

# IRO

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*Investor Relations Quarterly*

NATIONAL INVESTOR RELATIONS INSTITUTE

# Through the IR Looking Glass

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*IRQ* (ISSN-1093-510X) is published four times annually by NIRI at 8020 Towers Crescent Drive, Suite 250, Vienna, VA 22182. Beth Carty, Managing Editor, *IRQ*, Tel: (703) 506-3573.

SUBSCRIPTIONS: one year, \$100; two years, \$175. Air mail outside the U.S.: one year, \$150; two years, \$225. Single copies mailed upon request: \$35, including postage and handling; outside U.S.: \$40. Periodical postage paid at Merrifield, Virginia, and additional mailing offices. NIRI members and Postmaster: Send changes of address and all subscription correspondence to NIRI, 8020 Towers Crescent Drive, Suite 250, Vienna, VA 22182; e-mail address: irq@niri.org

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DIRECT ADVERTISING INQUIRIES TO: NIRI, 8020 Towers Crescent Drive, Suite 250, Vienna, VA 22182; Tel: (703) 506-3570; Fax: (703) 506-3571.

Printed in the U.S.A.



# Editor's Note

**T**he premise of this issue of *IRQ* brings to mind the age-old question of whether a tree falling in the forest makes a sound if no one is there to hear it.

Our contributors look at the practice of investor relations from the point of view of the audiences with whom we routinely interact. After all, if they are not hearing us, it might be time to move the forest or change how the trees fall. IR is about reaching out to audiences that have an interest in the company's financial and operating performance—and there are more of them all the time.

From our contributors' perspectives, audience means not only people but also how we connect with them. The authors remind us that even when audiences share certain characteristics, the best IR practice may well require understanding particular characteristics of audience segments. As familiar as we are with the word investor, sometimes we have to remind ourselves that the term may refer to a portfolio manager, an individual, an employee, a customer—not to mention that our practice includes relationships with related entities in addition to those who hold shares. There are analysts—financial and otherwise—regulators, the media, senior management. And then there are the growing expectations of investor relations practitioners to understand and interpret the overall investment environment with its new laws and emerging practices.

Our contributors come from a variety of disciplines, befitting the range of responsibilities inherent in investor relations practice. Even so, not all of the responsibilities that IROs shoulder are represented here—once again demonstrating how dynamic IR continues to be.

There's no time to debate whether the tree made a noise. We're too busy making sure that someone is there to hear us—not to mention understanding what they hear, how they hear it, what needs to be reported back and how we should improve the process next time around. Looking at ourselves through the eyes of our audiences may well make the practice easier.

*Connie Harrison*

Connie Harrison

May 13, 2003

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## WHITE PAPER

# Less Business as Usual?

IR Finds New Audiences  
as Disclosure Transitions  
to Transparency

[ 4 ]

**BY MARY BETH KISSANE, J.D., M.A.**

*President*

CORPORATE PERCEPTION RESEARCH LLC

TODAY'S HEADLINES TELL OF MARKET AND GEOPOLITICAL turbulence, investor unease, corporate scandals, media scrutiny, policy sea change, and new, reactive regulations. Although these are signs of our times, they are also strikingly similar to the circumstances that brought us the Securities Act of 1933, the Securities Exchange Act of 1934 and, of course, the Securities and Exchange Commission.

Despite the ring of historical familiarity, the SEC's reaction is not static. Chair William Donaldson has called for corporate officers and directors to "look beyond just conforming to the letter of the new laws and regulations" and to redefine corporate governance with practices that go beyond mere adherence to new rules to demonstrate ethics, integrity, honesty and

transparency. Donaldson observed, “The recent shifting of primary corporate governance responsibilities to the board of directors demands that directors be the true stewards of corporate governance.”

In other words, corporate governance is not a box-ticking exercise. Rather, it is a set of decisions made by responsible, accountable professionals charged with overseeing the team of executive managers who manage assets and run public companies to make money for shareholders. Although boards may employ help to meet these duties, they remain ultimately responsible for corporate governance.

The challenges that have always confronted investor relations professionals take new form now, at the smudge point between final Sarbanes-Oxley rule-making and the regulations’ execution and implementation. Kinks will need to be worked out as the marketplace puts into practice what lawyers and regulators have drafted. Investor relations officers are among the team of professionals at the forefront of implementing these efforts.

**ASSESSING NEW RESPONSIBILITY**

IR professionals’ vanguard, hot-seat position both enables and requires them to have real dialogue with senior management and corporate counsel about expected and actual market reaction to implementation of new regulations and corporate practices. Counsel that does its job well is always eager to obtain more and better information, because that leads to better legal counsel for management, which in turn allows management to make better business decisions and develop better corporate practices. Even when counsel is not eager for such input, it is increasingly in the interest of the IR professional to provide it.

Thus, recent developments present an opportunity — and a need — for IR professionals to assess the inevitable new lines of communication and responsibility emerging within their companies. They must seize the day

to ensure that their responsibilities remain well matched with their skills and that they, their companies, management and shareholders are best served in the developing new environment.

## **NUDGING COMPLIANCE TOWARD TRANSPARENCY**

Behind the SEC's recent reforms, as well as Regulation Fair Disclosure and Sarbanes-Oxley, lies a desire to move the mindset of corporate issuers from compliance toward transparency.

In attempting to achieve this, regulators surely will find that the devil is in the details. Senior U.S. corporate managers operate in the most litigious environment in the world. Case law offers legal protections such as the business-judgment rule because it is recognized that even when proceeding in good faith, managers will not always be right, and it is efficient and desirable to encourage them to take intelligent and well-reasoned risks to maximize their companies' assets and shareholders' investments.

When new, untested rules and regulations are rolled out in such a litigious environment, the protections of the business-judgment rule may not be sufficient to encourage innovation if basic standards remain undefined. For example, one of the hot issues debated after Reg FD took effect was whether the SEC would provide greater guidance on a definition of materiality.

## **FENCING ON A TIGHTROPE**

Much post-FD commentary focused on the simultaneous issuance of Staff Accounting Bulletin 99, which could be construed as stating that share price movement alone could create a presumption that material nonpublic information had been issued. Although the SEC stepped back from this argument, the press appears to continue to operate with this assumption.

Moreover, speaking in the weeks and months after Reg FD was enacted,

some former SEC officials claimed that the market knows clearly what materiality means. This is surprising, given that an often-quoted and seminal disclosure case, *SEC v. Bausch & Lomb*, indicates that making decisions on materiality is like “fencing on a tightrope.” If these officials are correct, tightrope fencing must have gotten much easier since that case was decided in 1977.

More likely, the SEC wants to change the fundamental mindset around disclosure issues so that if a decision on materiality is so close that you feel as if you are tightrope fencing, you’ll get down off the rope by disclosing.

Post-Reg FD, the SEC has maintained that close-call, tricky questions of materiality will not be fodder for the enforcement division. Instead, the agency has claimed that it will target for enforcement only companies and executives that clearly flouted prohibitions against selective disclosure of material nonpublic information.

Instead of providing comfort for lawyers, this places them in a quandary. Although the SEC’s stated intention not to enforce portions of FD as written indicates a common-sense approach that IR professionals can appreciate, lawyers by duty and by instinct are risk-averse. They will consider a rule or regulation on its face and warn clients of the risks involved under any plausible reading. FD and Sarbanes-Oxley do not yet have enforcement trails that are long enough to give lawyers the comfort they seek with respect to close-call issues of materiality.

The lawyers’ dilemma does not end there. Up-the-ladder requirements of Sarbanes-Oxley and a pending decision on noisy withdrawal have turned their world upside down.

U.S. culture incorporates an adversarial legal system. An attorney must vigorously advocate for a client, with the assumption that there is a strong advocate for the other side. This duty is so central to our legal system that attorneys may be disbarred if they fail to observe it. A system that ensures

that attorneys and clients can confide in each other creates an environment in which clients are encouraged to tell their attorneys the truth. This allows lawyers to make appropriate risk analyses and better counsel clients on inherent legal risks of alternative business strategies.

Up-the-ladder duties are premised on the legally sound principle that the client is the company—the board rather than individual officers or employees with whom lawyers may confer. Thus, up-the-ladder duties require that attorneys report to the board of directors if they believe that a corporate officer is acting improperly or taking undue legal risk.

While policy arguments for up-the-ladder requirements play well with the press, the investors and the general public, there is an inherent problem in the developing turn of events. In what is likely an unintended outcome, corporate officers and employees will not share as much detail with legal counsel. Therefore, legal counsel may be in a less favorable position to advise the client firm. Good intent, bad outcome.

Although there is little that IR professionals can do to alter this development, they would be well advised to keep it in mind and keep an eye out for the unintended consequences.

## **MORE PRESSURE ON IR PRACTICE**

Despite these changes, the challenge for senior executives vested with investor relations responsibilities remains the same: a need to tell how the company makes money for shareholders.

They are working under highly demanding circumstances. They must simultaneously dot the *i*'s, cross the *t*'s, transcend the tactics of compliance, and communicate strategically, honestly, effectively and well in a crowded and chaotic market with constant scrutiny and change; disseminate material news broadly and fairly to the market; and tell the company's story appropriately to all the right audiences. All of these things must be

done with limited time and the most appropriate use of shareholder dollars, protecting management’s time to focus on making good corporate decisions and taking appropriate corporate risks.

In this environment the press increasingly seems to flag potential SEC enforcement actions and investigations. As a result, even IROs with no responsibility for or interest in dealing with the press must understand how it works and be aware of key media deadlines to advise counsel and management on strategy regarding dissemination of corporate news.

The news media often cite Warren Buffett as the great communicator. Despite the fact that he offers little beyond SEC- and exchange-mandated periodic disclosures, participates infrequently in media interviews, does not host teleconferences or webcasts and frowns on providing guidance, he has designed an investor communications protocol that works well for his company and relevant audiences.

Buffett appears to observe the dictum of Albert Einstein that things should be made as simple as possible, but no simpler. He provides investors with a succinct, well-written synthesis of how the company makes money for shareholders on an annual basis—his famous annual letter to shareholders, renowned for its simplicity, straightforward style and depth of information. Buffett writes these letters with journalist Carol Loomis and strongly advocates that other CEOs author their own shareholder letters as if they were telling absent business partners what they needed to know about the past year and what the CEO expects in the year to come.

None of us is Warren Buffett, but we can adapt his fundamental reliance on clarity to get our story told appropriately to the right audiences. Buffett’s ideas, or others directed toward ensuring clear communication with shareholders and the press, will be even more important if the press affects enforcement actions.

## EMERGING AUDIENCES FOR IROs

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An old skill for many veteran IROs—and a newly required skill for all others—is the ability to build and maintain strong working relationships with corporate counsel, corporate secretaries, corporate governance officers and directors. The ability to bring relevant market intelligence to these professionals and to assist them in moving the company beyond compliance to transparency is an emerging necessity, to be pursued in all the ways that make long-term sense and pass the cost-benefit analysis for the company, shareholders and management team. That task is too important to be relegated to the level of box-ticking, unless that approach serves as the essential first step in getting the basics out of the way and then transcending them.

All the changes notwithstanding, the practice of investor relations fundamentally remains business as usual, albeit in a changing environment. It is up to investor relations officers to identify how change may bring opportunity for them and their companies.

*Carpe diem.* ■

**WHITE PAPER**

# Network Communication

Creating Better Understanding  
and Value for Intangible Assets

[ 11 ]

**BY CYNTHIA CLARK WILLIAMS***Assistant Professor of Organization and Communication Management*

BOSTON UNIVERSITY

THERE HAS BEEN A GREAT DEAL OF MEANINGFUL DISCUSSION and research on the importance of intangible assets to a company's overall valuation but comparatively little attention paid to whether such information should be disclosed, how it should be disclosed or the most effective way to communicate it.

