What Financial Analysts Want

Financial analysts
want more information.
Financial managers
want more understanding.

Financial analysts and corporate executives often seem caught up in an adversarial relationship with analysts seeming to want everything and financial executives releasing only the good news, saying, in effect, "analyze this."

Senior corporate executives commonly believe that capital markets do not properly understand and value their strategies and that financial analysts as information intermediaries are primarily to blame. In the view of many corporate executives, analysts are excessively focused on next quarter’s earnings and don't devote the attention necessary to understand the company’s past performance and the likely trends for the future.

To find out what analysts really want, we surveyed 140 sell-side star analysts. The results delineate some of the friction points where the different agendas of analysts and financial executives seem to conflict. The financial analysts came from a group honored as All-Star Analysts by The Wall Street Journal or as members of the All-America Team by Institutional Investor magazine.

What They Say About Annual Reports

Analysts report that private contacts and analyst meetings are the two primary sources of their information, with annual reports listed as third. But they complain that they receive very little information on the strategies of the functional areas of a company from any source and that key corporate risks they might expect to be included in the corporate annual report are seldom disclosed.

Half the star analysts believe that the current disclosures by corporations are inadequate to facilitate an increased role of investors in corporate governance. They further believe, in one of the most dramatic results of the study, that boards of directors are doing a poor job in representing the interests of most of the corporation’s stakeholders in monitoring corporate performance. In fact, 87% of the
Stakeholders in monitoring corporate performance. In fact, 87% of the star analysts believe that the board of directors represents the interests of corporate management, not the interests of the other stakeholders including institutional investors, individual investors, bondholders, and other creditors, employees, and community interests. These startling results may explain some of the reasons why stakeholders are concerned that they aren’t well represented in the corporate governance process.

An overwhelming majority of the analysts, 91%, believe they are getting the information they need to forecast future financial performance, but only 41% believe that they receive the information necessary to diagnose the source of any company problems if the strategy is ineffective. This information could be crucial to a proper valuation of the firm.

Most analysts do find annual reports an important source of information. The management discussion and analysis (MD&A) section and most other parts are well read and used. One notable exception is the balance sheet that analysts often perceive as irrelevant because of its reliance on historical costs and arbitrary write-offs of intangible assets. The essay and pictorial section garnered the lowest readership and was rated the least useful by the analysts.

Most analysts consider segment performance data followed by the three financial statements as the most useful data for their investment decisions. Though incomplete, the segment data does provide significant additional insights into the past operating performance of the company and its segments and insight into possible future performance.

The president’s letter, while not ranked near the top for usefulness, generally was seen as very useful for the evaluation of a company’s strategy. Expansion of this portion of the annual report to include more explicit discussion of the strategy of the company and its significant business units would likely be a valued improvement, they said.
What Else Do They Want?

Asked what additional information they would find useful in making investment decisions, more than 85% of the analysts said they would like more information on key business risks and uncertainties, financial liquidity and flexibility, the competitive strategy of the significant business units, and an identification of the corporate strategy. Jason N. Ader, analyst at Bear Stearns, told Strategic Finance that "The more financial information a company can provide to present the dynamic and accounting of the business is a positive change. We obviously understand the protection of competitive information in the role of an analyst, and I'm sensitive to that. But I think any information that you can provide an investor or analyst that speaks to the primary drivers of revenues and expense and the dynamics of what the primary expenses are helps you to understand really what makes the profits."

Ninety-three percent of respondents want more complete disclosure of product line and segment profitability data. This is consistent with the results that indicate the importance of the existing segment data to the investment decision.

Another item that star analysts want is a budgeted income statement for the coming year with an earnings forecast included in the MD&A section. This result is also consistent with other results related to the importance of MD&A. These voluntary disclosures should be an important part of a company’s communication strategy because they can aid significantly in how well the analysts understand the company and, ultimately, in improving the corporation’s share price.

Footnotes seem to frustrate analysts the most. When asked which components of the annual report they often have a hard time understanding and which they would like explained more, star analysts rated the footnotes first. Thirty-five percent of the analysts have difficulty understanding the footnotes, and 55% would like further explanation of the footnotes. Eighteen percent of the analysts had trouble understanding the statement of cash flows, and 34%
would like further explanation of this financial report. Some 49% would like further explanation of the MD&A.

The bottom line is that financial analysts want companies to be more forthcoming with their financial information and provide more voluntary disclosures that "tell the corporate story" to external users. They commonly believe that companies tend to provide only the information that is legally required unless they have additional good news they want to trumpet. If corporate disclosures are to be credible, full disclosure must occur in both good times and bad. A corporate communications strategy that recognizes the importance of open and honest communications to both financial analysts and shareholders is important to the fair valuation of a company’s stock.

