Roundtable on Corporate Disclosure

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Photographs by Yvonne Gunner, New York

Don Chew: Good afternoon and welcome to this third and last part of the National Corporate Finance Forum's annual conference. I'm Don Chew, editor of the *Journal of Applied Corporate Finance,* and I'll be serving as moderator.

Our topic is corporate disclosure. This may not sound very exciting—a lot of you may be thinking you're in for yet another primer on Sarbanes-Oxley—but let me start by saying that most of what you'll hear this afternoon has very little to do with regulatory compliance. The big news here is that, partly in response to Reg. FD and Sarbanes-Oxley, U.S. companies are now experimenting with disclosure in interesting ways. And the main message I hope you carry away from this session is that, at least for well-run companies, corporate disclosure may represent an opportunity to add value. Even for companies that are not so well run, better disclosure could end up increasing value by providing a catalyst for change.

Let me say a bit more about why I think companies should view disclosure as an opportunity rather than a burden. My former employer, Stern Stewart, is the popularizer of a measure of corporate performance called economic value added, or EVA. The main reason for a company to use EVA is that the most widely used performance measures—earnings and earnings per share—have some serious flaws as guides to corporate decision-making. As any financial manager will tell you, there are lots of ways for companies to increase next quarter's earnings that end up destroying value. In fact, George Benston, my first accounting professor at the University of Rochester in the late '70s, recently came out with a study showing that almost all of Enron's off-balance-sheet shenanigans were in compliance with the letter of GAAP accounting.

Another reason I'm excited about recent trends in disclosure has to do with my job for the past 24 years as editor of the *JACF.* The aim of the journal has been to communicate to corporate managers the practical uses of the best research in finance, most of which is being done by academics in business schools. And for purposes of this discussion, there are two important premises underlying most of the recent work.

The first is that notwithstanding the Modigliani and Miller irrelevance propositions that many of us were taught in business school, the corporate finance function does have significant potential to add value. How management evaluates the company's investment opportunities, how it chooses to fund those investments, whether it chooses to lay off major risks, how it evaluates the performance of the business units and rewards its employees, and what it chooses to tell investors—all of these things can end up having major effects, good or bad, on long-run profitability and value.

The second major premise underlying most of the research is that financial markets are efficient, or at least reasonably so. They're clearly not perfect. As our recent NASDAQ experience suggests, some prices can get out of line for quite a while. But I think it's fair to say that the *marginal* price-setters in our markets—and by that I mean the most sophisticated institutional investors and certain kinds of hedge funds—are generally pretty shrewd judges of corporate performance and value.

One implication of a reasonably efficient market is that in cases where GAAP earnings do a poor job of representing a company's long-run value, there are other ways for management to communicate that value to investors. One very effective way is just to offer to buy back stock. But for companies that need *all* their capital to grow, the main opportunity for communicating management's confidence about the future may be to commit to expanded disclosure and try to engage investors in a more strategic dialogue.

To discuss this possibility, we've assembled a panel that includes three senior corporate executives, a former accounting professor who now plays a major role in sell-side equity research at Morgan Stanley, a representative of the buy side, and three distinguished academics, including a former chief economist of the SEC. And before I go any farther, let me briefly tell you who the panelists are:

Joe Willett was, until his retirement two years ago, part of the senior management team of Merrill Lynch. Joe was Chief Financial Officer from 1993 to 1998, and he was Chief Operating Officer of Merrill's operations in Europe, Asia, and Africa from 1998 until his retirement in 2002.

Rick Passov is Vice President and Treasurer of Pfizer, Inc., and one of the principal organizers of this event. Before joining Pfizer in 1997, Rick worked in the treasury group at Intel.

Tom King is Treasurer of Progressive Insurance. Progressive, as you will hear, is a company that lives up to its name not only in underwriting insurance and servicing claims, but in the area of disclosure as well.

Trevor Harris is a Managing Director and head of the global valuation and accounting group in Morgan Stanley's

Equity Research Department. In the not-too-distant past, Trevor was a tenured professor of accounting at Columbia University's Graduate Business School.

John Graham is Professor of Finance at Duke University's Fuqua School of Business. John and two of his colleagues recently conducted a survey of some 400 U.S. managers on corporate disclosure policy. The findings of that survey, which have been cited in newspapers like the *Wall Street Journal* and the *New York Times,* will provide some important material for this discussion.

Amy Hutton is Associate Professor of Business Administration at Dartmouth College's Tuck School of Business and, before that, Associate Professor at the Harvard Business School. In the past, most of Amy's research concerned the stock market's ability to process earnings reports and other accounting-based information. But in recent years, the main focus of her work has been innovations in corporate disclosure, including a case study of Progressive Insurance.

Erik Sirri is Professor of Finance at Babson College and was Chief Economist of the U.S Securities and Exchange Commission from 1996 to 1999.

Charles Kantor is a buyside analyst and portfolio manager with Neuberger Berman, which was recently acquired by Lehman Brothers. Charles was once a colleague of mine at Stern Stewart before he was lured away to attend the Harvard Business School.

The Argument

Chew: Now that I've introduced everyone, let me repeat my earlier statement that disclosure can be used to increase a company's value. And I want to start by saying that there is absolutely nothing new about this idea. It's been implied in the teachings of most reputable business schools since the late 1960s, and it's something that the principals of Stern Stewart have been preaching since the mid-'70s.

To put this thinking in a nutshell, public companies should be run in most ways as if they were private. They should not attempt to maximize, or smooth, near-term earnings; instead they should aim to maximize the net present value of future cash flows. How do they do this? By taking on all investments that are expected to earn more than the cost of capital, and by rejecting—or quickly putting an end to—all others. And when the application of this "present value rule" requires that near-term earnings be sacrificed for longer-term value, companies should make a serious effort to prepare the market and explain why earnings are going to be down.

If the company's strategy is credible and its investor relations people are doing a good job, then the market should respond to the message. Now, it's true that the momentum people holding your shares aren't going to be very happy. But the theory, at least as I read it, says that when the momentum traders leave, there will be other kinds of investors to take up the slack. And these may be the kind of people you want holding your shares in the first place.

All this, of course, is much easier said than done—and I can feel the skepticism of the corporate treasurers in this room. Most of your experience with the market has probably taken the form of meetings or conference calls with sell-side analysts who seem to care about *nothing but* next quarter's EPS. I would also guess that most of the companies represented here offer earnings guidance of some kind, and they may even manage earnings to meet the forecast. And we're talking not only about Enron and WorldCom; we're talking about America's most admired companies, including GE, which has just begun to shake off the earnings management habit it seems to have acquired under Jack Welch.

Why do companies manage earnings? For one thing, it's a lot easier to produce higher earnings with creative accounting or cutbacks in R&D than by increasing revenue or efficiency. For analysts, it's much easier to try to pinpoint next quarter's earnings, especially with some help from management, than to do the hard work of thinking strategically and projecting future cash flows. But there's more at work here than just taking the path of least resistance. As John Graham is going to tell us in a moment, most corporate managers seem to *believe* that the market wants them to manage earnings, and that investors are willing to pay up for the artificially smooth earnings stream that results from earnings management. And as John will also tell us, almost 80% of the executives in his survey said they'd be willing to sacrifice long-term value to report smoother earnings.

But are the managers right about the market? And even if the market does appear to pay more for smoothed earnings for a time, how long can the accounting fiction be sustained? What happens to the firm's credibility with investors when the string of earnings increases is broken? And besides loss of credibility, what other damage can management end up inflicting in the pursuit of steadily rising EPS?

One implication of a reasonably efficient market is that in cases where GAAP earnings do a poor job of representing the company's long-run value, there are other ways for management to communicate that value to investors. One very effective way is just to offer to buy back stock. But for companies that need all their capital to grow, the main opportunity for communicating management's confidence about the future may be to commit to expanded disclosure and engage investors in a more strategic dialogue.

Don Chew

In an article published two years ago in the *JACF* titled "Just Say No to Wall Street," ex-Harvard professor Michael Jensen and Joe Fuller, the CEO of the Monitor Group, urged companies to put an end to what they called the "earnings guidance game." And I'll just read you the opening paragraph.

First came whispers and informal advisories to favored analysts about what to expect in coming earnings announcements. Then the conversations became more elaborate, giving rise to a twisted kind of logic. No longer were analysts trying to understand the company and predict what they might earn; instead the discussion revolved around the analysts' forecasts themselves. Would expectations be met? What would management do to ensure that? Rather than the forecast representing a financial byproduct of the firm's strategy, the forecast came to drive those strategies. While the process was euphemistically referred to as earnings guidance, it was in fact a high-stakes game with management seeking to hit the target set by analysts, but being punished severely if they missed.

After describing a number of cases where earnings management had disastrous effects on corporate strategy, the article holds up as a model the public refusal by two CEOs, Jim Kilts of Gillette and Barry Diller of USA Networks (now InterActiveCorp), to provide analysts with estimates of future earnings. In place of earnings forecasts, Jensen and Fuller recommend that companies disclose information about their strategic goals and value drivers, and about the risks associated with carrying out those goals and management's plans to address those risks.