True communication does not happen in a linear fashion. It occurs as a result of numerous conversations within one's network of affiliations—not unlike the workings of a computer local area network. People speak to one another in an interconnected, often circuitous fashion.

A model in which the sender disseminates information to receivers or seeks to persuade them is insufficient in that it doesn't represent how

communication really occurs. But it is this linear model that most IROs use when communicating with investors about both tangible and intangible assets. Using a linear model with the company's tangible assets doesn't pose as much of a missed opportunity as occurs when that model is used with intangibles.

One of the central errors of the linear approach is source bias. IROs and other senior executives tend to assume that investors are dependent only on them for information. Instead, IROs should look at the relationship among themselves, the company, investors and market intermediaries—their company's information network—as one of multiple sources of information. These actors comprise a network of affiliations that requires a different approach to communication and how its effects are evaluated. A credible management team and IR professional enhance effective communication. But it is counterproductive to assume a bias toward the company as the most important or most objective source of investor information.

A series of in-depth interviews with investor relations and corporate communications officers in late 2002 and early 2003 found that 90 percent of the respondents mentioned quality of management as a key intangible asset. Perhaps, like beauty, it is in the eye of the beholder, but these results only underscore the need for a broader—and thus more accurate—review of the company's communication network and its perceptions.

The degree to which the CEO, CFO, investor relations officer and corporate communications officer, acting as an internal information network, adopt an open approach to discussing financial and nonfinancial data, as well as what parameters they use to determine these values, are paramount in the establishment of credibility and trust. Absent from a linear communications approach are three critical elements of network communication that are especially important in communicating intangible asset value:

1. Sharing of information among key parties in the exchange
2. Feedback from them
3. Message adjustment

In order to take into account feedback, a necessary prerequisite for network communication, one must go through several iterations of the message. This ongoing process of sharing information leads to a greater mutual understanding of the network actors and their motivations, their perceptions about the company and the adjustment the company needs to make in order to close the gap between what it thinks the message is and what the network affiliates think it is.

Simply put, investor relations professionals can only know how well their message is understood if they allow and are engaged in sharing information with their network, and vice versa, on a regular basis.

## **WHY COMMUNICATE INTANGIBLES DIFFERENTLY?**

Intangible assets are by nature subjective and dynamic and therefore respond well to network communication. Discussing intangibles with the company's network of analysts, rating agencies, investors and the media involves a great deal of interaction, clarification and adjustment. It generally cannot rely on letting the numbers do the talking.

A number of participants in the in-depth interviews referred to intangible asset communication as the practice of adding color to what has already been made public. How companies communicate intangible assets is fundamentally different from how they communicate tangible assets for the simple reason that the intangibles are not static and don't fit the current transaction-based accounting system. Also, outlays for intangibles are immediately expensed while the revenue they may generate is delayed and

spread out over subsequent income statements.

There has been much discussion over the last decade — with a considerable surge in the last four years — of what constitutes an intangible asset and how it should be recognized. The discourse centers on the apparent limitations of the U.S. transaction-based accounting system that recognizes assets when they are transferred from one party to another. Corporate accountants, consultants and academics have argued that assets such as knowledge, reputation and brand can have value even though they have not been transferred. Indeed, with the exception of certain business combinations, the value of a company’s management and its expertise, credibility and communication skills are not transferred to another entity, although they certainly have value, both present and future. What would Microsoft be without Bill Gates, its patents and its name?

Because these assets have value, either in a financial or social capital sense, they are often disclosed in the same manner as material information. Most IROs in the research study felt that even though information about their company’s intangible assets might be considered voluntary disclosure, they chose to fully disclose it based on the simple question of whether the shareholders might want to know it.

One respondent, from a \$10 billion insurance provider whose company has an overwhelming majority of individual investors, categorized company information as formal, semiformal or informal. Formal information is that which is clearly material, semiformal is the information that adds color to the formal, and informal is the feedback from customers through the company’s toll-free 800 number. The company’s IRO estimated that 99 percent of its disclosures were voluntary but noted that the mechanism for all of its disclosure situations was largely the same.

## **REQUIRED OR VOLUNTARY?**

The decision about when and how to disclose intangible asset information is indeed opaque but represents a great opportunity to discuss the nuances of intangibles' value. The issue, though, is slowly becoming illuminated.

The Federal Accounting Standards Board added this agenda item to its long list of things to consider. In January 2003 FASB released an update on disclosure of intangibles after a year and a half of deliberations and a two-month comment period. Before the board temporarily suspended its review because of staff limitations, it decided to work toward required disclosure for intangibles and tentatively decided to use the asset classification approach, as stated in FASB Statement 142, which categorizes intangibles based on their similarity in terms of operational nature or use.

A good example of the dilemma facing IROs when it comes to intangible assets is the issue of governance. The quality, diversity and independence of a company's board lately have been topics not only in the news media but also at the dinner table. The topics provide the foundation for the new published corporate governance standards that companies feel compelled to meet.

With the plethora of rating metrics being developed, companies are wise to consider their governance ratings not only as an intangible asset—or liability—but also as required disclosure. Those that avoid disclosing their scores of their own volition will lose credibility along with the ability to adjust, refine or clarify their position.

## **BEST PRACTICES FOR COMMUNICATING INTANGIBLES**

Sharing information with the company's network of affiliations in order to gain a full understanding of the company's intangible assets relies on

the strength of the links in the network. Usually the IRO has spent time establishing these key professional relationships and can obtain honest feedback about perceptions of the company's image, identity and related value drivers. If not, relationship-building should be a primary focus of the IRO's communication efforts.

If relationships between the corporate communications and investor relations officers and with the senior management team have been built well, the next step is to consider the strength of the links with others in the network, such as stock and bond analysts, securities rating agencies and governance rating agencies.

The IRO team should then set out to determine exactly what is both unique and mentionable about the company among its peer group. Companies are likely to find unique features but may decide that disclosing these would compromise their competitive advantage too greatly. Certainly this is a concern, but with share prices and revenues down almost across the board, the company's intangibles increasingly are its value drivers.

Analyzing the company's competitive strategy, its market position and its identity among key actors will help determine unique and mentionable features. AFLAC did so effectively by injecting humor into the way it called attention to its distribution network for selling voluntary cancer insurance. Other companies have employees that set them apart. Genzyme employs three people in its corporate communications and investor relations department who have the types of genetic disorders that the company researches and who bring their knowledge of the physical and emotional dimensions of the disorders and broader information network to the company's communications with patient/customers.

Once a company uncovers its unique aspects, they can be tested among the information network members, enabling the IRO to gauge response and confirm the factors' value as intangible assets. The network's understanding

**FIGURE 1: THREE STAGES OF NETWORK COMMUNICATION**

Strengthen the Links	Strengthen the Message	Strengthen the Effects
<ul style="list-style-type: none"> <li>■ Establish interconnecting relationships with important links in the information network of your company and industry</li> <li>■ Analyze company's competitive strategy, market position, image and identity among key actors in the information network</li> <li>■ Share the information among links and determine level of convergence</li> </ul>	<ul style="list-style-type: none"> <li>■ Determine what is unique and mentionable about the company based on sharing of information</li> <li>■ Refine the message based on feedback from the network</li> <li>■ Disclose voluntary information early to establish industry vernacular or metric used for the asset category going forward</li> <li>■ Allow the network's credibility to spread the message further</li> </ul>	<ul style="list-style-type: none"> <li>■ Track message use to gauge level of acceptance, credibility and similarity of the message among different people in the network</li> <li>■ Use a real-time media metric application to benchmark company's results within peer group in a standards-based format</li> </ul>

of those assets is mostly determined by questioning media representatives, analysts, rating agencies and investors who regularly follow the company. The extent to which this web of key players understands and repeats a message is representative of the extent to which the company's communications program has achieved convergence internally and infiltrated the network externally.

This effective use of the feedback loop also describes the very process of communication convergence — the tendency of two or more individuals to move toward one point uniting them in a common interest — within the network of affiliates. It helps close the gap between what the company thinks is important, provided there is unity within, and what the external network thinks is important. Convergence is the value inherent in network communication.

Based on this feedback, the message can be refined. Including the refined message in communications with the network helps solidify it in the vernacular used in reference to the company. These people help spread the word through their own credibility in the industry, thus expanding the network further.

This feedback mechanism is also helpful in determining if the message has diverged at any point. Tracking the messages through the feedback loop can help the IRO gauge the level of acceptance, credibility and similarity of the message among different people in the network. The IRO must determine if convergence or divergence has occurred and, if so, when and among what groups. Further refinement may be needed.

It is useful to form memorable phrases about intangibles and to disclose them early by including them in news releases or webcasts. Early disclosure of this information helps to establish the vernacular used in the discussion of a particular intangible in much the same way that a company's first-mover position establishes its competitive advantage.

When the IRO senses that constituencies understand the intangible assets and may be entering the adoption phase, it is important to continue to repeat the features in news releases, interim reports, analyst meetings and industry conferences.

Although much of this evaluation is qualitative, the IRO can also gather more quantitative information by using real-time Web-based applications that search for and analyze financial media attention. Most of the automated applications are cost-effective and standards-based. Tom Siebel, of Siebel Systems, used this technique when he coined the term customer relationship management, applied the methodology repeatedly throughout his information network and in the process founded a new industry that is expected to reach \$16 billion annually by 2005.

The value of network communication versus linear communication is

that it enables an IRO to take into account the meaning that key individuals give to the information they communicate regarding intangible assets. These assets are less likely to be readily identified or understood than are their tangible counterparts. Furthermore, by activating and using its network of affiliations, the company is in a better position to match the messages internally with the meanings ascribed to them externally, uniting them in the common interest of achieving more accurate intangible asset valuation. ■

## ONE-ON-ONE

# Gold Standard

## Tiffany Manages the Company— and IR—for the Long Term

[ 20 ]

*Investor relations increasingly functions at the intersection of taking the company's story to investors and being investors' messenger to management. Handling the dual role can be a source of tension for the investor relations practitioner. Managing it well can also be the foundation of an investor relations program that is valued internally and respected externally, as is the case with Tiffany & Co. IRQ interviewed its chairman and chief executive officer, Michael J. Kowalski, on April 8, 2003, about the function of investor relations at the luxury-brand company. Tiffany's vice president of investor relations is Mark L. Aaron, who is also NIRI's chairman.*

**IRQ:** The chief executive officer and the senior management team make up a key audience for the investor relations officer. How does the IR position relate to your responsibilities as CEO, and what do you consider to be IR's most important function?

**MR. KOWALSKI:** Certainly the most important part of investor relations responsibilities is to communicate effectively our long-term company strategies to all of our stakeholders—especially to shareholders and to some

degree to the financial community at large. It's that simple. But I do want to put the emphasis on long-term strategy.

**IRQ:** What are the most important tools for the investor relations officer to be able to do that?

**MR. KOWALSKI:** The way we've done it at Tiffany is as much by simple evolution as by design. Mark and I have worked together for almost 20 years. He is very much a part of the strategic planning process. He participates in all of the meaningful strategic planning meetings, certainly wearing his investor relations hat, but also—equally important—wearing his general management hat.

It's not intentionally symbolic, but Mark's office is on the same floor as executive management so that he can have immediate and easy access to the management team and vice versa.

