SESSION 1: FINANCIAL ACCOUNTING AND REPORTING
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Using Imputed Earnings Forecasts from Residual Income Valuation to Estimate the Implied Risk Premium

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ABSTRACT: In this paper, the residual income valuation model is used to impute earnings forecasts. These earnings forecasts are compared to the corresponding actual earnings to derive earnings forecast errors, which are in turn used to estimate the implied equity risk premium. The implied equity risk premium is the assumed risk premium in the residual income valuation model that gives a zero earnings forecast error. In contrast to other approaches, the methodology used in this paper to estimate the equity risk premium with the model does not require analysts' earnings forecasts as an input. This is a major advantage because analysts' earnings forecasts are known to be biased upward, which biases the equity risk premium upward. Also, analyst forecast information is not available for many firms. The results convey that the equity risk premium is close to zero, which is much lower than the average equity risk premium based on historical stock and bond returns and significantly lower than the estimated premium found in a number of recent studies. The close to zero equity risk premium is more in line with findings in Mehra and Prescott (1985).