As I learned last fall from Tom King, who, as mentioned, is Treasurer of Progressive Insurance, some companies have been practicing this kind of disclosure for a long time. Progressive, as Tom will tell us, has never provided earnings guidance and for the past three years has been disclosing its operating P&L on a monthly basis, which has led the volatility of its stock price to drop by some 50%. The company has also produced a remarkably steady 15% rate of return for its shareholders since 1980, all without any attempt to manage earnings. What excites me about the Progressive story is that it may hold out a way for other companies to get out of the earnings guidance game, a way to break through the current

It surprised us to see such a high percentage of executives saying they would go for higher earnings rather than long-run value by cutting real investment. Also somewhat surprising was the reluctance to use aggressive accounting—for example, changing the assumptions underlying pension plan accounting—to boost earnings. I was puzzled by this finding because if you were able to persuade me that earnings management is a necessary evil, I would much rather see it carried out through accounting manipulation than cutbacks in real investment.

John Graham

impasse where managers distrust markets and markets distrust managers.

So with that as an introduction, I'll now turn the floor over to John Graham.

What Managers Think About Markets

John Graham: Thanks, Don. As Don mentioned, I recently collaborated with two colleagues, Cam Harvey at Duke and Shiva Rajgopal at the University of Washington, in conducting a survey on corporate practices in financial reporting. Survey research is by no means the standard academic approach these days; in fact it's sometimes looked down on in academic circles as "unscientific." The common attitude is that managers and investors can do very different things than what they say they do—and even if they do what they say, their real reasons for doing things can be different from the ones they cite.

But what I like about survey research, for all its limitations, is its ability to provide a bridge between theory and practice, between academics and corporate managers. For academics, we hope it shines a spotlight on some areas that need further research. For practitioners, our aim is to show what's going on in other companies and to encourage managers to reflect on common practices and, where there is clearly room for improvement, perhaps consider changing their company's practices.

In this survey, we asked corporate managers to tell us what they do in terms of both required financial reporting and voluntary disclosure—and why they do it. We asked them to comment on the importance of reported earnings and earnings benchmarks versus other possible measures of interest to investors. We asked them how and why they manage earnings—and under what circumstances, if any, they would be willing to sacrifice real value to hit an earnings target. We asked what happens to their stock price when they miss a consensus earnings number. How important are smooth earnings patterns? Do companies make voluntary disclosures—and, if so, why?

We sent out almost 4,000 questionnaires and ended up hearing from about 400 financial executives, giving us a respectable response rate of just over 10%. We also did 20 person-to-person follow-up interviews with responding CFOs and treasurers that each ran about an hour.

The first question in our survey was this: What's the most important metric to outsiders? Almost two-thirds of our managers said that some version of earnings is the most important number. Only 22% cited some kind of cash flow measure. Now, this is a little surprising to finance academics like me because we're always talking about cash flow as the ultimate source of value.

Which earnings benchmark is the most important? The most common answer was the previous year's same-quarter earnings, but a close second was the analyst consensus earnings estimate.

Why is meeting an earnings benchmark important? Well, the number one reason cited is to build credibility in the capital market. What executives mean by this is that when companies want to fund a new project, they want to be able to raise capital on economic terms. And if they're hitting their earnings numbers all along, they feel they're more likely to be trusted by the capital markets.

Another common reason for meeting earnings benchmarks is to maintain or increase the stock price—or at least to avoid the large negative reaction associated with missing an earnings target. Management's desire to maintain its reputation with the outside world also seems to be important, if only to help executives find their next job. Less important in managers' efforts to meet earnings targets, however, are some of the explanations put forth by academics, such as bonuses tied to earnings and the desire to avoid tripping debt covenants with minimum earnings and net worth provisions.

Why do managers think the market penalizes companies for failing to hit their earnings benchmarks? The dominant explanation is that this creates a lot of uncertainty about the firm's prospects. One popular variant of this explanation is that the failure to meet earnings targets suggests there are some previously unknown problems at the firm. We refer to this as "the cockroach problem." If you walk into a room and flip on a light and see a cockroach, you assume there are a lot more behind the wall. So the main concern expressed by most executives is that if they miss their earnings number, the outside world will say, "Almost everybody has enough flexibility to hit their earnings number; there must be big problems here."

The next set of questions had to do with earnings management. We asked what managers would do if they were coming towards the end of a quarter and were likely to miss their earnings number. Would they, for example, delay or cancel R&D, delay or cancel advertising, or delay maintenance to hit their earnings number? Fully 80% of the managers said they would reduce "discretionary" spending on R&D, advertising, or maintenance—and 55% said they would delay a project even if that meant sacrificing value. So there seems to be clear evidence here of a tension between delivering short-term earnings and making a positive-NPV investment. And, frankly, it surprised us to see such a high percentage of executives saying they would go for higher earnings rather than long-run value.

Also somewhat surprising to us was the reluctance of our respondents to use aggressive accounting—for example, changing the assumptions underlying pension plan accounting—to boost earnings. Our interpretation of this response is that it reflects a post-Enron effect. Either companies truly are less likely to do these things now, or they are no longer willing to admit to them in a survey. But I was puzzled by this finding—because if you were able to persuade me that earnings management is a necessary evil, I would much rather see it carried out through accounting manipulation than cutbacks in real investment.

Now let's talk about earnings smoothing. All else equal, managers would prefer that their companies have smooth rather than volatile cash flows. But the question is whether the market pays more for a smoother earnings stream, holding the volatility of the underlying cash flows constant.

The managers in our survey said that companies with smooth earnings are perceived to be less risky by investors, in part because smooth earnings make it easier for analysts and investors to predict the future. In fact, the executives said they want their analysts to be able to predict their earnings, and that such predictability reduces investors' required rate of return. Besides boosting the confidence of investors, smooth earnings are said to reassure customers and suppliers that the business is stable.

There was also the clear suggestion that a smooth earnings stream—and hence earnings management—could add value by reducing what the executives referred to as "information risk."

The market, according to these managers, places a lower P/E multiple on companies with volatile earnings; and the implication was that even an artificially smoothed earnings stream would lead to a higher multiple, regardless of the risk of the company's underlying cash flows.

To explore this implication, we followed with a very direct question: Would you sacrifice value to smooth your earnings? And as Don said earlier, 78% of the companies represented said they would sacrifice value. Now, about two-thirds of those executives said they would consider only "small" sacrifices in value, but the other third expressed willingness to consider "moderate" or even "large" ones.

The next set of questions concerned the relative importance of different kinds of investors in influencing the firm's stock price. Over half of the executives—in fact, 53%—said that the most influential group in setting their company's stock price is institutional investors. Another 36% said it is sell-side analysts. Virtually no one mentioned retail investors.

Up to this point, most of our questions have focused on mandated financial reporting. But lots of companies volunteer to provide additional information. So we asked our executives: Why do companies make voluntary disclosures?

The most-cited reason was to develop a reputation for transparent reporting. Again, it's all about building credibility. If I want to be able to convince you that I've got a little problem in the short term but my long-term prospects are good, I have to develop my reputation now for being forthright. Or to use a term I mentioned earlier, I can use voluntary disclosure to reduce "information risk," which translates into a higher P/E multiple and perhaps a lower cost of capital.

As we learned from follow-up interviews, part of the motivation for voluntary disclosure was to clarify some issues that are obscured by financial reporting. As a number of the CFOs commented, some of the footnotes to financial statements are so complicated that they don't see how most investors can possibly understand what's going on. And so they use voluntary disclosure to provide clarity where financial statements are largely meaningless.

Now, Don's mention of Progressive Insurance's disclosure policy raises another interesting question: Why don't companies just open their books and disclose everything, perhaps even on a real-time basis? The first reason is that companies are afraid of setting a disclosure precedent they can't stick to. If you provide some type of information this quarter, it's going to be a lot harder for you not to provide it next quarter. Another concern is giving away competitive secrets. Yet another is to avoid possible lawsuits; you don't want to put out information that can be used against you later. So companies are certainly willing to disclose more than they have to, but there are clearly limits.

To summarize, then, managers seem willing to sacrifice long-term value to meet short-term earnings targets and provide a smoother earnings stream. And most want to avoid missing an earnings target, for fear it will be interpreted as evidence of deeper problems. All this, as I've said, is somewhat surprising to academics steeped in the theory of efficient markets. But consistent with what we teach about the limits of GAAP statements as a guide to value, lots of managers use voluntary disclosures to reduce "information risk."

What Markets Do

Chew: Thanks, John. Now that John has told us what managers think about markets, Amy Hutton is going to give us an overview of recent academic research on how our markets respond to corporate disclosures. Amy, as I said earlier, is an associate professor at the Tuck School at Dartmouth, and she's been doing some very interesting work on corporate disclosure.

Amy Hutton: We've just heard John Graham say that corporate managers believe that investors are very focused on earnings per shares. What I'd like to share with you now are some findings in the academic finance and accounting literature that bear on this question of how markets work and what investors really want.