**IRQ:** How do you make sure that various stakeholder audiences understand investor relations' role at Tiffany?

**MR. KOWALSKI:** We don't view IR as spin doctors here. It's very much a matter of straightforward communication of the strategic plan and our financial expectations, which are aligned—almost precisely so—with our internal operating plans. There's not a separate or distinct investor relations story that Mark authors. His responsibility is to directly and transparently communicate our vision for the company as we see it unfolding at any point in time.

**IRQ:** How did Tiffany come to that realization?

**MR. KOWALSKI:** It's been the company's perspective since we went public in 1987.

But there was a watershed event for us in 1993 when it was necessary to restructure our Japanese business. That was a hugely difficult decision for our company, and it was something that the financial community in general could easily have misinterpreted. Just for background, we had to restructure

our business and take a significant charge to earnings. That happened only six years after we went public.

We provided a straightforward explanation of what our plans were, what we believed had gone wrong, and how long we thought it would take to fix it. We were realistic about the task before us. The Street responded well to that approach.

If there is a single object lesson that reinforced our approach to investor relations, it is that experience. It was an important event for the company, and we were absolutely convinced that the path we were taking was the correct one. We simply told it like it was.

**IRQ:** How do you make sure that investor relations is fully integrated with other corporate functions at Tiffany?

**MR. KOWALSKI:** That's been fairly easy for us. Maybe it goes back to the initial public offering in 1987. A significant percentage of our current management team was here at the time and participated in the IPO. A slightly smaller management group remembers the leveraged buyout a few years before that. At the time of our IPO, we made equity fairly broadly available to managers in the form of stock options. Even though we are approaching \$2 billion in sales, we're still small enough to act on a strong entrepreneurial spirit. There is an interest not only in personal financial well-being but also simply pride in how we are perceived by the larger financial community. So we actually haven't had to work too hard to integrate investor relations into how Tiffany functions. Mark regularly speaks to our management, and there's widespread interest in how the financial community evaluates Tiffany.

**IRQ:** What kind of intelligence do you expect Mark to bring you from the Street or from the financial community in general?

**MR. KOWALSKI:** We're really most concerned about understanding the nuances—very precisely how people are reacting—and their degree

of understanding, not necessarily their degree of acceptability. We don't spend a lot of time worrying about whether a particular analyst or anyone else agrees with our point of view. Our priority is to make sure that they understand our strategy.

What I'm most interested in hearing regularly from Mark is how people are reacting to what we're saying, in terms of the questions that are being asked, the objections that are being raised or the positives that are being perceived—the perceptions of our strategy that ultimately impact valuation. I'm also interested in consumer perceptions. Many of the analysts and people on the Street are proxies, to a limited degree, for our customer base. It really is a matter of understanding all of the soft issues surrounding the communication of our strategies and whether people understand them. If they're not understanding, what can we do to make it clear? If they disagree, that's another matter, and there's nothing for us to do about it but try to communicate our story effectively.

**IRQ:** Do you measure those perceptions on a regular, formal basis?

**MR. KOWALSKI:** It's very informal. It's over lunch. It's over coffee. It's after a meeting. I don't think a day goes by that Mark and I don't speak. For example, if Mark has a concern or if a strategy that we have been articulating is being misunderstood, we try to address those issues.

An example would be our investment several years ago in Aber Diamond Corporation, a Canadian mining company. We took an equity interest in anticipation of sourcing a large percentage of our diamonds from the mine. Mark made it clear that there would be a lot of concern and a lot of confusion. Not surprisingly, there was. We needed to work especially hard to clarify our strategies and then, ultimately, to realize that we would simply have to be vindicated by time. There was a point when there was nothing more to be said on the subject. People would simply have to respect our judgment or disagree with us. And the results would tell the tale.

**IRQ:** That also fits with Tiffany's emphasis on long-term strategy and getting away from many investors' focus on quarterly results.

**MR. KOWALSKI:** Any luxury brand obviously has to think long and hard about long-term brand management. Way back in 1987, we made a strategic decision that we would not overly focus on Street reaction or short-term earnings performance and that we would forego short-term earnings opportunities like licensing the Tiffany name. We made that decision to protect the long-term health of the brand.

At times we have been roundly criticized for taking too long-term a view. The most vivid recent example was in the late 1990s when e-commerce was the popular topic.

We made it very clear that we thought e-commerce would represent a long-term viable opportunity for us. We believed that we had many incredible, inherent advantages in pursuing that business. But we were going to take our time, and we were going to do it right. We were heavily criticized for that. Now no one's particularly interested anymore, but e-commerce has been wonderfully successful for us. It's highly profitable and we think that we made the right decision.

If we had to defend ourselves against the pressures of short-term decision-making, we did so — because we understand perfectly what is required for the long-term health of the Tiffany brand. Our long-term investor relations orientation is a perfect reflection of the long-term strategy for brand development. In that sense it has been easy for us because the two are perfectly consistent.

**IRQ:** Given that long-term orientation, how do you set goals for investor relations and measure it?

**MR. KOWALSKI:** I try to measure it fairly qualitatively. I'll go back to something that we discussed a little while ago. Do people fundamentally understand our strategy? If they do, we've succeeded in our IR program.

I don't necessarily worry about multiple, stock price or relative multiple. Our job is to manage the company, Mark's job is to communicate our strategies, and it's someone else's job to evaluate that. As long as our story is out there—and it's a clear and accurate reflection of our long-term strategies—we've done our job. If people don't like those strategies, that's another issue, but it has nothing to do with investor relations.

**IRQ:** Your approach to investor relations certainly works for Tiffany. Would it work for other companies as well?

**MR. KOWALSKI:** Our approach reflects how we try to run the company. I absolutely think that an objective of investor relations is not to maximize the stock price or the P/E ratio or any other measure of valuation. A lot of that just reflects how you position the numbers but doesn't accurately present the company's story. The way to practice investor relations is not to make it about maximizing stock price but to make it what it really should be, the company's story. Investor relations is a communication mechanism and then it's a feedback mechanism.

**IRQ:** Let's talk about some recent developments that affect the practice of investor relations. We would like to hear your thoughts on Reg FD and what appears to be growing support for more transparency, for example.

**MR. KOWALSKI:** I was and continue to be very pleased with Regulation FD and the impact that it has had on helping make the playing field appropriately level. It just makes great sense. Maximizing transparency to the extent that it improves the efficiencies of the capital markets also makes great sense. The only issue that I have with transparency is competitive implications. One needs to be careful that in telling the company story one doesn't tip one's hands to competitors.

Clear and open communication supports our objectives. What we communicate is precisely what we're really about. I think greater transparency is very much a positive.

**IRQ:** How much have targeting and getting more analyst coverage been a part of your investor relations interest, and is that changing now given Wall Street's problems?

**MR. KOWALSKI:** It's wonderful to talk to either a sell-side or buy-side analyst who has a fundamental knowledge of the company. As the CEO—and I presume as an investor relations professional—that's both rewarding and stimulating. I'd much rather deal with a smaller group of analysts who really understand the company than a larger group with only superficial understanding of what we're about. That's something that we struggle with all the time because we don't want to appear to be exclusionary in any way. We certainly don't reward or punish people on the basis of their depth of knowledge or whether they are recommending or not recommending the company.

Sell-side analysts, because of the breadth of their industry knowledge, are likely to provide real interpretational value. In those situations I feel really good about talking to sell-side analysts. When I don't see a distinction between that analyst and a buy-side analyst, I wonder, Where is the value added?

**IRQ:** Another topic that is much on the minds of investor relations officers is corporate governance, especially the requirements of the Sarbanes-Oxley legislation. How does corporate governance factor into Tiffany's investor communication plans?

**MR. KOWALSKI:** Opinions about the new law are vacillating. I would just point out that for us not a lot has changed. There is an added burden of compliance that we have absorbed, but we gladly comply with the corporate governance requirements. There is nothing new for us in that respect.

**IRQ:** Are we getting into a situation where collectively we should begin to accept that there has been fundamental change in the economy as opposed

to viewing the downturn as a temporary situation before the economy again hums along at a high rate?

**MR. KOWALSKI:** Whether that's true or not, it's certainly a distinct possibility. From the point of view of our own business and from an IR point of view we have to be prepared to face that reality. Clearly the wind was at our backs throughout most of the 1990s. Maybe it will never blow again that strong from that direction, or at least not for a long time. Our question at Tiffany is how we return to strong levels of growth without that economic wind at our back. It is a different kind of challenge. Reality may be dawning on a lot of people right now.

**IRQ:** In that comment, you're telling us how you practice investor relations at Tiffany. You're telling us that you look at the business, at what is happening in your markets and for your company—out of that comes the strategy—and out of that strategy comes your investor relations plan.

**MR. KOWALSKI:** Our strategies clearly have to be grounded in economic reality, and we can't be afraid to face that reality, as harsh as it is. We've tried to communicate that as well. ■■■

## **ACADEMIC RESEARCH**

# Resuming Old Patterns?

After Reg FD Analysts Still Play a  
Key Role in Information Flow

[ 28 ]

**BY ERIC ZITZEWITZ, PH.D.**

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EVEN THOUGH REGULATION FD HAS SET STANDARDS FOR disclosure for almost three years, the rule still generates controversy.

Regulation Fair Disclosure was introduced to fight the “first call” problem, which developed from the methods that companies had come to favor in how they disclosed information to the public markets. For an analyst, being a company’s first call was an extremely valuable position to occupy.

For example, in 1999 Compaq and Abercrombie and Fitch each reportedly informed selected analysts—ahead of the rest of the market—of disappointing sales growth. By the time the news was public, their stocks had fallen 16 percent and 33 percent, respectively. In both cases, the analysts

who got the first calls also received significant short-selling opportunities for themselves and their clients.

The selective disclosure in the Compaq and Abercrombie cases was not then treated as a crime, but the activity hardly was victimless. Trading on nonpublic information creates a wedge between the returns to average investors and the cost of capital to a company. In addition, companies can use the promise of selective disclosure implicitly or explicitly to encourage analysts to bias their opinions favorably. An individual company may benefit from the better coverage. But collectively firms would be better off if they avoided this game, especially if it helped restore the credibility of equity analysis.

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Reg FD attempted to address that problem by prohibiting senior executives and investor relations personnel from knowingly or recklessly making selective disclosures of material nonpublic information. For proponents, this regulation simply made illegal what constituted insider trading in every way but name. But opponents of Reg FD have argued that forcing companies to disseminate information only as part of broadly public disclosures could have a chilling effect on the overall flow of information, potentially increasing rather than decreasing information asymmetries.

The debate was—and still is—highly politicized. Democrat-appointed SEC chairman Arthur Levitt championed Reg FD. All three Bush-appointed chairmen—acting chair Laura Unger, Harvey Pitt and William Donaldson—opposed it. Surveys suggest that majorities of individual investors and CFOs support the regulation, and analysts, brokerages and institutional investors oppose it. This is not surprising; selective disclosure tends to benefit analysts and their favored clients while small shareholders and companies raising capital pay for any wedge it creates.

## **ACADEMIC RESEARCH ON REG FD**

The stark and controversial policy experiment that Reg FD embodies is too tempting a topic for academics to avoid. Various papers have used different methodologies to test whether it has indeed leveled the playing field and whether it has led to the chilling effects about which opponents warned.

The studies typically have chosen proxies for the amount of private information in the market and tested whether that proxy increased or decreased after Reg FD. The proxies have included bid-ask spreads, the price impact of trades, stock-price volatility, and the accuracy and dispersion of analysts' earnings forecasts. Other studies have looked at block trading patterns and abnormal stock returns before earnings announcements and at company practices like holding open conference calls.

