative when the potential brokerage profits are higher (e.g., high trading volume, high volatility, and high institutional ownership) and lower when information processing costs (e.g., more business segments) are high. We also find that the informativeness of analyst research and informativeness of financial statements are complements.

JEL classification: G12; G14; M4

Keywords: Analyst's forecasts; Capital markets; Informativeness

1. Introduction

We study the determinants of the magnitude (i.e., absolute value) of stock price reaction to analyst reports. We define the informativeness of an analyst report (referred to in the paper as AI, analyst informativeness) as the average magnitude of a firm's stock price

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*Corresponding author. Tel.: +1 617 253 0994; fax: +1 617 253 0603.
E-mail address: kothari@mit.edu (S.P. Kothari).

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reaction to analysts' reports in a given year. Our measure of informativeness is related to the variance measure of informativeness of earnings reports pioneered by Beaver (1968) and used in subsequent research (see Landsman and Maydew (2002), and Francis et al., (2002) for recent applications).

Much of previous research studies the informativeness of consensus forecast, whereas our primary focus is on examining the average price impact of *individual* analyst reports and determinants of the informativeness of a report.[1] Such research on the informativeness of analyst reports is important for several reasons. First, recently voiced concern about the integrity and objectivity of analysts in the academic literature and in the financial press raises skepticism about the informativeness of analyst research. Our analysis of the informativeness of analyst reports is helpful in ascertaining whether and how much price-sensitive information exists in a typical analyst report.[2] Second, analysts as information providers in capital markets decide on which firms to follow and how many reports to issue on each firm. By investigating the determinants of analyst informativeness (AI) we examine whether the incentive to provide informative reports influences analysts' decisions to follow a firm. Finally, previous research suggests that there is also demand for analysts to simply repackage and re-transmit and also to interpret corporate disclosures to generate investment banking and brokerage business, potentially making analyst reports less informative. The net effect of the aforementioned three reasons on the average informativeness of analyst reports is an empirical issue. Moreover, cross-sectional variation in the informativeness of the reports is determined by multiple factors, with some of those being endogenous, the focus of our study.

Our examination of the determinants of cross-sectional variation in AI is similar to examining why some firms' returns are more volatile than others. Clearly, event-specific factors cause price movements and therefore return volatility, but in explaining differences in volatility one seeks to understand why news comes in larger doses for some firms and in smaller doses for others. Our study provides evidence on why for some firms the average magnitude of news in analyst reports is greater than that for others.

Previous research has typically examined the relation between analyst following and firm characteristics under the assumption that analyst-following proxies for the resources devoted to information collection and thus the informativeness of analyst reports (see Bhushan, 1989a, O'Brien and Bhushan, 1990; Lang and Lundholm, 1996; Hong et al., 2000). Unlike prior research, we do not assume that the richness of the information set attributable to analysts is automatically an increasing function of the number of analysts following for a firm. We examine analyst following as one factor among many that can positively or negatively influence the informativeness of analyst reports. In addition, our

[1] Lys and Sohn (1990) is an exception, but they also do not directly focus on estimating analyst informativeness.

[2] Note that in an efficient market, analyst reports that lack integrity and objectivity are likely to be less informative. However, if market participants are assumed to fixate on or under- or over-react to analyst reports, then analyst research would appear informative (i.e., generate a stock-price reaction), but it would also cause returns to be predictable—contrary to market efficiency. In recent years, behavioral finance theory has gained acceptance among academics and practitioners, and thus hypothesis assuming market inefficiency should also be considered. Return-predictability tests that are designed to discriminate between analyst informativeness in efficient markets and under/overreaction are beyond the scope of this study. Preliminary analysis conducted in an earlier version of the paper suggest lack of return predictability, which is consistent with analyst informativeness as if market participants filter out irrelevant and misleading information in analyst report.