Going way back in the accounting literature, we've known for a long time—in fact, since the late '60s—that there are large reactions to earnings announcements. But we also know, from research that started in the early 1980s, that stock prices reflect a lot more information than just earnings. Indeed, finance theory, supported in part by this evidence, suggests that stock prices reflect information that affects investors' expectations about not just the next quarter's or the next year's earnings, but about earnings that go well into the future.

Now, as Don mentioned, I'm a professor of accounting, and I want to start by talking about an aspect of accounting called "revenue recognition." The principle of conservatism that informs most of GAAP accounting requires that companies not recognize revenue until it has

We need to think about the possibility that management's behavior—its practice of providing earnings guidance and then managing earnings to meet the forecast—has led to precisely the kind of market behavior that managers claim to be reacting to. By setting up and playing the "earnings guidance game," management may have validated an alternative governance mechanism that no economist approves of. After all, if the only piece of information that comes out of a firm in a given quarter is the earnings number, that's what outsiders are likely to focus on. By agreeing to participate in this signaling game with analysts, managements have given earnings a significance that at least long-run investors never wanted it to have. And that explains why the market responds to an earnings miss by pummeling the stock.

Amy Hutton

been earned and can be realized. So even if a company could forecast a big chunk of revenue with perfect certainty, it couldn't recognize it right away. But these revenues are very likely to be reflected in the company's stock price long before they show up on the P&L. As we like to tell our students, stock prices are forward looking, but earnings are backward looking—and because earnings are backward looking, they are useful only insofar as they allow investors to predict the future. So even if investors appear to focus on quarterly and annual numbers, the information that goes into the setting of stock prices is much greater than the information reflected in earnings.

What's more, according to some recent studies, the relevance of earnings actually seems to be declining over time. For example, a 1999 study by Jennifer Francis and Katherine Schipper conducted a very creative thought experiment. They asked, "If God could come down and whisper in your ear one piece of information that would help you predict stock prices over the next year, what information would you want?"

One obvious candidate is the year-to-year change in earnings. Now, it turns out that if you knew that number in advance during the years 1954 to 1971, you would have been able to predict about 64% of the following year's change in stock prices. But over the period 1972 to 1994, which is when their study ended, that number dropped to about 55%.

What's also interesting is that if you instead knew the next year's change in cash flows, you would capture only about 20% of the stock return—which suggests that the accrual process performed by accountants does have value, and that earnings are in fact a more relevant piece of information than cash flows. But in contrast to earnings, the relevance of cash flows does not seem to be falling; it's stayed pretty constant.

One explanation for the declining relevance of earnings may be the fact that reported earnings are becoming more volatile, while cash flow volatility has remained pretty much unchanged. Such earnings volatility appears to derive from the increased conservatism of accounting numbers, with the FASB putting out a series of pronouncements leading to more conservative recognition of revenue and deferral of gains. The greater volatility of earnings relative to cash flows is a concern for the accounting profession, because we like to think of earnings as a little bit better than cash flows in terms of taking out some of the volatility and providing a better prediction of long-term performance.

Despite the fact that earnings have been declining in relevance over time, we do know that investors pay a lot of attention to them. I'd like to focus for a moment on the issue of earnings smoothing raised by John's survey. A 1999 paper by Mary Barth, John Elliott, and Mark Finn looked at what happens to companies that produce five or more years of consistent, upward-trending earnings. What they found is that such companies trade at premium P/E ratios that increase over time—very much consistent with momentum traders' views of the world. So, investors do seem to value smooth, upward-trending earnings in the way that managers think they do. But as the managers also suggest, when the string of earnings increases is broken, the premium valuation disappears—and almost immediately.

This is very much consistent with John's "cockroach" theory of earnings misses. If you report a downtrend in earnings, it probably means that you have not had the highest-quality earnings in the past—that you've perhaps stretched your accruals to meet targets in previous quarters, and now it has caught up with you. None of this, by the way, suggests that investors are either naïve or respond mechanically to earnings reports. They understand the earnings management game that is going on here. And they understand that when you miss the earnings number, it has bigger implications for the reality lying below the numbers.

But if investors respond harshly to earnings misses, does that mean markets are fixated on earnings? Not necessarily. In fact, most of the evidence in the academic finance literature suggests that they are not. For example, a number of studies show that investors value R&D spending, even though it's expensed on the corporate income statement. A much-cited study by John McConnell and Chris Muscarella in the late '80s showed a positive stock price reaction to announcements of all kinds of big capital investments, even though earnings were going to suffer somewhat in the interim. And a fairly recent study in the *JACF* of M&A activity in the '90s found a positive stock price reaction to announcements of purchase transactions of about 4%, on average—and a negative 4% reaction to announcements of poolings. The reason this finding bears on the earnings question is that, under the old accounting, poolings enabled companies to avoid amortization of goodwill and so report higher earnings. And if investors cared

only about earnings and the accounting treatment of the transactions, the results should have been the exact opposite.

So, to summarize my comments up to this point, there is lots of evidence that managers behave as if markets are fixated on earnings. But there is also considerable evidence of the market's willingness and ability to look through and beyond earnings.

Let me also say that I agree completely with John in thinking that I would much rather have managers manipulating accounting—within the bounds permitted by GAAP—than making cutbacks in real investment. The market should be able to handle the first of these two problems; the damage from the second is more costly and harder to repair. The economic reality, of course, is that neither earnings guidance per se nor accounting manipulation is going to alter the underlying risk of the firm's operating cash flow. The reassuring thing about accounting, from an outsider's perspective, is that the accounting numbers at least eventually tell you what is going on: that is, in the long run, the sum of earnings is the same as the sum of cash flows because the accruals net out to zero.

Now, let's look at one more study of how corporate managers seem to be influenced by the behavior of investors. Brian Bushee, who was formerly my colleague at Harvard and now teaches at Wharton, has produced a very clever study showing that managers are more likely to cut their R&D to meet an earnings benchmark when they have a lower percentage of institutional investors holding their shares. So the implication here is that corporate managers feel more confident that the institutions will understand an earnings miss motivated by long-term considerations, but they are not as willing to trust less sophisticated retail investors.

Even more interesting, Brian went on to classify institutional investors into three categories—transients, dedicated investors, and quasi-indexers—based on certain characteristics such as turnover and concentration of holdings. As we might expect, the managers of companies with the largest percentages of transient institutional investors were significantly more likely to cut R&D than the managers of firms owned by the other two groups. And this finding raises a couple of interesting possibilities. The most obvious is that managers face greater pressure from transient investors—and you can substitute the term "momentum traders" here if you wish—to hit earnings targets. The other interesting possibility, which Don raised earlier, is that companies may be able to influence the kind of investors who end up holding their shares by the kinds of information they provide and by the amount of attention they devote to earnings.

With that backdrop of manage-ment's behavior, let's now go back to investors' behavior, and look at it with the idea that investors understand what managers are doing. The first thing we know is that investors react very strongly when there's a missed earnings number. And if you are a high P/E multiple, high-growth firm, the stock price reaction is even more negative. Maybe it's because you were overvalued, or maybe it's because the growth expectations built into your price, once viewed as credible, are no longer taken seriously.

But what's important to recognize here is that this research does not suggest that investors are myopic or that markets are inefficient or irrational. What we need to think about is the possibility that management's behavior—its practice of providing earnings guidance and then managing earnings to meet the forecast—has led to precisely the kind of market behavior that managers claim to be reacting to. That is, by spending so much time guiding and managing earnings, managers may unwittingly have given a degree of credibility to the earnings number that neither managers nor investors believe it ought to have. By setting up and playing the "earnings guidance game," management may have validated an alternative governance mechanism that no economist approves of. After all, if the only piece of information that comes out of a firm in a given quarter is the earnings number, that's what outsiders are likely to focus on. By agreeing to participate in this signaling game with analysts, managements have given earnings a significance that at least long-run investors never wanted it to have. And that explains why the market responds to an earnings miss by pummeling the stock.

On the brighter side, there is a recent study by Frank Heflin, K. R. Subramanyam, and Yuan Zhang that shows that stock price reactions to earnings announcements have become more muted in the wake of Reg. FD. That is, there's now less of a response to earnings surprises than before. The authors of the study argue that perhaps this is because so many companies are now putting out much more information prior to earnings announcements, and so the earnings themselves are becoming less of an information event. And that may be the way to change the focus, to change the dia-

Since beginning our practice of monthly disclosure in the spring of 2001, the volatility of our stock price relative to a broad market index has fallen sharply—by as much as 50%. And the way I like to interpret this is that by releasing monthly data we have provided a dose of tranquilizers to the investing public. Volatility is not good or bad per se, and we don't target a certain level of volatility. What we do know is that investors don't like uncertainty, and we seem to have found an effective way to deal with that.

Tom King

logue around disclosure.

So, again, what this all suggests to me is that perhaps managers get what they ask for. If you agree to focus on earnings, talk mainly to analysts, and spend a lot of time forecasting and guiding, then the analysts become really important in your world. And that's how the consensus earnings forecast *becomes* the key benchmark. John Graham reported in his survey that it is the largest, fastest-growing companies with the broadest analyst coverage that tend to provide earnings guidance. And the managers of these firms are also more likely to identify sell-side analysts as having an important influence on their stock price. By contrast, the managers of smaller, slower-growth companies are much less likely either to provide earnings guidance or to view analysts as affecting their valuation.