In general, these studies have tended to find only modest changes after Reg FD. It is puzzling that a policy that provoked such intense debate should apparently have such limited impact.

All studies of the effects of Reg FD face two related difficulties.

The first is that Reg FD was implemented in October 2000, and lots of other capital market changes occurred almost simultaneously. Most obviously, the Nasdaq collapse began in earnest in September, and the economy entered a recession in March 2001. In addition, the exchanges adopted decimalized pricing in late 2000 and early 2001.

A stock-market decline, decimalization and the arrival of more than the usual amount of earnings information — most of it negative — could easily have had more significant direct effects on all of those measures than did Reg FD itself.

The second problem is that many of the measures are inexact proxies for the effects of Reg FD. The more considerations other than Reg FD that might affect the proxy in question, the more one might conclude that other changes in late 2000 overwhelmed the effects of Reg FD.

## MEASURING INFORMATION CONTENT DIRECTLY

My Reg FD research attempted to address these challenges.

First, I used methodologies that directly measure the amount of new information in particular analysts' earnings forecasts. I then could measure the share of new earnings-related information that individual analysts revealed to the market compared with the share that was revealed simultaneously by multiple analysts. This approach directly captures the intended effect of Reg FD, which is to force firms to release information simultaneously rather than selectively. I also tested for a chilling effect by measuring the share of total information about earnings that was revealed via forecasts versus the share that was revealed as an earnings surprise.

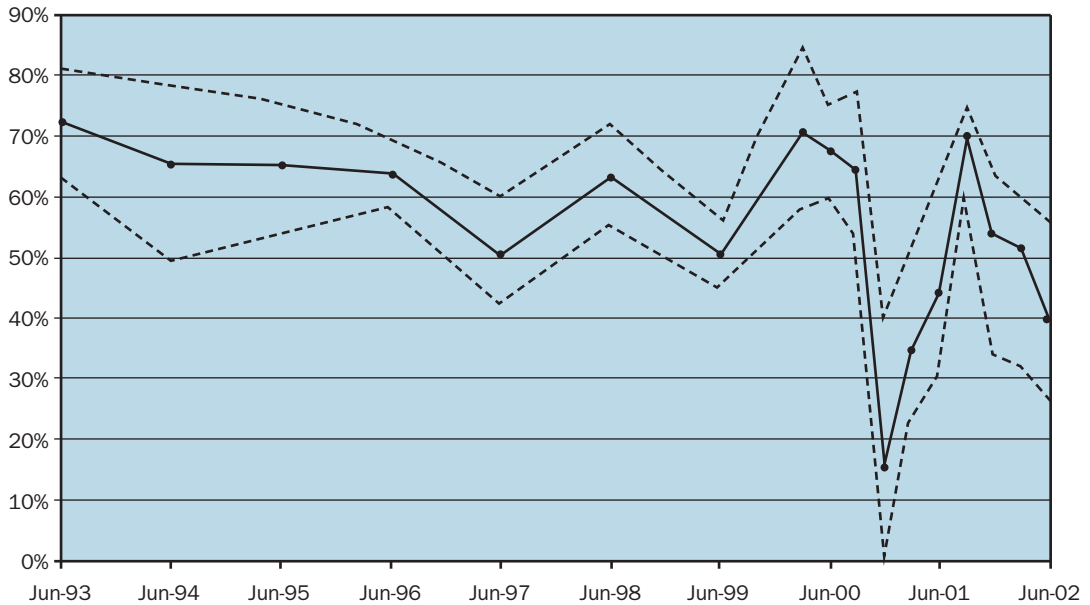
In addition to using this more direct measure of Reg FD effects, I also used matched sampling techniques to control for the effects of the recession. Specifically, instead of just comparing the pre- and post-FD periods, I constructed a pre-FD sample of firm-quarters with the same proportion of bad news about earnings as in my post-FD sample.

It turns out, however, that using my measures of shares of information dramatically reduces the sensitivity of results to whether and how one controls for the recession. Intuitively, one might expect that as the recession began, analysts' forecasts would naturally be less accurate and more dispersed, even without Reg FD. But it is harder to imagine why a recession would affect the share of information that is revealed to one analyst instead of to a group.

## ANALYSTS' ROLE IN REVEALING INFORMATION

My research covered the share of information revealed via individual analyst forecasts from 1993 through 2001. Individual analysts' share was fairly steady at about 65 percent until the quarter in which Reg FD went into effect. It then dropped to 17 percent in the fourth quarter of 2000 but increased to

**FIGURE 1: SHARE OF INFORMATION REVEALED BY ANALYSTS**



Dashed line indicate 95 percent confidence intervals.

between 40 percent and 60 percent in 2001 and 2002 — returning almost to pre-Reg FD levels.

This suggests that Reg FD had a dramatic impact in reducing selective disclosure when it was first implemented but that two-thirds of that effect has since disappeared. An analysis of monthly data suggests that the drop in selective disclosure occurred in August 2000 — the month that Reg FD was announced — and the subsequent increase occurred in January 2001.

It should be noted that even under full compliance, one would expect individual analysts to reveal new information about earnings to some degree. Analysts can uncover information in ways that do not involve selective disclosure and violations of Reg FD, such as during supplier interviews or through diligent analysis of publicly available information. But the fact that their share of new information declined dramatically with the announce-

ment of Reg FD but is now close to its pre-FD levels suggests that while Reg FD was initially effective at limiting selective disclosure, it no longer appears to be as effective.

This raises the question of enforcement. The SEC did not announce its first Reg FD enforcement actions until November 2002, when it settled charges with four companies, only one of which was fined — and that for a fairly modest amount of \$250,000. Since January 2001, the SEC has been run by Republican appointees who were on the record opposing Reg FD and who have discussed the need to revisit it while they have been in office.

Companies might therefore have been understandably skeptical about the extent to which the regulation would be enforced. Whether they remain so depends on whether the light penalties handed out in the first cases set a precedent or merely represent a warning shot. ■

**ACADEMIC RESEARCH**

# Everyday Pricing

## Do Pro Forma Earnings Mislead Investors?

[ 34 ]

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Quarterly earnings press releases have focused investor attention on an unorthodox measure of corporate profitability — pro forma or cash earnings used instead of the officially sanctioned GAAP numbers.

There is at present no agreed-upon definition of pro forma earnings. Firms are free to develop their own formulas for calculating pro forma earnings because press release interpretations of GAAP earnings are unregulated and unaudited. Some firms calculate and report pro forma earnings figures that exclude nonrecurring gains or losses from GAAP

earnings. Others also exclude ongoing intangible-asset amortization and stock compensation expenses. Still others exclude routine expenses for depreciation, interest, payroll taxes and marketing costs.

Until recently, there was no requirement that firms disclose the details of their pro forma calculations. This disparity between GAAP earnings and the numbers that firms highlight in news releases has led some critics to refer pejoratively to pro forma earnings as earnings excluding all the bad stuff.

There are at least two potential reasons for the popularity of pro forma earnings. One is that pro forma numbers more accurately depict economic performance than do GAAP earnings. A more perverse explanation for why firms report pro forma earnings is that doing so allows them to appear more profitable than they truly are. Critics argue that pro forma numbers mislead investors when legitimate expenses are excluded and when calculation details are not explained.

This paper has two objectives. First, we document the frequency and magnitude of pro forma earnings in press releases issued during June through August 2000 and describe the firms that engaged in this financial disclosure strategy. Second, we present evidence on whether investors are misled by pro forma earnings disclosures.

**TESTING THE IMPACT OF PRO FORMA REPORTING**

To investigate this question, we used a market multiples approach to test for fundamental mispricing of the shares of firms that report pro forma earnings. We also examined the behavior of stock returns at quarterly earnings announcement dates when pro forma earnings numbers were disclosed. These two approaches complement one another and allowed us to examine whether deviations from fundamental prices occur in conjunction with the disclosure of pro forma earnings numbers.

Our results indicated that income-increasing pro forma adjustments to

GAAP earnings are large, encompass more than just the elimination of nonrecurring items, and often exceed the adjustments made by analyst tracking services such as Zacks Investment Research or First Call. However, we found no evidence that investors price firms with pro forma earnings differently than they do firms that disclose only GAAP earnings. This means that share prices, on average, do not behave as if investors just focus myopically on press release headlines when evaluating earnings performance.

This paper adds to the growing academic literature on pro forma earnings. There are two distinct strands to the literature. One is represented by studies investigating the properties of Street earnings—the adjusted earnings per share numbers prepared and distributed by analyst tracking services since the late 1980s. These studies document a growing divergence between Street earnings figures and GAAP earnings and find that Street earnings are more highly correlated with stock returns than are GAAP earnings. However, the adjusted earnings figures constructed by analyst tracking services often do not correspond to the earnings numbers highlighted by management in press releases.

A second strand of research provides direct evidence regarding companies' earnings disclosure strategies. These studies rely on pro forma earnings numbers constructed by management and highlighted in press releases issued by the firms themselves.

Theoretical and experimental research in this area suggests that investors with limited attention, experience or expertise may mistakenly assign too high a share price when firms report pro forma earnings conspicuously at the top of their news releases. However, studies that look at actual stock market prices have so far produced inconclusive results.

Barbara Lougee and Carol Marquardt in their 2002 study identified 479 press releases issued between 1997 and 1999 that included pro forma earnings figures. They found that pro forma earnings did not possess

incremental information content relative to GAAP earnings except when the press release contained a reconciliation of the two earnings figures or when the pro forma figure allowed the firm to avoid reporting a loss or a negative earnings surprise. On the other hand, Neil Bhattacharya, Ervin Black, Theodore Christensen and Chad Larson's 2002 study identified 1,149 pro forma earnings press releases issued from 1998 to 2000 and found that pro forma earnings were more informative and persistent than GAAP earnings but less informative and persistent than Street earnings.

Both studies limited their analysis to within-sample comparisons of stock returns and alternative earnings measures for firms that used pro forma earnings disclosure strategies. By contrast, this study used a more powerful between-sample design and provided direct evidence on whether investors price the pro forma firms differently from how they price other firms.

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## **REPORTING EARNINGS**

The term pro forma is Latin for "as a matter of form." In accounting, pro forma traditionally has meant the presentation of financial data in which certain amounts are hypothetical. These hypothetical amounts can relate to proposed or recently completed business transactions or to retroactive accounting adjustments. For example, Regulation S-X of the Securities and Exchange Commission requires publicly traded firms to furnish pro forma financial information in connection with business combinations and spinoffs, when a significant portion of a business is sold and when funds are received through a security offering. Pro forma information is also required when firms change certain accounting principles, correct errors in previously issued financial statements or use the purchase method of accounting for a business combination.

The goal of traditional pro forma accounting is to recast previously reported financial statement amounts as if the business transaction or

accounting event had transpired in an earlier period. Explanatory notes describing the pro forma adjustments are required so that readers understand which items are based on fact and which on assumption.

This paper focuses on pro forma financial disclosures of a different sort — those that present current-period earnings computed with methodologies other than GAAP.

Firms registered on the New York Stock Exchange, the American Stock Exchange and Nasdaq are required to publish the current quarter's GAAP earnings along with a comparable GAAP earnings figure for the same period of the previous year. However, at the time of our study there were few other formal guidelines regarding the content of quarterly earnings press releases except that they must not contain counterfactual or materially misleading information. The Financial Accounting Standards Board in particular has no authority or responsibility for regulating the content of corporate press releases. Moreover, the pro forma earnings disclosures that firms highlight in their press releases do not typically appear in their SEC filings.

