

## **The Dispersion in Analysts Earnings Forecasts and the Relative Importance of Earnings and Book Value in Equity Valuation**

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In this study we examine a condition under which current earnings may not be a good indicator of future earnings. This condition is high uncertainty in future earnings in the form of high dispersion in analysts' earnings forecasts. We use I/B/E/S analysts' one-year-ahead earnings forecasts to proxy for market participants' expected future earnings and to make inference on the informativeness of current earnings. We speculate that high uncertainty in future earnings translates into a reduced role of current earnings in explaining contemporaneous equity price and an increased incremental ability of book value (beyond current earnings) to explain equity price. Our results support this speculation. When the diversity of opinion about future earnings is low, current earnings is perceived by market participants as a good value indicator. In this case, book value adds very little beyond current earnings in explaining market prices of equity stocks. On the other hand, when the diversity of opinion about future earnings is high, current earnings does not explain as much of the variation in equity price; instead, book value plays a much more important role in equity valuation. Additional tests show that these results are not driven by the concentration of negative earnings observations and small firms in our high forecast dispersion portfolio.

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### **INTRODUCTION**

Assessing firm value is obviously an important task for the investment community. Also, valuation is a fast-growing service provided by forensic accountants. The answer to the question of what is a business worth can have a variety of applications. For example, attorneys frequently desire to value privately held businesses in divorce settlements on behalf of clients. In addition, valuation services are performed for a variety of other reasons, including shareholder disputes, mergers and acquisitions, insurance claims, and bankruptcy cases. The forensic accountant, therefore, must be well trained in business valuation theory including the determinants of equity value.