But the big question here again is: Can management change the behavior of its investors, or perhaps even the composition of its investor base, by changing the kind of information it provides? Skeptics like to say that small firms effectively avoid the earnings obsession because they are *unable* to attract analysts. But what about larger companies with more options? Maybe they don't have to spend so much time talking to analysts about EPS. And that's something I hope we explore in this discussion.

And let me close by just pointing to some cases of what I consider to be promising innovations in disclosure. Following Reg. FD, Emerson Electric began to disclose on a monthly basis the rolling three-month average of the percentage change in underlying orders for each of its five operating segments. Intel started holding mid-quarter conference calls to provide a business update. If you go to their Web site, their investor relations section provides a detailed forecast of revenue and gross margins—and it even gives you all the expense items. So, if you're an analyst covering Intel, you've got a lot more information on which to build your projections.

Another interesting case is InterActive Corp, which is the new name of the old USA Networks. They recently stopped giving earnings guidance and started releasing the operating budget for each of their big divisions. In fact, InterActive also puts out its five-year plan, along with a statement of its strategy. Are they

giving away company secrets? The managers I spent time talking to say that the company's success has nothing to do with keeping the strategy secret, but everything to do with executing the strategy. It's kind of like Home Depot, which has clearly succeeded because of its low prices and high customer service. There's no secret there; it's just darned hard to execute.

The basic idea is that, by providing expanded disclosure, companies can empower their analysts. This is the polar opposite of what Enron did, which was to create extreme dependence. As we now know, Enron's analysts didn't have a clue about what was going on inside the company. But they somehow managed, during the 16 quarters leading up to the disaster, to hit Enron's numbers within a few pennies. And as we now know, it was all an accounting fiction. The analysts were being spoon-fed all along the way.

So Reg. FD can be viewed as a good thing in the sense that companies are now saying to their analysts, "Rely on your own analysis; we can't give you the answer anymore." Companies are now either providing their business outlook, like Intel and InterActive, or disclosing operating metrics that should allow the analysts to forecast results. And Progressive Insurance, as Don told us, has also come up with an interesting approach that I think we're about to discuss.

Going to Monthly Reporting: The Case of Progressive Insurance

Chew: That's right—and thanks, Amy, for that overview of the literature. Let's now hear from Tom King, the treasurer of Progressive.

Tom, in an interview some months ago, you told us that Progressive has never provided earnings guidance, does not manage earnings, and does not even mention earnings in its dialogue with investors. You also said that when Reg. FD was enacted in 2001, your board of directors considered initiating earnings guidance, but then decided on a completely different approach—the release of monthly operating results. Could you tell us why the company doesn't talk about earnings and give us the thinking behind Progressive's change in policy after Reg. FD?

Tom King: Let me start by telling you a little about our business as an auto insurer. You pay us a premium and, in exchange for that cash, we assume the risk that you will have an automobile accident in the next six months. If you knew more than we did about the probability of your having an accident, we wouldn't have a viable business. But the key thing is that there's tremendous uncertainty about what's going to happen. And that, as briefly as I can put it, is why we do not offer earnings guidance. We can't predict the future. We just don't know what's going to happen to interest rates and accident frequencies and medical care costs and the price of gasoline and so on. And we don't want to mislead you into thinking that we do.

Our strategic goal is to become the U.S. consumer's first choice for auto insurance in the U.S. One of our competitive strengths is our pricing method. If we can set rates that are more accurate than anyone else's, we can grow profitably by avoiding something our actuaries call adverse selection. To set accurate prices, we need accurate estimates of incurred losses that we have sustained to date. And that is the primary purpose of our financial statements: to provide management with the most reliable basis for setting prices.

Why is pricing so important? If we set rates that are too high, you won't buy our insurance. If we set rates that are too low, we're selling dollar bills for 95 cents and we'll go broke. So we want to get it just right. On our balance sheet, we have about $4 billion of loss reserves. We have a corporate actuary whose job it is to give us the most accurate estimates possible of what our losses will turn out to be. Given a base of $4 billion, a 1% change in the actuary's estimate would translate into a 12-cents-a-share change in our reported EPS. And when you estimate a pool, a 1% change is just a sneeze; it's not much of a change at all.

But the important point here is that we have voluntarily given up our ability to change reserves to manipulate earnings. We give complete independence to our head actuary and his staff to revise loss reserve estimates up or down as they see fit. So if they get additional information or they have a new model or their moods change and they want to adjust loss reserve accruals, they can do it. And reinforcing their independence is the fact that our actuaries' performance evaluations are tied to how well they predict what the losses turn out to be over the following year.

So, as a consequence of this actuarial policy, we as management don't know what our loss reserve estimates are going to be. And this means that we essentially have no way of managing earnings. So why get into the game of providing guidance?

Of course, this has created a challenge for our investor relations people. We know that you as an investor have the right to receive sufficient information to make informed judgments about our debt and equity securities. We don't know what the future holds. But we've decided to do the next best thing: we have committed ourselves to sharing with you the information that management has about our recent performance—and we provide this information *every month.*

We started this practice of monthly disclosure in the spring of 2001 by providing underwriting results—essentially operating costs and expected losses as a percentage of premiums taken in. Since then, we have expanded the scope of these disclosures so that we now release a condensed GAAP balance sheet, income statement, and estimate of earnings per share. Our investors now have access to the same operating data that management has, they have the same macroeconomic data that we do, and so they are now in a position to make their own judgments about our performance and prospects.

Now, has this policy increased the market value of our shares? I can't say for sure. What I can tell you is that the volatility of our stock price relative to a broad market index has fallen sharply—by as much as 50%—since the spring of 2001. And the way I like to interpret this is that by releasing monthly data we have provided a dose of tranquilizers to the investing public. Volatility is not good or bad per se, and we don't target a certain level of volatility. What we do know is that investors don't like uncertainty, and we seem to have found an effective way to deal with that.

So, to repeat, once we started releasing information more frequently, we found that the volatility of our share price went down. But that brings me to Don's question about the effect of our policy change on our ownership base. The answer is that our ownership base has remained pretty much the same. We continue to have major, long-term holders, including Peter Lewis, our former CEO who is now chairman of the board. We believe there is a clientele effect associated with our financial reporting policy; we have attracted long-term owners who seem comfortable with our approach.

Chew: Tom, have you ever targeted certain investors? Have you ever said to yourselves, here is an investment firm whose style clearly fits our approach?

King: No, we haven't. But, as I mentioned during our interview, we have discouraged certain people from buying our stock. A well-known momentum investor had been in and out of our stock three times in the past five years; and when they requested a meeting with management, we told them that we didn't think it was a good idea—our company was not the right match for their investment style.

Our view is that if we communicate openly and act consistently over time, the right investors will find us. You as an investor have 20,000 stocks across the planet to choose from. And if you want steadily increasing earnings per share, you're more than welcome to invest in some very well-run companies like AIG or General Electric or Dell. But if you want to invest in a company that uses financial reporting primarily as a tool to guide its pricing, and only secondarily to inform its investors, then we are a stock for you.

The Case of Merrill Lynch

Chew: Thanks, Tom. Let's now go to Joe Willett. Joe, you were CFO of Merrill Lynch from '93 to '98. And like Progressive, Merrill did not guide earnings during this time. Why didn't you do it, and what kinds of information did you provide instead? And did this policy have any discernible effect on Merrill's stock price and the kinds of investors that were attracted to the firm?

Joe Willett: In listening to some of the presentations earlier today and in looking at the literature on guidance, I was struck by how quickly two different things have gotten strung together. One is earnings guidance—that is, managing information and expectations to guide analysts and professional investors toward a particular number. The second is earnings management, which is changing the accounting or taking real actions to meet the earnings target. My guess is that the reason these two practices are so often linked is that companies that set out to manage earnings are invariably forced into managing investors' expectations, since it's very difficult to continue to meet earnings targets for long unless you somehow generate the targets themselves. And maybe that's how this whole business of earnings guidance got started.

We favored providing a lot of information, and disseminating it as widely as we could, having to do mainly with the way the business is run. You want to give investors a window on how management thinks about the business: what the strategy is, and the financial, investment, and operating policies that are being used to carry out the strategy. That means talking about the key value drivers in the business, the macroeconomic factors that would influence business, new products and services, and the targeted customers for each. These are the things investors want to understand. And I think the disclosure of this kind of information is all part of a continuous process, and not something that's concentrated around the announcement of quarterly earnings.

Joe Willet

But once the practice had become established and taken on a life of its own, it's not hard to see the motives for the implicit collusion between companies and analysts in the guidance game. CEOs don't want to miss a target for fear of exposing to investors what John Graham called the "cockroach" problem. And analysts don't want to be embarrassed. So once this game got started, there were people with an interest in seeing it continue.