Two explanations for the growing popularity of pro forma earnings among managers are evident in the financial press. One is that managers use the announcement strategy to better communicate the firm's true economic performance. A second explanation is that managers use this announcement strategy to obscure the firm's true economic performance, apparently because they believe that readers will rely on pro forma earnings to evaluate the firm's quarterly earnings performance and that they themselves will face inconsequential penalties if the strategy unravels.

Managers who use a pro forma strategy to more accurately communicate the firm's true performance are doing so to avoid the possibility that investors might otherwise under-price the shares. On the other hand, pro forma earnings announcements that obscure firm performance presumably are

intended to induce investors to over-price the shares.

Our price tests relied on comparisons between firms that adopted pro forma disclosure strategies and benchmark firms that did not. If managers are successful in misleading investors, the shares of pro forma firms should be overpriced compared with those of benchmark firms. Otherwise, the share prices of pro forma firms on average should be valued similarly to those of benchmark firms. Evidence indicating that pro forma firms are priced higher than benchmark firms would be consistent with the notion that some investors are misled by pro forma earnings disclosures.

A second implication of our analysis is that any share price differences attributable to the use of a pro forma disclosure strategy should be apparent at the earnings announcement date when pro forma results are first disclosed. Consequently, we also compared the earnings announcement stock returns of pro forma and benchmark firms for evidence of a differential response to earnings information. If differences in share prices or returns are detected, the differences should also be correlated with characteristics of the pro forma disclosure strategy.

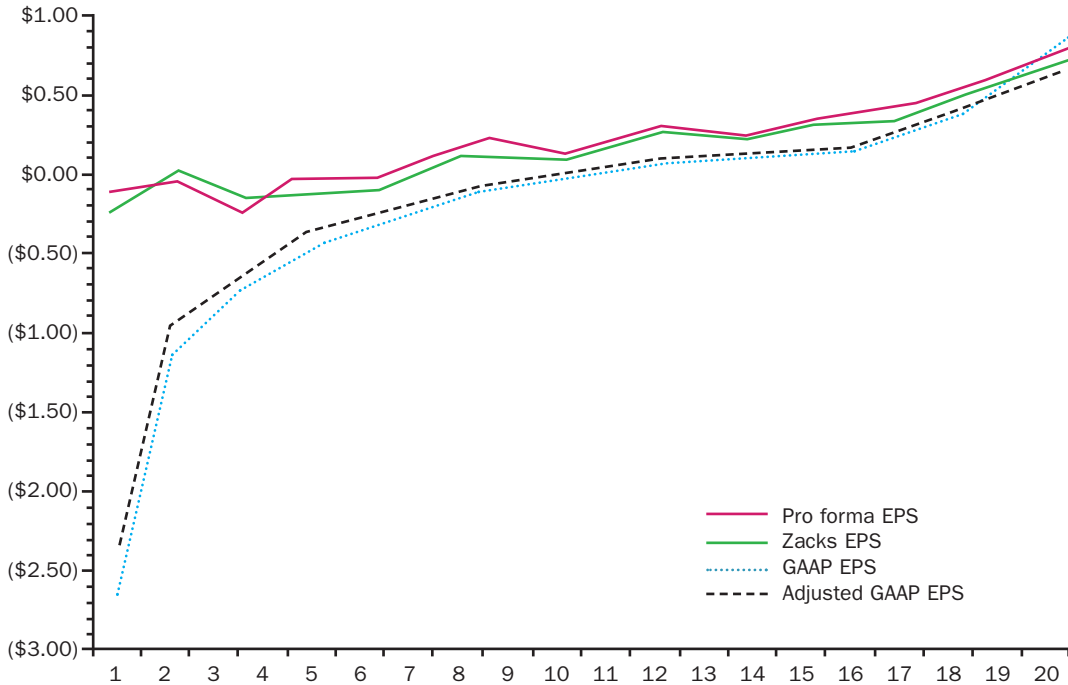
## **SAMPLE SELECTION**

We used the electronic text search capability of Dow Jones Interactive to identify candidate earnings releases published between June 1, 2000, and August 31, 2000. The sample selection process involved three steps.

First, we identified quarterly earnings releases in which the words “pro forma,” “cash” or “cash basis” appeared adjacent to “earnings,” “EPS,” “net income,” “loss” or “net loss.” Each release was then read and retained if the pro forma adjustment was for the current quarter; pro forma earnings were featured in the news release headline and lead paragraph; the release was not issued by a bank, other financial services firm or foreign-domiciled company, and the firm was listed on the NYSE, AMEX or Nasdaq that quarter.

**FIGURE 1: PRO FORMA QUARTERLY EARNINGS**

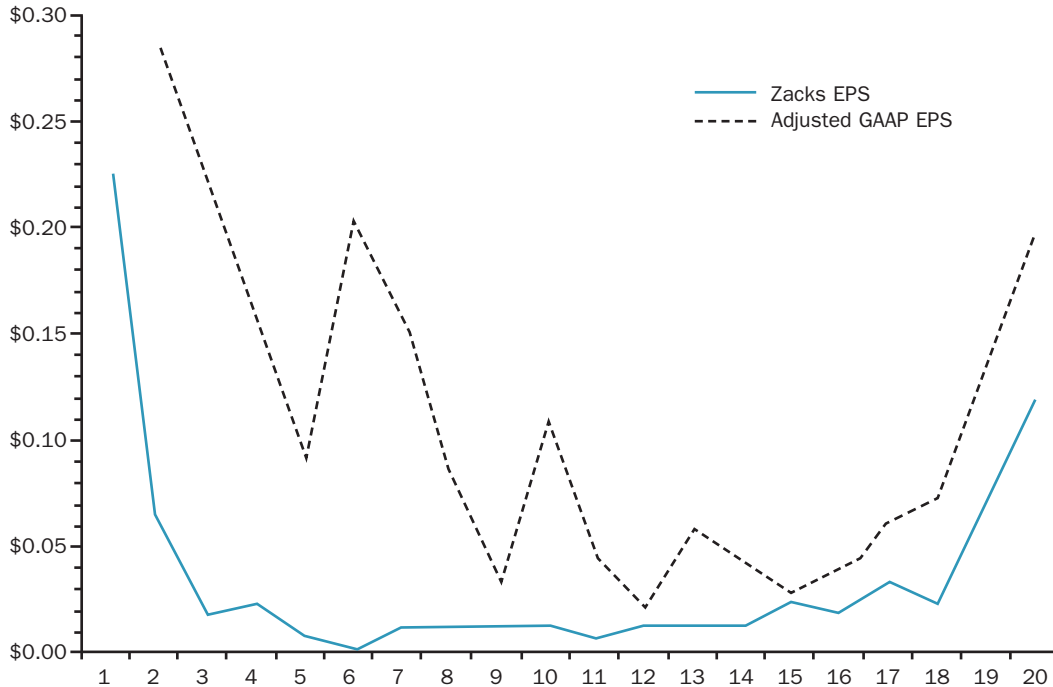
**Panel A: Median quarterly pro forma and actual earnings per share**



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The second step was to calibrate the text strings used to identify sample firms. We examined the second-quarter earnings releases issued by 238 cash-EPS firms identified by First Call. Of those firms, 48.3 percent highlighted pro forma earnings numbers using words captured by our original search strings. Another 13.5 percent disclosed only GAAP earnings numbers in their press releases. The remaining 38.2 percent of the releases prominently featured pro forma earnings numbers using phrases such as “adjusted” net income or loss, earnings “before noncash charges,” or earnings “excluding” one or more GAAP accrual items. The final step in the sample selection process involved expanding the electronic text search to capture releases highlighting variations of these descriptions.

Figure 1 describes the pro forma earnings disclosures made by sample

**FIGURE 1: PRO FORMA QUARTERLY EARNINGS****Panel B: Difference between pro forma and actual earnings**

firms. For purposes of this figure, firms with the lowest quarterly GAAP earnings per share were assigned to Group 1 and the highest EPS numbers to Group 20. Panel A compares the magnitude of pro forma quarterly earnings and EPS to the GAAP numbers reported by sample firms and to EPS as reported by Zacks Investment Research. Zacks and other sell-side analyst tracking services compile proprietary EPS figures that exclude certain GAAP items presumably not included in analysts' EPS forecasts. Those adjustments are intended to ensure comparability between analysts' EPS forecasts and the EPS outcomes used to construct Zacks' proprietary earnings surprise metrics.

Among the sample firms, 36.3 percent reported pro forma losses for the quarter, 54.7 percent reported GAAP losses, and 39.2 percent had losses

as computed by Zacks. Eighty-nine firms (20.5 percent) reported GAAP losses but pro forma profits, and 18 firms (4.2 percent) reported pro forma losses but GAAP profits. Among sample firms, 45.7 percent used the phrase pro forma, whereas 21.5 percent used variations of cash earnings. Another 24.9 percent used phrases like “earnings before” or “excluding” various items, while the remaining 7.9 percent used “adjusted earnings” to describe their pro forma calculations.

Three features of Figure 1 are noteworthy. First, GAAP EPS falls below pro forma EPS in every case except for group 20. This means that income-increasing pro forma adjustments to GAAP earnings dominated the sample, although a small number of highly profitable firms sometimes made income-decreasing pro forma adjustments. Second, firms’ pro forma adjustments to GAAP earnings went far beyond eliminating nonrecurring items. Third, Zacks earnings closely tracked the pro forma EPS amounts reported by the sample firms. Pro forma EPS equaled Zacks EPS in 58.7 percent of the sample.

Panel B of Figure 1 depicts the difference in median pro forma EPS and two other EPS amounts—adjusted GAAP earnings per share and the Zacks EPS. As these data clearly show, median pro forma EPS lies above the adjusted GAAP and Zacks EPS amounts. This means that the income-increasing pro forma adjustments to GAAP earnings made by sample firms go beyond the elimination of special items and are often larger than the proprietary adjustments made by Zacks.

Panel A of Figure 2 shows what GAAP items are excluded from pro forma earnings. Half of the sample firms omitted amortization of goodwill and other intangibles. Other common exclusions were stock-based compensation expense, acquisition and merger costs, charges for purchased R&D, unspecified nonrecurring and special items, restructuring costs and severance charges, and asset sales or equity investment gains and losses. Few sample firms described the excluded items in detail or disclosed the

**FIGURE 2: EARNINGS CHARACTERISTICS**

**Panel A: GAAP items excluded from pro forma earnings  
(% of sample but includes multiple items)**

Amortization of goodwill	50.8
Amortization of (unspecified) intangibles	49.7
Stock-based compensation including payroll taxes on exercised stock options	38.3
Acquisition and merger costs	21.2
Purchased in-process R&D charges	15.5
Depreciation and depletion	4.6
Other items including:	42.3
Amounts labeled as nonrecurring and special items	14.8
Restructuring costs and severance charges	8.8
Asset sales and equity investment gains and losses	9.7
Deferred compensation, financing charges, management fees, non-operating items, unspecified noncash charges and miscellaneous items	9.0

**Panel B: Prior quarterly earnings releases that disclosed pro forma earnings  
(% of sample)**

Zero (first use this quarter)	25.3
One quarter	26.1
Two quarters	17.9
Three or four quarters	19.7
Five to eight quarters	9.6
More than eight quarters	1.4

dollar amount of each adjustment to GAAP earnings. Only one firm reconciled its pro forma earnings on a line-by-line basis to its GAAP income statement. Consequently, we could not determine the dollar amount of GAAP exclusions by category or their impact on individual GAAP financial statement components.

Panel B describes the historical frequency of pro forma earnings disclosures by sample firms. About 25 percent of the firms first disclosed pro forma amounts in their June through August 2000 quarterly earnings release. Another 26 percent started reporting pro forma amounts one quarter earlier, but only 11 percent had disclosed pro forma amounts for more than four quarters prior to our sample period.