One of the most important elements of a good corporate communications strategy is that those communications must be consistent, honest, and forthright. But star analysts believe that there is a substantial difference in corporate disclosure practices related to whether a company is doing well or not. For example, 90% of the respondents believe that managers disclose honestly what is legally required and provide additional information publicly that is useful for decisions when the company is doing well. Only 45% believe this is true when the company isn't doing well. Similarly, 85% believe that managers respond effectively to investors' informational needs when the company is doing well but only 39% when the company isn't doing well. Finally, 29% of the analysts believe that managers disclose in language that is difficult to understand but complies with the law when the company is doing well, but 49% believe managers disclose in foggy language when the company isn't doing well.

Needed: Change in Communications
Our survey results strongly suggest that corporations need to change how they communicate. There are pressing investor needs for improved quality and quantity of corporate disclosures. If leading analysts have difficulty understanding the footnotes, which are essential to the understanding of the financial statements, how can other analysts—much less shareholders—understand them? Corporate officers have little to fear from increased disclosure because they usually are win-win situations where it is in the best interests of the company to develop and implement consistent and credible communications. By making financial reports more central to a communications strategy, companies can improve relations with stakeholders and analysts. Studies have shown that such communications can have a significant positive effect on share prices.

The accounting profession and corporate financial managers need to develop ways to communicate effectively to their constituents so the corporate story is understood. Corporations devote substantial effort to developing an overall corporate strategy as well as strategies for functional areas including marketing, finance, and operations and for all significant business units. Yet, they often are ineffective in
communicating those strategies to those who make investment recommendations and investment decisions. Also, they often neglect to develop a comprehensive corporate communications strategy that is important in telling the corporate story. Our survey captures the resulting dissatisfaction of analysts regarding the adequacy of corporate communication. Financial managers can improve communications with analysts and investors by adopting a new attitude and new strategies to communicate more effectively with financial analysts and other stakeholders.

The survey results also point to some improvements that could be made at little cost. The design for a well-crafted financial statement that will be an effective corporate communication tool might include:

- The Chairman’s letter to the shareholders should be a vehicle to clearly communicate a company’s strategy, the key elements of its business model, and its key success factors and risks. Such an articulation should enable the reader to identify the company’s value proposition and the performance measures so the reader can assess how effectively the value proposition is being implemented. The value proposition is that set of unique products or services a company provides that creates value for customers. It’s what makes a company unique and permits it to create value and earn a profit.

- Management Discussion and Analysis (MD&A) should focus on insiders’ assessment of the effectiveness of the company’s strategy and its value proposition and relate the financial results to management actions. If a company is in multiple businesses, the MD&A section should be organized so the discussion focuses on each of the strategic business units of the company. An effective way to link management actions and the company’s financial results is to use nonfinancial performance metrics that tie a company’s current actions to its future performance.

- Footnotes should explain the links between the company’s business strategy and its financial reporting choices. After all, accrual accounting is a way to capture the future financial consequences of a company’s business decisions. Financial reporting often involves making decisions regarding the certainty of future payoffs from current activities. A sound financial reporting strategy will base these assessments on management’s inside information on business factors such as the company’s customers, products, and competition rather than relying on accounting technicalities and conventions. Articulating the rationale behind a company’s financial reporting choices, therefore, is critical to inspiring the readers’ confidence in the credibility of the financial numbers reported.
• Presentations to analysts, conference calls, and other investor relations efforts, though critical, can't be viewed as a substitute for a thorough and well-designed financial report. Annual reports are the most widely used and lowest-cost medium of communications between a company and the external world. If you're receiving a lot of questions from the analysts' community, you should recognize it as an indication that you didn't get your annual report right.

Corporate managers complain that the financial community doesn't understand their company and isn't valuing its stock properly. Often that can be corrected through a more effective corporate communications strategy that provides both shareholders and analysts with the information they need to make investment decisions and, at the same time, inspires confidence in the company's financial reporting.

How the Study Was Conducted
Our research study of analysts' opinions was carefully controlled, and second mailings were made to all participants in the study to elicit additional responses and to compare the responses from the first mailing to those of the second to provide confidence that nonresponse bias doesn't exist. (The Chi-square test for nonresponse bias provides confidence that respondents do represent the surveyed analysts and that the results aren't biased by when or if a particular analyst responded.) We are thus confident that the responses from these analysts are representative of the leading sell-side analyst community and that the results have important implications for corporations and their senior managers as they develop and implement corporate communications strategies.