But as with Tom's company, we at Merrill Lynch were opposed to this whole process of guidance for several reasons. First, private conversations with analysts or portfolio managers to guide them to an earnings number—the whisper campaigns Michael Jensen describes in his article—always struck me as inherently distasteful, something that clearly flies in the face of full and fair disclosure to a wide range of investors.

Much of the current discussion about

guidance centers on Regulation FD, and I guess that's not surprising. But it's important to remember that there were rules against selective disclosure long before FD. And it seems to me that a policy of private guidance quickly runs afoul of those rules that existed well before the year 2000. Some of you might recall the so-called "mosaic" theory of selective disclosure that grew out of some court cases a couple of decades before Reg. FD. As I recall, that theory said that the disclosure of bits and pieces of information, each pretty inconsequential when considered alone, could amount to a material disclosure when viewed together. So, we believed that selective disclosure of any material information was wrong both legally and ethically well before Reg. FD came around in 2000.

My own view, then, is that Reg. FD perhaps wasn't really necessary. But it has served to create a bright line around this issue, to broaden the context away from just insider trading, and to establish a clear warning in the marketplace against selective disclosure—all of which, I think, is probably a good thing.

Now, beyond the legal and ethical aspects, I've never been persuaded by the business appeal of guidance. First, excessive guidance amounts to doing the analyst's job for him or her. And in some ways, that relieves the analysts of the responsibility to get behind the company, understand what it's doing, and then—and only then—start talking about future earnings.

Amy mentioned the case of Enron, which is probably the best example of a situation where analysts seemed to have very precise earnings numbers every quarter, but very little idea what was really going on in the company. And that is one of the major risks of providing guidance—it can undermine the independence of your analysts. But perhaps my biggest objection to a program of guidance is that it invariably focuses the analyst's attention on the short run, on the next quarterly earnings announcement, and it therefore promotes a very short-term orientation. And it seems to me that this is exactly the opposite of the kind of behavior you want to encourage in your investors.

Don, you asked about the types of investors that bought Progressive stock and the types of investors that buy Merrill Lynch stock, and how you try to influence that. I think it's very hard to influence who buys your stock. The reality is that you're going to get some investors you like and you're going to get others you'd prefer not to have. In general, most companies want to attract long-term investors. You want investors, not traders. And the way to encourage investors to own your stock is to focus your disclosure on matters of longer-term profitability and value.

What kinds of information should a company provide? Well, first of all, we favored providing a lot of information, and disseminating it as widely as we could, having to do mainly with the way the business is run. You want to give investors a window on how management thinks about the business: what the strategy is, and the financial, investment, and operating policies that are being used to carry out the strategy.

That means talking about the key value drivers in the business, the macroeconomic factors that would influence business, new products and services, and the targeted customers for each. If it's a product, who's buying it? If it's a service, who's using it? Are the customers in developed or underdeveloped markets? And on what basis does management allocate capital? These are the kinds of questions that investors want answers to. And I think the disclosure of this kind of information is all part of a continuous process, and not something that's concentrated around the announcement of quarterly earnings.

Chew: Joe, what would you be willing to say about the risks associated with Merrill's performance? What would you say about its interest rate exposure, for example?

Willett: We would talk a lot about our management philosophy and approach to managing risk, and about the various kinds of risks that can influence results, such as the levels of interest rates, stock prices, trading volumes, underwriting activity, M&A activity, a whole host of things. But you do not want to provide formulas—no models, no forecasts, and no valuations. I think the information should be kept fairly general. Some of it's going to be indirect, but again it should all be designed to provide a window on what management is doing.

Chew: What do you think about Tom King's model of monthly disclosure of operating results?

Willett: I like the idea insofar as it takes attention away from the quarterly earnings event, whose importance has been blown way out of proportion. But the risk is that more frequent disclosure

might cause people to focus on the short run more than they ought to. Now, given the reduction in the volatility of Progressive's stock price, I guess my concern is unfounded—and the policy seems to have worked well in that respect. But I'm not convinced that monthly disclosure is the best approach for every company.

The Case of Pfizer

Chew: Thanks, Joe. Let's turn now to Rick Passov, who is Treasurer of Pfizer. Rick, what's your position on earnings guidance? What aspects of Progressive's disclosure policy, if any, would work for Pfizer, where the value of the stock depends so heavily on intangibles like the expected payoff from your R&D program?

Passov: Well, Don, I guess by virtue of how you've lined up the other companies on this panel, it would appear that I am the designated defender of earnings guidance. Pfizer has provided earnings forecasts in the past. But I also think that much of our disclosure practice is consistent with what Progressive is doing. For example, we provide information on performance by product, including volumes sold and prices paid. Analysts also have access to Scripps data and other generally available information that helps them to develop a perspective on earnings trends. So I think that our policy is one that focuses partly on quarterly earnings and partly on the long run. And it's one that reflects our conviction that good management involves balancing short-run and long-run performance goals.

Why have we provided earnings guidance? Part of the reason, paradoxically, has to do with the longer-term nature of investment in the pharmaceutical business. Because the payoffs are so far down the road, we feel that investors might actually welcome some guidance as to how *we think* we're doing—and, as I said, we supplement this with information on product level sales.

My own view is that earnings guidance does not necessarily lead to earnings manipulation. I think it's important to give analysts enough information to enable them to understand the key drivers of profitability. I also think it can be useful to provide management's view of earnings and return on equity in an industry where it's very difficult to see one or two years down the road. An important part of the analyst's job is to then discern the extent to which performance targets are met not by accounting manipulation but through effective use of the company's resources.

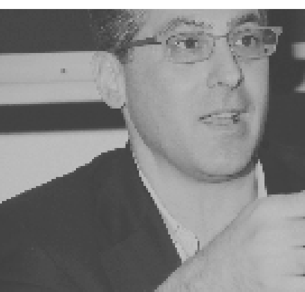
As for the connection between earnings guidance and earnings management, I disagree with Amy's suggestion that earnings management started out as a conscious signaling strategy by certain managers. I think it requires a high degree of complicity between managers and analysts for a practice to become as widespread as some suggest earnings smoothing appears to have become. It took an awful lot of factors, the confluence of many events, to get the valuations of companies so far out of line with their fundamentals. And these valuations had a huge behavioral impact on the companies themselves, which had to weigh the cost of missing an earnings forecast when they were trading at 50 or 60 times earnings. The best corporate managers probably tried to help investors understand their companies' business prospects. But there were others who yielded to extreme temptations, accentuated by their option holdings, to inflate their stock prices by complying in any way they could with analysts' demands for earnings.

My main point in saying this is that I think it's instructive to look at changes in the corporate investor base during the past five to seven years—the emergence of day traders, the impact of the Internet, the proliferation of the new TV shows devoted to real-time stock quotes—I think all of these developments had profound effects on managers' behavior and, to a certain degree, on which managers survived in their companies.

Hutton: In defense of Pfizer's use of earnings guidance, I've done some research that shows that companies where intangibles are a high percentage of total assets are more likely to guide. My guess is that in such cases the analyst community faces a greater challenge in setting up milestones and evaluating the company's progress in meeting them. And given the reality that the market is going to respond to your earnings number, it may make sense for managers to participate in the forecasting process.

But given all the other disclosures that are or could be provided—particularly information about actual as opposed to projected performance—what is the *incremental* value of providing a forecast? What's the benefit you're getting for that risk that you're taking? My presumption would be that if you've guided for a quarter and you miss, you get a much more negative reaction than if you didn't guide at all.

Passov: My personal view is that it's basically okay to provide guidance and



Our policy focuses partly on quarterly earnings and partly on the long run, which reflects our conviction that good management involves balancing short-run and long-run performance goals. My own view is that earnings guidance does not necessarily lead to earnings manipulation. I also think it's okay to provide guidance and turn out to be wrong as long as it's very clear to the investor why. This means that, when giving guidance, companies need to be very clear about the assumptions underlying their forecast. And as Tom King said earlier, making these assumptions clear should also help your analysts use your actual reported interim results to produce more accurate forecasts of quarterly and annual earnings.

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Chew: Rick, how do you communicate to the market the value of your R&D program, where you're clearly spending a lot of money up front with the expectation of a long-run payoff?

Passov: That's a challenge. We have a communication package that describes our "pipeline." Our pipeline is divided into three distinct phases, and in our investor communications we talk about the most promising products in each of them. Phase I are compounds in early-stage toxicology testing that have shown some efficacy against disease. Phase II consists of compounds in early-stage human trials, and Phase III of compounds in late-stage human trials. Maintaining the consistency of these reports is important to giving investors information that allows them to track the progress of different products. And, as we are constantly reminding investors, we are attempting to track a process that from discovery to phase III

trials typically takes from seven to ten years, depending on the product.

Now, in some ways, our dialogue with investors is similar to what Tom King and Progressive have established through their monthly disclosures. But there is one important difference: our investors want to get a good sense of the likely payoff from our current and future investments in R&D, and the statistics necessary to communicate *prospective* results are quite different from those that can be used to convey *actual* results. That's not to say there aren't some major challenges in, say, estimating future loss reserves. But actuarial science provides a fairly reliable basis for making these estimations. By contrast, projecting the payoff from R&D will always be more art than science.