Figure 3 reports selected characteristics of sample firms. Panel A con-

trasts the economic sectors included in the pro forma sample with that of all firms for purposes of this study—companies trading on the NYSE, AMEX or Nasdaq exchanges during June through August 2000, excluding firms in the financial services sector.

Although 70.8 percent of the pro forma firms belonged to the computer and technology sector, every other economic sector was represented except for auto, tires and trucks.

Panel B shows that Nasdaq firms comprised 78.7 percent of the sample, a result consistent with the concentration of pro forma firms in the computer and technology sector. Panel C indicates that pro forma firms were less profitable but had larger market capitalization than firms which only disclosed GAAP EPS during the sample period.

Pro forma firms also tended to be more risky, as measured by market beta, with less equity ownership by insiders, higher growth expectations and more coverage by sell-side analysts. Pro forma firms and GAAP firms appeared to be similar in terms of trailing 12-month sales, institutional ownership and number of shareholders.

## **PRICING PRO FORMA EARNINGS**

We used a market-multiples approach to test for fundamental mispricing of the shares of pro forma earnings firms. This approach involved estimating multiple regression models that attempt to explain the cross-sectional variation in valuation ratios. The goal was to develop reasonably parsimonious models that produced a warranted multiple—enterprise value to sales, price to book or price to earnings ratio—for each pro forma firm.

The warranted multiples were constructed from regression model parameter estimates for firms that did not use the pro forma disclosure strategy. Consequently, the warranted multiples reflect the large-sample relation between a firm's valuation ratios and variables that should explain

cross-sectional variations in those ratios. Our mispricing tests were then based on differences between the actual market multiples of pro forma firms and warranted multiple estimates.

This approach has several desirable properties. The estimation procedure produces within-sample warranted values that are unbiased and produce minimum variance. Our particular specifications incorporated a variety of industry and firm-specific controls—for example, profitability, growth and risk—that have been found to explain a substantial portion of the cross-sectional variation in share prices for large samples of firms. Using several different market multiples allowed us to triangulate results across different pricing metrics. However, the market-multiples approach is not immune to criticism, so we also calculated results based on residual income valuation model specifications.

The estimation sample comprised U.S. firms in the Compustat industrial and research files that were also included in the Zacks Investment Research historical database of analysts’ earnings forecasts, excluding financial services firms. Firms were required to have a consensus forecast of long-term growth from Zacks available in the earnings announcement month. We also eliminated firms with a stock price below \$2 per share or trailing 12-month sales below \$1 million. Pro forma firms were not included in the estimation sample.

Our research found that pro forma firms did not appear to have traded at a market premium or discount during our sample period. Our market multiple tests of price levels did not support the notion that pro forma firms are systematically priced differently than GAAP firms.

If investors react to pro forma earnings information and price pro forma firms differently than they do GAAP firms, those share price differences should have been evident in the behavior of stock returns at the time of the quarterly earnings announcement. After all, earnings announcements, made via press releases and conferences calls, are the vehicles that

**FIGURE 3: CHARACTERISTICS OF FIRMS**

	% sample	% all firms
<b>Panel A: Economic sector representation</b>		
Consumer staples	2.8	5.6
Consumer durables	2.5	7.3
Retail and wholesale	7.4	9.8
Medical	3.5	12.5
Autos, tires and trucks	0.0	1.3
Basic materials	0.2	4.6
Industrial products	3.0	6.3
Construction	0.5	3.2
Conglomerates	0.5	0.9
Computer and technology	70.8	32.0
Aerospace	0.5	1.3
Oils and energy	1.4	4.8
Utilities	0.7	3.9
Transportation	0.9	2.7
Business services	5.3	3.8
<b>Panel B: Exchange listing</b>		
New York Stock Exchange	20.8	32.3
American Stock Exchange	0.5	6.0
Nasdaq	78.7	61.7

[ 46 ]

	Sample mean	Sample median	Percent of sample by population quintile				
			Smallest	Quintile 2	Quintile 3	Quintile 4	Largest
<b>Panel C: Profitability, firm size, market risk, ownership and growth expectations</b>							
Quarterly EPS (GAAP)	\$(0.26)	\$(0.08)	0.39	0.15	0.16	0.16	0.14
Quarterly EPS (adjusted GAAP)	\$(0.20)	\$(0.03)	0.39	0.13	0.16	0.19	0.13
Quarterly EPS (Zacks actual)	\$0.03	\$0.06	0.24	0.21	0.29	0.14	0.13
Market capitalization (\$ million)	\$8,783	\$1,246	0.01	0.03	0.09	0.30	0.57
Sales (trailing 12 months, \$ million)	\$1,247	\$135	0.07	0.22	0.25	0.22	0.24
Market beta	1.20	1.10	0.05	0.12	0.15	0.25	0.43
Institutional ownership	40.70%	38.30%	0.13	0.22	0.20	0.23	0.22
Insider ownership	16.20%	7.40%	0.27	0.24	0.18	0.13	0.18
Number of shareholders	5,286.6	1.10	0.28	0.16	0.15	0.20	0.20
Market-to-book ratio	15.2	5.5	0.09	0.08	0.15	0.28	0.40
Analysts' EPS growth forecast	36.20%	36.70%	0.04	0.08	0.14	0.19	0.55
Analyst coverage	6.7	5.0	0.06	0.11	0.27	0.30	0.25

firms use to convey their pro forma results. To investigate this question, we examined the behavior of earnings announcement stock returns for the second quarter of 2000.

We used two return windows: a three-day window centered on the earnings announcement date and a 22-day window ending one day after the earnings announcement date. The three-day window has the advantage of better isolating the share price response to definitive second-quarter earnings announcements. However, the 22-day window allows for the possibility that some firms pre-announced their quarterly earnings.

The unexpected component of quarterly earnings — the surprise — was measured as the difference between the Zacks adjusted EPS and the most recent analysts' consensus EPS forecast, scaled by the absolute value of the forecast. Zacks' EPS deviates from GAAP basic EPS in that it excludes earnings components deemed irrelevant to analysts and their EPS forecasts.

As shown in Figure 4, the mean three-day stock return for pro forma firms was a negative 1.49 percent and significantly smaller than the 0.48 percent mean return for GAAP firms. When the return window was extended to cover possible earnings pre-announcements, the pattern reversed. The mean 22-day return for pro forma firms was 3.78 percent and significantly larger than the 0.88 percent mean return for GAAP firms.

No clear pattern of results emerged when we examined the stock return behavior of portfolios formed on selected characteristics of the pro forma disclosures. For example, the mean three-day return for firms that reported pro forma profits and GAAP losses was a negative 3.71 percent and significant, but the 22-day return for that portfolio was statistically indistinguishable from zero. Explicit use of the phrase pro forma in an earnings release was associated with a mean 22-day return of 6.88 percent, but the mean three-day return was indistinguishable from zero.

The mean consensus forecast of second-quarter earnings for pro forma

firms was \$0.09 per share, substantially below the \$0.30 per share forecast for GAAP firms. Twenty-eight percent of the pro forma firms were forecast to have a loss that quarter compared with only 14 percent of GAAP firms. However, the size of the forecast loss — about \$0.33 per share — was essentially the same for the two groups. More than 60 percent of the earnings surprises for each group was positive.

We conducted two additional tests in an attempt to unravel these findings.

The first controlled for differences in the earnings surprise distributions of the two groups. We first sorted GAAP firms by earnings surprise into 20 portfolios of equal size. As shown in Figure 5, Panel A, with three exceptions the three-day portfolio returns for pro forma firms were below those of GAAP firms. The pattern is reversed in Panel B, where portfolio returns are measured over 22 days.

The second test sharpened this analysis by estimating two cross-sectional models of earnings announcement stock returns using variables that included the earnings surprise and its interaction with accounting losses, new economy firms and pro forma firms.

Our research found that the stock return behavior of pro forma firms at the earnings announcement date did not appear to differ from that of other firms in our sample after controlling for GAAP operating losses, new economy membership and forecasted EPS growth. This conclusion also held when the pro forma sample was restricted to firms that explicitly used the phrase pro forma or cash earnings in their press releases, reported pro forma profits but GAAP losses for the quarter, did not typically use a pro forma disclosure strategy, and reported pro forma EPS in excess of the Zacks EPS for the quarter.

Given the widespread use of residual income valuation models in academic research, we performed a second series of price level tests substituting residual income models for the market multiple models. Our

**FIGURE 4: SECOND-QUARTER 2000 EARNINGS ANNOUNCEMENTS**

	Mean	Median	Percent positive	Two-sample p value
<b>Pro forma firms (n=256)</b>				
3-day stock return	(1.49)*	(1.63)*	43.00	0.014
22-day stock return	3.78*	3.37*	56.60	0.062
EPS forecast	0.09**	0.09**	70.30	<0.001
Forecast dispersion	0.02	0.01		0.375
Forecasted losses (n=72)	(0.35)	(0.19)		0.624
Earnings surprise (%)	16.03**	7.02**	67.60	0.037
Forecasted EPS growth	33.25	30.00		<0.001
<b>GAAP firms (n=1688)</b>				
3-day stock return	0.48	0.65**	55.60	
22-day stock return	0.88*	0.77*	52.40	
EPS forecast	0.30**	0.25**	84.80	
Forecast dispersion	0.03	0.01		
Forecasted losses (n=243)	(0.32)	(0.21)		
Earnings surprise (%)	6.32**	4.00**	62.20	
Forecasted EPS growth	19.24	16.67		

\* p < 0.05 for two-tailed tests of means (medians) different from zero.

\*\* p < 0.01 for two-tailed tests of means (medians) different from zero.

residual income valuation model tests did not support the notion that investors price pro forma firms differently than they price other firms.

## CONCLUSIONS

Income-increasing pro forma adjustments to GAAP EPS dominated the sample, although some highly profitable firms occasionally made income-decreasing pro forma adjustments.

Our ability to calibrate the magnitude of individual pro forma adjustments was hampered by firms' use of rather vague categories to describe the expenses excluded from their pro forma results and by the absence of detailed reconciliations to GAAP earnings. We also found that pro forma EPS

equaled the EPS figure reported by Zacks Investment Research in about 59 percent of the cases. When the two figures differed, it was because the income-increasing adjustments to GAAP earnings made by Zacks were smaller than those made by the firms themselves.

We found no evidence that pro forma firms were priced differently than GAAP firms for our sample period. Similarly, we found no evidence of a stock return premium or penalty for pro forma firms at the earnings announcement date. Collectively, our results provide evidence that investors were not misled, on average, by pro forma earnings disclosures issued during June through August 2000.

