**Earnings Forecasts: A Primer**

By BEN MCCLURE Updated June 26, 2022

***Investopedia*** *https://www.investopedia.com/articles/stocks/06/earningsforecasts.asp#:~:text=To%20predict%20earnings%2C%20most%20analysts,factors%20that%20influence%20corporate%20growth.*

Reviewed by THOMAS BROCK

Fact checked by HANS DANIEL JASPERSON

Anyone who reads the financial press or watches financial news on television will have heard the term "beat the street," which really just means to beat Wall Street earnings forecasts. Wall Street analysts' consensus earnings estimates are used by the market to judge stock performance. Here we offer a brief overview of the consensus earnings and what they mean to investors.

**KEY TAKEAWAYS**

* Large brokerages hire a slew of analysts to publish reports on various corporations upcoming profit reports, including earnings-per-share and revenue forecasts.
* Consensus earnings estimates refer to the average or median forecasts of a group of analysts as to what a company is expected to earn or lose in a given period of time, typically quarterly and annually.
* While there are some flaws in the system, consensus estimates are perceived as significant in terms of understanding a stock's valuation and are monitored by investors and the financial press.
* Whether a company meets, beats or misses forecasts can have a huge impact on the price of the underlying stock, particularly in the short term.

**What Are Consensus Earnings?**

Consensus earnings estimates are far from perfect, but they are watched by many investors and play an important role in measuring the appropriate valuation for a stock. Investors measure stock performance on the basis of a company's earnings power. To make a proper assessment, investors seek a sound estimate of this year's and next year's earnings per share (EPS), as well as a strong sense of how much the company will earn even further down the road.

That's why, as part of their services to clients, large brokerage firms—the sell side of Wall Street and other investment communities—employ legions of stock analysts to publish forecast reports on companies' earnings over the coming years.

A consensus forecast number is normally an average or median of all the forecasts from individual analysts tracking a particular stock. So, when you hear that a company is expected to earn $1.50 per share this year, that number could be the average of 30 different forecasts. On the other hand, if it's a smaller company, the estimate could be the average of just one or two forecasts.

A few companies, such as Refinitiv and Zacks Investment Research, compile estimates and compute the average or consensus.

Consensus numbers can also be found at a number of financial websites such as Yahoo! Finance. Estimates are found by looking up individual stocks, for example, Amazon.

Some of these sites also show how estimates get revised upward or downward.

Consensus earnings estimates are not fixed—analysts will typically revise their forecasts as new information comes in, such as company news or regulatory or industry-specific information.

**What Time Period Is Covered?**

Consensus estimates of quarterly earnings are published for the current quarter, the next quarter and so on for about eight quarters. In some cases, forecasts are available beyond the first few quarters. Forecasts are also compiled for the current and next 12-month periods.

A consensus forecast for the current year is reported once the actual results for the previous year are released. As actual numbers are made available, analysts typically revise their projections within the quarter or year they are forecasting.

Even the most sophisticated investors, including mutual fund and pension fund managers, rely heavily on consensus estimates. Most of them do not have the resources to track thousands of publicly-listed companies in detail, or even to keep tabs on a fraction of them, for that matter.

**Why Focus On Earnings?**

Many investors rely on earnings performance to make their investment decisions. Stocks are assessed according to their ability to increase earnings as well as to meet or beat analysts' consensus estimates. This influences a company's implicit value (i.e., the personal perceptions and research of investors and analysts), which in turn can affect whether a stock's price rises or drops.

The basic measurement of earnings is earnings per share. This metric is calculated as the company's net earnings—or net income found on its income statement—minus dividends on preferred stock, divided by the number of outstanding shares. For example, if a company (with no preferred stock) produces a net income of $12 million in the third quarter and has eight million shares outstanding, its EPS would be $1.50 ($12 million/8 million).

So, why does the investment community focus on earnings, rather than other metrics such as sales or cash flow? Any finance professor will tell you the only proper way to value a stock is to predict the long-term free cash flows of a company, discount those free cash flows to the present day and divide by the number of shares. But this is much easier said than done, so investors often shortcut the process by using accounting earnings as a "good enough" substitute for free cash flow. Accounting earnings certainly are a much better proxy for free cash flow than sales. Besides, accounting earnings are fairly well defined and public companies' earnings statements must go through rigorous accounting audits before they are released. As a result, the investment community views earnings as a fairly reliable, not to mention convenient, measure. (To read more, see: Getting The Real Earnings.)

**What's the Basis of Analysts' Forecasts?**

Earnings forecasts are based on analysts' expectations of company growth and profitability. To predict earnings, most analysts build financial models that estimate prospective revenues and costs.

Many analysts will incorporate top-down factors such as economic growth rates, currencies and other macroeconomic factors that influence corporate growth. They use market research reports to get a sense of underlying growth trends. To understand the dynamics of the individual companies they cover, really good analysts will speak to customers, suppliers and competitors. The companies themselves offer earnings guidance that analysts build into the models.

To predict revenues, analysts estimate sales volume growth and estimate the prices companies can charge for the products. On the cost side, analysts look at expected changes in the costs of running the business. Costs include wages, materials used in production, marketing and sales costs, interest on loans, etc.

Analysts' forecasts are critical because they contribute to investors' valuation models. Institutional investors, who can move markets due to the volume of assets they manage, follow analysts at big brokerage houses to varying degrees.

*Consensus estimates are so consistently tracked by so many stock market players that when a company misses forecasts, it can send a stock tumbling; similarly, a stock that merely meets forecasts might get sent lower, as investors have already priced in the in-line earnings*.

**What Are the Implications for Investors?**

Consensus estimates are so powerful that even small deviations can send a stock higher or lower. If a company exceeds its consensus estimates, it is usually rewarded with an increase in stock price. If a company falls short of consensus numbers—or sometimes if it only meets expectations—its share price can take a hit.

With so many investors watching consensus numbers, the difference between actual and consensus earnings is perhaps the single most important factor driving share-price performance over the short term. This should come as little surprise to anyone who has owned a stock that "missed the consensus" by a few pennies per share and, as a result, tumbled in value.

For better or for worse, the investment community relies on earnings as its key metric. Stocks are judged not only by their ability to increase earnings quarter over quarter but also by whether they are able to meet or beat a consensus earnings estimate. Like it or not, investors need to keep an eye on consensus numbers to keep tabs on how a stock is likely to perform.