Chew: How do you assess period-by-period changes in the value of the pipeline? And do you reward the head of R&D, or hold him or her accountable, on the basis of those results? Tom King mentioned that, at Progressive, they pay their head actuary for accuracy in predicting future losses, which effectively bonds the company's statement to its investors that its reserves are the best possible estimates, and not a tool for managing earnings. Is there any kind of evaluation or compensation system at Pfizer that would give the market the same confidence about the information you provide about your R&D program?

Passov: It would be nice if such a system could be developed. But the length of the investment cycle in the pharmaceutical industry and the lack of standardization in the data have made that a difficult problem. In the absence of a reliable statistical framework, my own view is that the best guarantee of a value-adding R&D program is to make sure that the current CEO and the head of R&D are going to be in their respective positions for a long time. This reminds me, by the way, of GE's policy of appointing a CEO who can look forward to a 20-year run. I think that's important in a business with large capital investment and long payoff cycles.

A Buyside Perspective

Chew: Thanks, Rick. Now that we've heard from our three corporate executives, let's turn to our two representatives of the investment community. And let's start with Charles Kantor, who works on the buy side as an analyst and portfolio manager with Neuberger Berman. Charles, can you tell us a little about how the buy side works, and how that might differ in important ways from what the sell-side analyst community does?

Kantor: Thanks, Don, for inviting me to this discussion. And let me start by offering the usual disclaimer that these are my own views and not necessarily those of my firm, or even of the people I work with on the "Kaminsky team," which is the second largest team in Neuberger Berman's private asset management division.

We currently manage about $3 billion of our clients' capital. Our fiduciary responsibilities are first to preserve and then to grow our clients' wealth in a way that is consistent with their investment objectives. We do this with a team of 20 people, ten of whom are dedicated to investing, portfolio management, and research. We run separate client accounts, which means our clients get to see our buy and sell decisions and our current holdings at the end of every month. We have complete discretion over our clients' capital.

At any given time, we own approximately 25 to 30 securities. We are long-term investors and our largest holdings vary little from one year to the next. We own companies that are small, medium, and large. Some are growth, some are value, some fall in between. My job is to choose the best securities from the universe of some 20,000 stocks that Tom referred to earlier—and this provides us with considerable investment freedom. We don't invest in mutual funds, and our benchmark has nothing to do with the S&P.

We follow a very research-intensive process, one that relies on doing our own work. We draw upon a wide variety of information sources, including SEC data, company literature, business publications, and communication with research partners at Neuberger Berman and at a wide range of Wall Street sources and in the hedge fund community. The emphasis, however, is on original industry and company research, which can be done through attendance at company and industry conferences, field trips to company facilities, and interviews with corporate management at all levels. If you rely on the research of others, you know only what they know. And what they don't know could get you into a lot of trouble.

When speaking to company representatives, we prefer to speak to people that *do* things as opposed to people who talk about things. So, at Progressive, for

example, we would probably much prefer to meet the actuary or a group of product managers rather than the CEO or CFO. The CEO can articulate the strategy and the capital allocation process, but we want to go down deep in the organization to evaluate the consistency between the CEO's message and what really goes on in the trenches—that's the only way to get a good sense of a company's culture.

Now, let me address this question about the sell-side. Like most institutions, the sell side has its strengths and weaknesses—and how you make use of this information source is critical. We use the sell side mainly for the depth of their knowledge about specific industries. The best sell-side analysts really understand the drivers of profitability in their industry, and the difference in business strategy among companies competing in the same industry. They also have a good sense of the competitive changes taking place within an industry. This kind of insight can be very helpful to us in picking stocks. But we don't use sell-side recommendations for valuation purposes or as a basis for picking stocks. That's where we think we have a comparative advantage, and that's what we do.

So, we sometimes find research from industry specialists to be extremely valuable, especially when it comes from out-of-the-box thinkers. But we pay virtually no attention to their earnings forecasts or their price targets on securities—and that, unfortunately, is what a lot of sell-side firms spend most of their time doing. In my opinion, they ought to devote far less effort to what I think of as reporting and focus more on providing the insightful research that many of the industry specialists are capable of.

Having said all that, the sell side is going through a dramatic change right now, mainly in response to regulatory changes designed to address some conflicts of interest inside investment banks and other financial institutions. And I'm sure Trevor Harris will be saying more about this in a moment. But we see major changes going on inside the various sell-side firms that cover Neuberger Berman. A lot of experienced people are leaving for better opportunities with the buy side, particularly hedge funds. And many of the people who are choosing to stay are doing their jobs differently, providing a much more diverse kind of coverage than in the past. Some sell-side firms are hiring less experienced analysts, or asking their more experienced analysts to cover more companies. Some also seem appear to be tilting their coverage universe toward large market cap companies. The big question the managements of the sell-side firms are now asking themselves is this: Since investment bankers are no longer allowed to share revenue for company coverage, who will pay for our equity research? How they answer this question will shape the sell-side research product going forward.

This may sound self-serving, but these changes in the sell side are proving to be a tremendous advantage for our style of investing. Although we do own some very large companies, we tend to spend much of our time looking at companies with market caps of from $1 billion to $10 billion that are now finding it harder to get coverage and get their message out. In this sense, the cutbacks in the sell side may have provided us with an opportunity to get higher risk-adjusted returns on our investment in research.

Chew: Charles, you seem to be suggesting that reductions in sell-side coverage are creating opportunities for the buy side by causing prices to drop below their fair value—perhaps there's some kind of illiquidity discount now being priced into their shares. But what about the possibility that the sell side is creating opportunities for other investors by overreacting to earnings misses?

Kantor: Over time, I think the sell side has probably provided a number of more attractive entry points for people like us. After all, in our business you not only have to identify good businesses, you've got to choose *when* to buy the stock. So, in the case of a clearly well-run company, a price drop in response to an earnings miss could be a great time to buy. But before we decide to buy, we generally want to understand why certain analysts are bearish. We sometimes learn a lot by consulting others whose opinions differ from our own.

But let me return to my earlier point about the proper use of the sell side. We have a tremendous amount of capital invested in these 25 companies; and if a sell-side analyst can explain to us why our investment in one of these companies is a mistake, we find that incredibly important. Analysts generally tell us we are wrong for three reasons. Sometimes we differ on valuation; these are cases where, in the analyst's view, the stock is too expensive. More common, though, is the possibility that there's a real secular change going on in the industry that they're more attuned to because of their industry expertise. The third possibility is that the analyst has a different view of

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Charles Kantor

the strategic direction the firm is pursuing—and this is something we definitely want to hear about.

Chew: What kinds of information do you want companies to provide?

Kantor: This whole question of Reg. FD and guidance looks to me like a great opportunity for a major change in corporate disclosure. We've never gone into a meeting and asked management what their quarterly earnings are going to be. We ask strategic questions: What's the business risk involved? What management reports do you use to run your business? How does the firm allocate capital? How conservative are the financial assumptions underlying your business model? What growth strategies are you pursuing over the next five years? And how are you spending your advertising budget? We have great discussions—and none is this is in violation of Reg. FD. I think if you ask the right questions, you get very instructive answers.

But now I want to say something you might disagree with. I haven't thought this through fully, but I think some companies probably can and should give guidance, and other companies probably can't and shouldn't. I think it may relate to the size of the company and the business the company is in. Some businesses are just naturally stable. If you invest in a dairy company and milk consumption

has gone down 1% a year for the last five years, that should be a more stable business than figuring out, say, where a technology company's earnings are going to come out. The volatility of a tech firm's reported earnings is tremendous. If you don't understand that the business is volatile, then you shouldn't invest in that company. And as it turns out, of the 25 to 30 companies we own, roughly a third provide no EPS guidance, another third provide annual guidance, and the rest provide quarterly guidance.

Chew: One reason Tom's company doesn't forecast earnings is that top management is worried about what the operating managers are going to do to meet the earnings targets. Are they going to cut customer service or delay payouts on claims? It seems to me that earnings management is a potential problem even for a company with relatively stable earnings. So I guess I don't see the upside for continuing to guide earnings. You're still putting the focus on earnings and maybe you want it somewhere else.

Kantor: For most companies, we get to listen to what they say to the public four times a year. While we pay attention to a security's short-term results, we tend to pay most attention to management's comments about their ability to execute their long-term plans. But earnings do convey important information—for most companies, growth in revenues correlates very highly with growth in earnings and growth in cash flow. We need to make judgment calls about how effective management is in its allocation of capital, and what types of returns they're getting. We invest in some very stable businesses whose performance is fairly predictable. Some of those companies provide guidance and some of them don't. We invest in other businesses that are inherently volatile. Those businesses perhaps shouldn't provide guidance—but, again, some do and some don't.

Having said this, we share Tom's concern about the kind of behavior that can result from providing guidance, the downward spiral of short-term decision-making that can infect the culture. And that's why we try to understand a firm's culture and what makes it work.