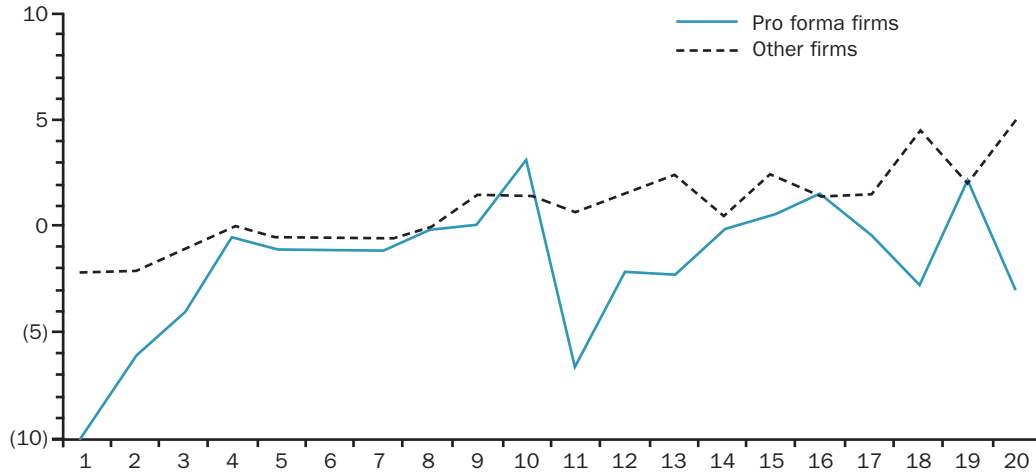
Management-initiated pro forma adjustments for special items and goodwill amortization occur frequently in our sample. Our results are consistent with prior evidence indicating that these two components of GAAP earnings have little influence on share prices because investors correctly recognize the transitory nature of special items and goodwill's lack of impact on cash flow.

The general tenor of the evidence from our study is that pro forma earnings are more informative for equity valuation purposes than are GAAP operating earnings and exhibit stronger association with analysts' earnings forecast revisions. Our finding was that investors do not seem to focus myopically on the earnings number reported conspicuously in the press release headline and lead paragraph but instead consider a richer set of information when evaluating firm performance.

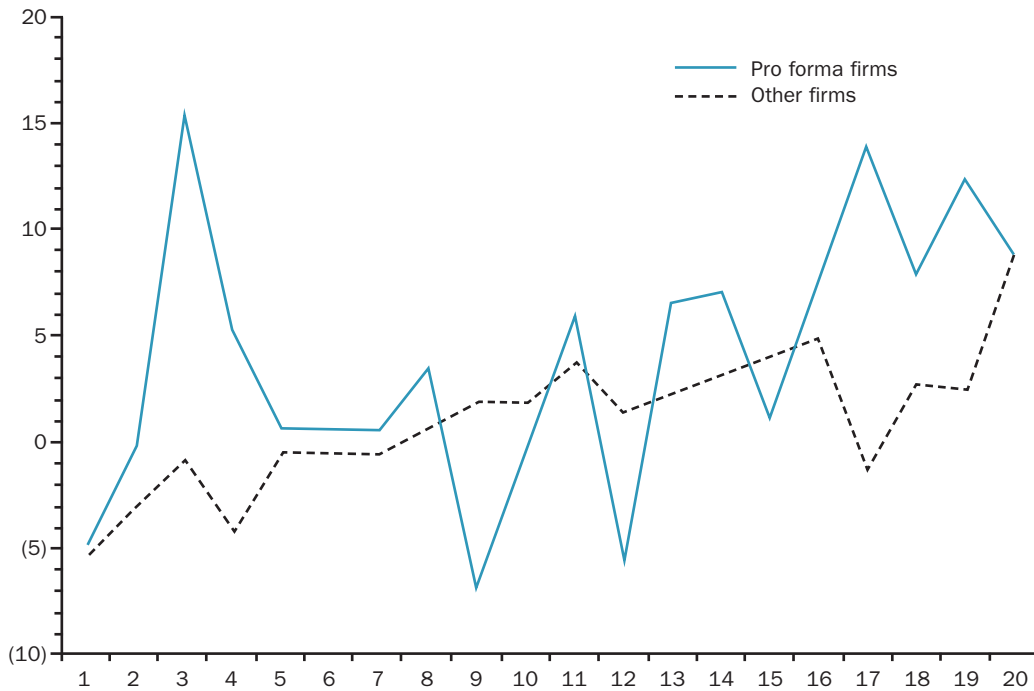
There are two important caveats to this study. One is that our evidence should be interpreted as pertaining to the way in which investors price the average firm in our sample rather than to how each individual pro forma firm is priced. The possibility remains that some pro forma firms are mispriced and that some investors occasionally are misled by pro forma disclosures. For example, our results are consistent with the notion that sophisticated investors arbitrage away temporary price premiums or penalties assigned

**FIGURE 5: RETURNS FOLLOWING EARNINGS SURPRISES**

**Panel A: Median three-day stock return (%)**



**Panel B: 22-Day stock return (%)**



to pro forma firms by unsophisticated investors who are misled by the disclosure strategy. Our research methods are not designed to detect potential wealth redistribution effects of this sort.

A second caveat is that our results are based on pro forma disclosures issued during a single earnings season—June through August 2000. Anecdotal evidence suggests that pro forma disclosures have since become more common and less transparent. In fact, there have been occasions when companies announced their pro forma results without simultaneously disclosing how they calculated them or what their actual results were under GAAP. Widespread criticism of pro forma earnings reports has prompted self-regulatory guidance issued jointly by the Financial Executives Institute and the National Investor Relations Institute as well as cautionary advice and strict disclosure rules issued by the SEC. ■

**PERSPECTIVES ON IR****In the Know****How Audiences Relate to  
IR Practices**

[ 53 ]

*Ask investor relations practitioners why their role has expanded and the list of reasons is likely to start with legal and regulatory initiatives, splash-over from corporate scandals and Wall Street upheaval, or the effects of the bull market. Good reasons, all. Yet another development that deserves to be listed but seldom is articulated is that IROs increasingly touch more audiences with broader expectations for the IR function. IRQ asked representatives of several key audiences what they expect of IROs.*

**PERSPECTIVE ON RATINGS:  
SCORING CORPORATE GOVERNANCE****BY HANK BOERNER***Managing Director*

ROWAN &amp; BLEWITT

Investor relations officers usually focus on their companies' equities and are not often involved in the credit rating process. They view the debt markets as the province of the corporate treasurer and others, because credit ratings are intended for use in debt or fixed-income markets.

Traditional credit ratings—more accurately, credit risk profiles—are important tools for both private and publicly owned corporations. The rating assigned by an independent, objective agency is required for access to the debt markets and determines cost of funds. A Standard & Poor's, Moody's or Fitch rating will be necessary at some point in the growth cycle of every business.

Forward-looking IROs are beginning to pay more attention to the credit agencies, following the lead of equity analysts who are now focusing on published credit and risk ratings as they perform their evaluations. Investors have learned that events in the credit market, such as a credit downgrade, can immediately affect the share price of the company involved.

That bridge between ratings and investing decisions is catching the attention of a number of agencies and investment community advisers. In various forms, they are developing scores that apply the concept of attribute measurement to equity-related topics. One of the more promising is the corporate governance score developed by Standard & Poor's, which is relying on its reputation for objectivity and reliability as well as its assessment skills to develop a comprehensive process for evaluating and scoring corporate governance, which may well become the primary crossover product of importance to both credit and equity institutional investors.

S&P develops the in-depth corporate governance scores that it publishes for public companies independently from its credit-rating operations. The McGraw-Hill Company subsidiary points out that it has built fire walls between its rating groups to make sure that no confidential information gathered by its credit-rating operations is shared with those who calculate corporate governance scores.

## **CORPORATE GOVERNANCE SCORES**

The corporate governance scoring process is based on two important principles:

1. Corporate governance as the interaction of a company's management, board and shareholders to ensure that all financial stakeholders—shareholders and creditors—receive their fair share of the company's earnings and assets.
2. The corporate governance score is an opinion. In the case of the corporate governance score from S&P, it is the view of that agency's experts on the extent to which, after careful evaluation, they perceive that the client company has adopted codes and guidelines of generally accepted corporate governance practices that clearly serve the interests of its financial stakeholders.

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S&P began developing its corporate governance score in 1998 in response to customer requests for information on emerging markets such as Russia and Asia-Pacific. The initial scoring of corporations outside the United States began in 2000, and the scoring of U.S. companies began in October 2002.

### **TAKING PART IN THE SCORING PROCESS**

Investor relations officers and others who are drawn into the corporate governance scoring process should evaluate its impact from several angles:

- Whether the board or executives believe that the company would benefit from a thorough corporate governance review that leads to compiling an evaluation and possibly publishing the score
- Whether the company can interact with the reviewing body during the evaluation and analysis process
- Whether the reviewing body looks at both public and nonpublic information

The S&P corporate governance scoring process is voluntary, interactive and focused on both public and nonpublic information, excluding confidential material provided to its credit rating arm. As with S&P credit ratings, it is solely up to the client company's discretion whether to make the corporate governance score public; the company can request a confidential governance evaluation and keep the results confidential. The company can also use the evaluation to improve its governance and then have a score developed and published, by S&P and through its own communication avenues.

### **WHAT IS EVALUATED?**

The agencies and services that have begun developing scoring systems typically review key elements and related components like the following:

- **Ownership.** The structure and influence of external shareholders and transparency of ownership
- **Investor Participation.** Investor rights, stakeholder relations, shareholder voting and meeting procedures, ease of access to meeting information
- **Financial Matters.** Communication transparency, information disclosure, quality and content of public disclosure, auditor independence, audit process
- **Governance.** Board structure and process, board composition, the board's role and effectiveness, outside directors' role and independence, compensation

The scoring documents provide detail on each component that the provider identifies as critical. S&P's corporate governance score uses a range of 1 to 10, with 9 to 10 considered very strong and the middle of the range a good outcome for an initial evaluation.

## **RELEVANCE TO INVESTOR RELATIONS**

At present there is still considerable discussion about the value and effectiveness of various corporate governance scores and ratings being offered by pioneering providers in the wake of Sarbanes-Oxley legislation. To the extent that corporate governance becomes a critical factor in financial analysis and investors pay more attention to companies' scores, the independent scores and ratings could become important tools for investor relations officers. A McKinsey survey in 2000 found that investors were ready to pay a premium for companies that practice good governance. A follow-up in 2001 revealed that board practices were as important as financial performance in evaluating investment opportunities. A separate survey by Harvard's Paul Gompers demonstrated an 8.5 percent excess annual return for well-governed companies.

There could be another value for the client company that commissions such an evaluation: It will give management a framework for benchmarking the organization's corporate governance best practices and identifying areas needing attention and improvement. This resource could be helpful as new corporate governance rules for NYSE- and Nasdaq-listed companies take effect and compliance with those new rules requires objective guidance.

## **PERSPECTIVE FROM THE INDIVIDUAL INVESTOR: DIRECT COMMUNICATIONS WORK**

**BY RICHARD A. HOLTHAUS**

*President and Chief Executive Officer*  
NATIONAL ASSOCIATION OF INVESTORS CORPORATION

A topic that is sure to come up in almost any investment community conversation is how much has changed and how quickly. The economy weakened, corporate credibility sank, Wall Street buckled, war threatened, stock value evaporated, investors shrank.

That condensed version of recent events suffers from the usual limitations of instant analysis. Of even more consequence for the investor relations practitioner, however, it lumps all investors in the same pattern of behavior. Although individual and professional investors share a common goal of profiting from their investments, they follow distinctly different paths to reach their buy, sell and hold decisions. IROs who ignore that reality short-change their programs and their companies.

Recognizing that individual investors are a key audience for investor relations is a necessary first step in reaching out to this desirable audience. It is important to keep in mind, too, that not all individual investors follow the same investment practices, just as professional money managers have different styles and approaches. For purposes of this discussion, we will concentrate on the expectations of committed, analytical retail investors who bring a long-term focus to their investment process. In many ways they represent the ideal target for investor relations activities.

## **STICKING WITH THEIR PROCESS**

With the intense focus on what has changed for investors in the past few years, it is easy to overlook the fact that individuals still research opportunities, analyze performance and vet investment candidates against informed opinions. What has changed is whose opinions count most in that evaluation.