Hutton: Charles, is it possible that management, by providing guidance and then meeting it, contributes to investors' misperception of risk? Certainly Enron is an extreme example. But the fact that analysts could forecast performance and Enron could meet it time after time appears to have given investors a false sense of security. As an investor, I may have bought into Enron's story and believed that while I don't understand the business, somebody else understands it well enough that I actually get fooled into thinking it's less risky than it really is.

Kantor: I think it comes back to my statement that if you rely on the research of others, you can get into trouble. Not everyone is in the position of having the time to invest in research. And such people should probably not be buying individual stocks, but index or sector funds instead.

To figure out what was going on with Enron, one had only to look at the balance sheet and recognize that this company was generating no cash flow. I spent some time with Rich Kinder, a senior executive at Enron who left to set up a pipeline company that was the nucleus for what became the Kinder Morgan companies. Rich wanted the company to invest capital in something management felt was mundane and boring, but Enron's focus was on much riskier, high-growth businesses—in part because the market seemed to be valuing top-line growth rather than profitability—and so they parted ways. And this goes back to a point that Rick Passov made earlier. When your P/E gets to be very high, there is an underlying incentive to produce earnings, no matter how you do it.

Chew: Why didn't the market see through Enron, Charles?

Kantor: Because in the short term, the markets are a voting machine. Over the long term, they are a weighing machine. In the short run, a lot of good analysts and investors were fooled.

A Sell-Side Perspective

Chew: Let's turn now to Trevor Harris, our representative of the sell side. Trevor, would you start by telling us what you think about Progressive's policy and earnings management in general? We'd also like to hear your view of the strengths and weaknesses of the sell side and where you think the industry is going.

Harris: Given the role that Don has cast me in, I'm not sure if I should thank him for having invited me or not. Like Charles, I also need to preface my remarks with a disclaimer. Because I have even more regulatory constraints than Charles, I'm not actually going to

talk about specific companies; otherwise I'd have to give you information about whether we do business with them, and I probably don't know that myself. So, what follows are my views and not necessarily Morgan Stanley's, although I will try to represent what I believe are our firm's views in most areas.

Let me start off by saying that I think what we're really talking about here are different ways for corporations to reduce uncertainty in the marketplace. As Rick Passov was telling us earlier, a pharmaceutical analyst is definitely starting with trying to understand the product pipeline. And so you begin with the Scripps data, which then get translated into a whole bunch of other kinds of information.

As Rick also said earlier, the real challenge for management is to present investors with a credible and coherent long-term view while periodically reassuring them by meeting shorter-term milestones as well. So, in this sense, as Rick said, you have to balance the long and the short term. And if you look at the evidence that Amy just summarized, earnings is the measure of short-term corporate performance that has traditionally been most closely associated with stock returns. But when you go deeper than that, you will find—both in the academic evidence and in research conducted at firms like Morgan Stanley—that other measures, such as high returns on invested capital and other indicators of a company's efficiency in managing capital, provide even more insight into how companies produce superior stock returns.

But there is one thing you should keep in mind about the sell side: Our primary job is to meet the demands of our clients, who are mainly institutional investors. So what we actually supply is what our clients ask for. Charles is one type of client, but there's a wide array of different investors that use sell-side analysis and research. If your job is to choose a portfolio of a handful of stocks among 20,000, there is no way Charles or anyone else has enough time in the day to filter all the information. And that's where sell-side research arguably provides a service.

But now let's take Amy's point about earnings guidance. Some of us at Morgan Stanley have taken the position that the sell side would function more effectively if companies stopped quarterly guidance as a matter of policy. And I tend to agree. Without the distraction of guidance, we could spend more time doing real fundamental analysis of issues like the quality, or sustainability, of earnings.

But there's another point that I think is particularly important. If you look at who is evaluating sell-side research, if you look at the surveys that come out, what are they evaluating? It's earnings forecasting ability, often on a quarterly basis, and stock picking. But this is a mistake—sell-side analysts shouldn't really be in the business of picking stocks. Their job is to provide valuable information for the people whose job it is to pick stocks, and that's buyside investors. The proper role of the sell-side, in my view, is to give investors an indication of where the fundamentals of the firm are relative to the stock, which can then guide individual investors in making their own risk-reward tradeoffs. Someone who is interested in a short-term investment is likely to have a different use for our research than someone whose intent is to buy and hold.

There's one other point that I think should not be underestimated. Given the limited usefulness of the mandated disclosures, forecasting future performance is incredibly difficult. And it's even harder to predict cash flows than to predict earnings or other more traditional accounting measures. What's more, I would argue that the easiest number for managers to manipulate, if they choose to do so, is operating cash flow. All you have to do is securitize your receivables one minute before your quarter ends, and you can significantly increase your reported cash flow. And unless you voluntarily reveal that, no one will have a clue. Or you could defer payables by one day. But neither of these manipulations will affect earnings. So I think there's a widespread misconception about both the reliability and stability of cash flow versus earnings, particularly in a multinational corporation where you've got all sorts of currency issues.

I would also contend that the financial reporting model makes it even more difficult to do a meaningful forecast. For this reason I would prefer that corporations not rely on the GAAP financial reporting model, but start to give us real information that would help us do our jobs. For example, to make a forecast using a cost of sales number with any real meaning, you've got to have a good understanding of what the labor costs are, what material costs are, and so forth. And this raises the question: Why would a company disclose selling costs and general administration costs as a single number? Most companies do it this way, even though I believe there's not a single

company that manages its sales and distribution business the same way they do their general and administration side. So there are a lot of simple things that I would argue can be done to improve disclosure that have nothing to do with the issue of guidance that has dominated this discussion.

But let me make one last point about guidance. Rick said earlier that the nature of information dissemination through the financial press—and I mean press in a very broad sense—has changed fundamentally in the last five years. Information is now broadcast in a variety of channels, including 24/7 financial news networks and an array of Internet services providing continuous news, data, and technical analysis. sell-side analysts who believe they are only in the business of conveying news-type information will not be around five years from now. No one is going to pay us for that kind of information.

So, in this sense, the elimination of guidance is just part of a trend whereby companies and the analysts who follow them address the fundamental uncertainty about future performance faced by investors. Companies want to reduce uncertainty to the extent they can. Call that guidance, but it's not a specific number. It's a much broader set of information.

Chew: Trevor, what do you think of Amy's classification of investors into three categories and about companies' abilities to target long-term holders and persuade them to buy their stock?

Harris: Our three corporate panelists are better qualified to talk about attracting certain kinds of investors. But let me approach the question by saying that I think there's a widespread misconception about the incentives and styles of the different kinds of buyside firms. It's true that there are a lot of buyside firms with a very quarterly focus and orientation because that's the way their investors are looking at their performance. But at the other extreme are investors, including a large number of hedge funds, that make investments with a very long horizon. In fact, many of our hedge fund clients will take positions for years both on the short side and the long side. They're looking to identify companies that are going to outperform their competitors, regardless of what the broad market does.

Chew: Contrary to the conventional wisdom, then, when a hedge fund asks for a meeting, should management say yes?

Harris: It depends on what kind of hedge fund you're talking about. They have huge pools of money, and a lot of the marginal flow is going through that investment group. And by categorically rejecting a group called hedge funds, you are potentially missing out on some very good fundamental investors; they do fundamental analysis in a very thorough and serious way.

Passov: This reminds me of a recent case where the stock of a California company called Terayon Communications was bought by a hedge fund that then became the lead plaintiff in a class action lawsuit filed against the company for failing to meet its earnings guidance. As things turned out, the hedge fund also had the largest short position in that company's stock. The company doesn't have much capital, and it would face very high transactions costs in raising more capital—even if their product is about to be the greatest thing in the world. But that one small investor imposed a tremendous cost on them. And to expect managers to ignore such possibilities when setting their investor relations policy is clearly unrealistic. The legal and regulatory hazards associated with disclosure and investor relations may help explain how we all could have gotten so far away, in some respects, from good management practices.

Chew: But, Rick, isn't that just one more reason why companies shouldn't provide guidance in the first place?

Passov: Perhaps. I think we all agree that managers should make decisions that are in the long-run best interests of the firm. But we need to recognize and prepare for the possibility that there will be times when the market does not appreciate what we're doing. And when that happens, companies have to search for a better way to tell their story. It may come down to something as simple as Tom King's suggestion that you find a single variable, or handful of variables, that best represent your business, and then commit to reporting those variables to your investors on a regular basis. But, again, we shouldn't underestimate the challenges, and the pitfalls, in getting the market to take the long view.

The New Regulatory Environment and the Future of the Sell Side

Chew: Rick's comment provides a nice lead-in to the issue of regulation, which

I think our entire regulatory, disclosure, and securities analysis system is about to evolve in a fruitful way. The main value of this new regulatory regime is that it will force people to become much more skeptical about GAAP income and to do much better analysis of the quality of earnings. As a consequence, companies will provide more information, and analysts will get a better sense of how to evaluate companies over longer periods of time. There are enough alternative sources and knds of information that can now—or will soon—be accessed in a relatively transparent format that we will no longer need GAAP income statements and balance sheets. The information now required by the SEC will be at most a starting point for a valuation process that ends up producing a measure of economic income that looks very different from GAAP.

Trevor Harris

There is now an evolving project at the FASB to produce an operating income statement that starts with GAAP income and then makes a number of adjustments to get closer to a measure of operating income or cash flow. What seems to be driving this effort is the accounting profession's sense of the declining relevance of earnings. It's an effort to help accounting keep up with the main value drivers of a business—for example, to provide proper revenue recognition for industries that didn't exist when some of the mandates were first written.

Erik Sirri

we've so far managed to avoid. Tom King has said that Progressive's long-standing disclosure policies were completely unaffected by the passage of Reg. FD and Sarbanes-Oxley. But let's now turn to Erik Sirri, who was chief economist of the SEC from 1996 to 1999. Erik, is it possible that a company could have structured its disclosure program in such a way that it would never run afoul of Sarbanes-Oxley or Reg. FD?

Sirri: Let me start with the disclaimer that I'm an economist and not a lawyer. My impression is that the disclosure provisions of Sarbanes-Oxley speak mainly to internal procedures, internal processes and controls. It concerns, for example, certification by the CEO and CFO of written and statutory mandated disclosures. As far as I know, Sarbanes-Oxley doesn't by itself restrict disclosure; it doesn't stop you from making certain voluntary types of disclosures.

But, as Trevor Harris suggested to me just before this session began, companies may be raising regulatory uncertainty by making a novel kind of disclosure—and this can certainly result in some costs. So one effect of Sarbanes-Oxley on disclosure may be to discourage some kinds of innovation. We all know the old caution about being the first to do something different; it's sometimes better to watch and go second.

Regulation FD is a completely different animal. It is designed to ensure that issuers do not disclose material information on a selective basis and that all investors receive important news about a company's prospects at the same time. At bottom, it is a thoroughly populist rule that was a reaction to the ability of some institutional investors to get important information about an issuer before it was made public, and certainly before the average retail investor got it.

So it is important to note that a firm could never run afoul of Reg. FD by saying nothing; FD only concerns disclosure that are made. Corporations that have gotten into trouble with Reg. FD have done so by disclosing material information to small groups of investors, such as

at industry gatherings, while not previously or simultaneously disclosing the information to the market at large.

Harris: Don earlier asked Joe Willett a question about how corporations should talk about their major risks. What we are seeing on this front is a growing tendency for companies to forecast *ranges* of likely outcomes rather than point estimates. But let me point out that there is a possible downside to this practice: Once companies start disclosing ranges of earnings estimates, it's tempting for external parties to start second guessing where you ended up falling within that range, and why you may have chosen where you did as opposed to somewhere else in the range. And until this new regulatory environment sorts itself out, companies may be uncomfortable providing ranges. So I think that, in the current context, the best practice may be to let people know as much as possible about your assumptions and about how much uncertainty surrounds them.

Sirri: I want to follow up on a point that Trevor just made about cash flow and earnings. There is now an evolving project within FASB to produce an operating income statement that starts with GAAP income and then makes a number of adjustments to get closer to a measure of operating income or cash flow. What seems to be driving this effort is the accounting profession's sense, to use Amy's words, of the declining relevance of earnings. It's an effort to help accounting keep up with the main value drivers of a business—for example, to provide proper revenue recognition for industries that didn't exist when some of the mandates were first written. And the fact that accountants are now entertaining major changes during what amounts to a new regulatory regime makes designing a corporate disclosure program even more challenging. The complete reexamination of accounting and regulation that is going on today reminds me of what happened during the Securities and Exchange Acts of the 1930s.

Harris: I agree completely. I made a presentation at a business school last week where I argued that if our reporting and regulatory environment doesn't change, our financial reporting system will become meaningless and therefore largely ignored by market participants. As Amy suggested earlier, there are enough alternative sources and kinds of information that we can now—or will soon be able to—access in a relatively transparent format that we will no longer need GAAP income statements and balance sheets. The information now required by the SEC will be at most a starting point for a valuation process that ends up producing a measure of economic income that looks very different from GAAP.

But to address your point more directly, I think that this new regulatory regime is just a transitional phase. Its main value is that it will force people to become much more skeptical about GAAP income and to do much better analysis of things like the quality of earnings. As a consequence, companies will provide more information, and analysts will get a better sense of how to evaluate companies over longer periods of time. The process is going to take time. And as Erik suggested, you may have to be careful about going first. But I think our entire regulatory, disclosure, and securities analysis system is about to evolve in a fruitful way.

Sirri: I think that's right. Our conversation up to this point has been about two subjects—corporations and sell-side analysts—and we find ourselves in a position where both are changing their practices quite dramatically. And that's not a coincidence, of course, given what's happened in the last few years.

But when I think about what's going to happen to sellide research over time, what comes to mind is an old paper by Jack Hirshleifer in the *American Economic Review* that argues that if you really do produce uniquely valuable information, you're sort of stuck. You can try to sell it, but you're never going to get full value because people won't believe you. The only profitable use for your information is to trade on it as a principal. And that's essentially what a hedge fund does. If you have some really good sell-side analysts, you can pay them a lot of money, but a hedge fund will always pay them more. And so I think the sell-side brokerage firms all now have to ask themselves: What is our true comparative advantage? And what service are we really providing the market?

Boston is a big buyside town. If you ask the various kinds of buyside shops how they look at the sell side and what value they get out of it, you will get different answers depending on whom you ask. If you ask people at very large buyside firms—at places like Scudder, Fidelity, Putnam, with their scads of analysts who've got their own models—about the value of sell-side analysis, they talk about their industry-specific knowledge. But, as

Charles Kantor said earlier, I don't think the buy side is interested in the earnings numbers; they've got their own. But they do value the industry analysis.

On the other hand, if you go to a medium-sized or small buyside shop, one thing they say they value is the access to management that a sell-side firm can provide. For example, when Rick Passov comes to Boston, he's probably not going to stop at a $100 million shop to talk about what's going on at Pfizer. But I think the people at those firms like being invited to hear what Rick has to say. And that's something the sell side brings to many of its buyside clients.

So, I think the sell-side analyst community is now at a critical turning point. I was never certain what the sell side really brought to the table, but they are now going to have to answer that question for themselves.

Toward a New Equilibrium

Chew: Let's come back to John Graham's survey, the place we set out from. John, based on the findings of your survey, the academic studies, and what we've heard today from the panelists, what do you think is really going on here? Are managers being shortsighted because markets are shortsighted? Or do markets insist on earnings mainly because they know managers pay so much attention to them? And if markets are capable of taking the long view, how do we get beyond the current situation where managers distrust markets and markets distrust managers?

Graham: Before I answer your question, let me just comment briefly on the guidance issue that we've focused on. From our interviews with financial executives, there seem to be two main kinds of companies that are stopping guidance. One is companies with high and stable profits, whose earnings are so predictable that they don't need to guide investors. At the other end of the spectrum are companies that are in fact very volatile and very risky. These companies give up guidance because they're afraid to guide and then miss the number.

But between these two extremes is the vast bulk of companies that appear to feel they have to guide. Now, why do they feel that way? Judging from our survey, managers seem to believe they have to guide because if they miss an earnings target set by analysts, the market will penalize them severely. And this leads to the temptation to make short-run decisions to meet earnings rather than maximize long-term value.

So, in the language of economists, we now seem to be in a bad equilibrium. A lot of managers feel they are forced to sacrifice long-term value to meet the short-term consensus. They really don't like the earnings game, and they know that it can lead to poor business decisions. But they believe they have no other choice.

Now, even if the market is not as short-sighted as managers think it is, I believe that some parts of the investment community put too much emphasis on quarterly earnings announcements. In particular, sell-side analysts at least appear to have too much influence on market opinion. And the short-term focus reinforced by the analysts' behavior can be very destructive. As the authors of the recent Google press release put it, "A management team distracted by a series of short-term targets is as pointless as a dieter stepping on a scale every half hour."

How do we break out of this equilibrium? As Mike Jensen has argued, companies need to stand up and say, "We're not going to play the earnings game anymore." They need to come into analyst meetings and say, "You know what? We missed our earnings this quarter. We could have hit that earnings number if we had made some perfectly legal GAAP assumptions and cut back on some maintenance on our plants. But we decided not to do it because we thought it would obscure our earnings and put our future at risk. We did what we thought were the right things to do."

When a critical mass of companies starts behaving this way, the bad equilibrium will be broken. But even though there may be a couple of dozen companies that now seem to be moving in this direction, it's not clear that enough companies are doing it.

Kantor: You need more than a critical mass of companies; you need a critical mass of investors as well. There are investors, including some hedge funds, whose entire business model is trading around the quarter. They spend the entire quarter figuring out where the quarter is going to come in, and where the stock is likely to go.

Graham: I didn't mean to imply that investors are not an important part of the equation, but I guess I don't know how you change their behavior. My thought is that it now makes sense for corporations to take the first step. And when they do that, then I think investors will respond.

Harris: That's right, let the markets work. Markets will work fine if you give them a chance.

Chew: That sounds like a good note on which to end this discussion. Thank you all for taking part.