Perhaps not surprisingly, investors increasingly rely on their own initiatives more than they trust Wall Street's resident experts. In practical terms, that means individual investors devour more sources of information, raise more questions about companies' operations and financial reporting, and dig more deeply into corporate strategy than they used to. IROs accustomed to the Street's quarter-to-quarter attention span may find their stories wanting when the focus shifts to the individual investor's longer-term horizon.

Investor relations officers who try to deflect that discussion do so at their peril. Investors who are willing to commit to the market for the long term have been known to develop a mindset that can be compared with how they view grocery staples—those items always have a place in the pantry, and the time to buy is when the products are on sale. Individual investors with that perspective look at Wall Street today and see bargains. To take the analogy one step further, they also tend to read the labels—and therein is both a challenge and an opportunity for investor relations practitioners. The audience may be receptive to the message, but only performance turns listeners into buyers.

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## **WHAT INDIVIDUAL INVESTORS EXPECT**

The more these committed individual investors rely on their own initiative to assess investment opportunities, the more they demand timely, honest communications with clear explanations of a company's growth plan and how it is faring.

One of the biggest mistakes companies make in communicating with individual investors is to let an impression build that they are less than willing to discuss certain topics related to their business. Online access to Securities and Exchange Commission filings has made it easier for all stakeholders to track corporate developments. Even so, companies that rely on SEC filings as a primary means of disclosure can quickly come to be perceived as making shareholders dig for information. Even the most capable individual investors will likely choose to move on to less demanding opportunities. And in this kind of market they can find numerous candidates worthy of consideration before they decide where to commit their investment dollars.

These able individual investors also value contact with management. Webcasts play a growing role in their information-gathering process. Regional investor fairs sponsored by National Association of Investors Corporation

chapters continue to attract attendees primarily because they represent opportunities to interact directly with company officials.

Investor relations officers who make themselves available to individual investors—by e-mail and phone as well as in person at events where these investors gather—play an important role in positioning their companies as accessible and worthy of investment consideration.

### **FINDING COMMITTED INDIVIDUAL INVESTORS**

Assuming that investors' expectations for a respectable performance track record are met, investor relations practitioners who reach out to long-term-oriented individual investors find that they tend to support management, hold stocks for an average of three to seven years compared with fund managers' average of less than a year, and buy stock worth \$10,000 to \$20,000 when they are ready to make an investment.

As a matter of fact, NAIC members add \$190 million to their investment portfolios each month. The total portfolio of these hundreds of thousands of savvy individual investors exceeds \$125 billion, which would rank among the 10 largest funds in the United States if that money were managed by a single institution.

Indeed, IROs can use NAIC as a targeting mechanism to find these desirable individual investors. Corporate membership provides access to NAIC members through a number of programs, both directly at investor fairs and NAIC's annual national convention and indirectly through its Web site, direct mailings and *Better Investing*, its monthly magazine distributed to members and sold on newsstands.

There are other tools available to the IRO who wants to learn more about the company's shareholder base and how its demographics are changing. Depository and transfer agents' reports that track shareholders of record and the numbers of shares they own are available to corporate officers.

Comparisons of proxy requests provide the basis for calculating average shareholdings and yield insight into the extent to which brokerage firms seem to be supporting interest in a particular stock. Relationships with brokers can help gain access to their internal broadcasts, another vehicle that helps bring about the contact with management that individual investors value.

For many investor relations officers, however, the necessary first step still is to put individual investors on their radar screens—to include them in laying out their investor relations plans and budget, with appropriate targeting, goal-setting and measurement. IROs and their companies benefit when they include these savvy, committed, substantial investors in their programs. Moreover, there has never been a better time to reach out to them. They have funds to invest, they like equities, and more than ever they are relying on their own research to make investment decisions. The welcome mat is out for IROs whose companies deliver performance and whose corporate stories are straightforward, substantive and sensible.

On the other hand, Enron and its ilk never made it onto the annual list of NAIC members' top 100 stocks because these common-sense investors couldn't tell how those companies really made money. NAIC members also avoided the worst of the technology bubble. They stuck to their analytical guns and avoided companies without "E" to go along with the "P" in their price-earnings ratios.

Those examples provide another lesson for how commentators, investor relations officers, corporate executives and others in the investment community should view investors. The reminder is simply this: All investors invest, but woe to those who assume that all investors invest in the same way.

## **PERSPECTIVE FROM THE BUY-SIDE: ACCESS TO MANAGEMENT AND INFORMATION**

**BY JOHN L. RUTLEDGE**

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EVERGREEN INVESTMENT MANAGEMENT COMPANY

What does the buy side want from IR?

Accessibility, consistency, predictability—and no surprises—is the answer that most investor relations officers expect from buy-side analysts or portfolio managers—or, for that matter, from sell-side analysts.

To that list, the buy side would add compliance with best-practices disclosure policies. That is why Regulation FD generally finds an enthusiastic audience on the buy side. We use and value Wall Street brokerage sell-side research, but we do not want to be dependent on it. We do not want to learn about a new material development from the Street.

What this means for IROs is that they should pay meticulous attention to determining just what is material and then correctly and fully disseminating that information. That calls for issuing a press release to all the news media first, before anything else, and following up with a telephone and webcast conference call as appropriate.

There is nothing more enraging to buy-side analysts and portfolio managers than for a company to call selected favored sell-side analysts first, giving them information that turns out to be material by its near-term impact on stock price. Whether such conversations are an effort to curry favor with selected sell-side analysts, an attempt to sugarcoat what may be unfavorable news, or soft research to determine what the market reaction might be doesn't matter. It is just wrong.

The buy side always finds out about poorly disseminated stories. But these professional investors should not have to chase after the facts. Their telephone calls to numerous brokerage analysts and to the company's IR

officer should be interpreted as a clear signal that the company has seriously mishandled an important news item. Buy-side investors do not fault the Street in these matters; we fault the company. No IR officer wants this situation to arise — and it is avoidable.

Here is a look at some common forms of communication with investors and how the buy side views them.

**Quarterly Earnings Press Releases.** From the buy-side perspective, these documents should include absolutely everything that management has to say about the past quarter. Any numbers related to the quarter just past, no matter how minor they seem, should be in the press release and not dribbled out during a telephone conference call, sometimes only in response to a specific question.

If the company provides forward guidance, it should be given completely in the press release and not held back for the telephone conference call, as is the practice at far too many companies.

**Private Telephone Conversations Between Individual Sell-Side Analysts and the Company’s Investor Relations Officer After the Quarterly Conference Call.** Speaking for myself as a buy-sider, I am uneasy about this common practice. Clearly the sell-sider is looking for unique, proprietary information. All I can say is that the information exchanged better not be anywhere near material.

**Research Report Review.** Another common practice that gives us on the buy side concern is investor relations’ review of sell-side research reports before they are published. The purpose of the review may be described as a fact check, but that is work that the writers themselves can do. Submitting the draft to the investor relations officer ahead of publication thus appears to be a way for the analyst to feel safe or — worse — a means of currying favor with the company.

In my view, the IRO should return the draft report unread, with “no

comment” written across its cover sheet. IROs can repeat the previously disclosed official company guidance, but nothing more.

**Road Shows.** From my perspective, there is no problem in having a particular brokerage investment house sponsor an information-only road show, as long as the event is placed on the company’s IR Web site calendar so that any investor who wants to can attend or at least know about the meeting.

### **WANTED: MANAGEMENT AVAILABILITY**

What buy-siders really want is management availability for frequent talks and meetings with investors, including group meetings. Investors in mid- and large-cap companies do not need one-on-one meetings as much as do small-cap investors, who generally have less Street coverage to help gain insight into how the company operates.

Bottom line, the buy side appreciates having executives frequently meeting with investors at brokerage-sponsored conferences or on self-sponsored road shows.

The buy side views the role of the investment relations officer as absolutely key in maintaining a steady and smooth flow of appropriate company information to investors. When IR is handled well, there is no need for damage control. A well-run investor relations operation means satisfied investors who never have to chase down a story or a surprise development—because the investor relations officer is always ahead of the curve when it comes to disclosing important new information. ■

**CASE STUDY**

# Subjective Analysis

## Re-Examining Relationships With the Sell Side

[ 65 ]

THE DAY AFTER YAYBLOCKS CORP. RELEASED QUARTERLY earnings was typically calm for investor relations officer Sandra Pondra. With those activities behind her, she looked forward to her version of closing the books—wrapping up investors’ issues, analysts’ reactions to the earnings report, and how the story played in key media in a report for the toy company’s senior management team.

The process had gone well that quarter, she thought. It was the first time that all five members of the audit committee had weighed in with comments on the news release draft, in addition to what seemed like a growing list of reviewers among the internal financial staff, independent auditors and legal counsel. With an eye toward renewed emphasis on GAAP accounting, Yayblocks had expanded the news release and prepared conference-call remarks to walk investors through the numbers while emphasizing the functions that it now considered to be core operations.

In the course of reinventing itself as a manufacturer and distributor

rather than a manufacturer and retailer, Yayblocks had incurred a number of charges related to discontinued operations and raised its debt level significantly. Even though disposing of its retail stores took longer than expected, the company pursued an aggressive schedule for organizing its new distribution system. It seized an opportunity to invest in a regional consumer goods distributor and then bought and built businesses to replicate that structure in selected other markets, even though its initial plan was to hook up with established distributors and develop a captive system as needed to fill gaps.

[ 66 ] Although Yayblocks' management team was satisfied with overall progress, the plan's execution made for messy interim financials. In prepared remarks that the executives delivered at industry conferences and in Sandra's day-to-day interactions with investors, the company had gone to what it considered great lengths to explain the impact of the various decisions on its financials as well as to keep investors focused on the longer-term strategic benefits. Moreover, as a medium-sized company, Yayblocks had only a handful of sell-side analysts following it. Two had specific toy industry knowledge. The rest were consumer goods or leisure industry generalists. As a matter of fact, one of Sandra's goals for the current fiscal year was to take a new look at sell-side coverage, increase it if possible, and at least make sure that Yayblocks had the right analysts' attention in light of its recent restructuring.

Indeed, Sandra had made a mental note to accelerate that process as the conference call's question-and-answer period wound down. Only three analysts had bothered to join in the call, and their questions were more concerned with topics that she considered financial minutiae than with strategic direction. Similar near-term emphasis cast a shadow over the analysts' post-earnings snapshot reports. On top of it all, the analyst who knew the company best called to say that he had accepted his firm's staff-reduction severance package.

Sandra pondered how much attention to give to the sell-side reactions as she prepared her post-earnings-announcement summary. She knew that the CEO was becoming impatient with what he considered analysts' lack of appreciation for Yayblocks' strategic initiatives. She also weighed how to contend with the broadening estimate range. She was keenly aware that arithmetic more than analysis increasingly drove the consensus number and that shrinking coverage potentially gave individual estimates too much sway. On top of all of that, she anticipated that a key analyst's departure would reignite the CFO's interest in paid research, a project that seemed to come up with greater frequency given Yayblocks' own strategic transformation and the investment banking and brokerage industry's turmoil.

The more Sandra thought about those issues, the harder it was to finish the post-earnings report, especially its section on key issues and proposed follow-up with the financial community.

*For help in sorting through Yayblocks' sell-side relationships, IRQ turned to experts in investor relations and communications. Here are their responses.*

## **FOCUS ON THE OWNERS, NOW**

The first—and most penetrating—question: Why, Yayblocks? Why agonize over this situation: Few analysts bother to join the call, the best one in the industry is quitting, their analysis is mostly arithmetic, their questions focus on financial minutiae.

Follow your own advice, Ms. Pondra: Take a new look at sell-side coverage and think about who really sets the equity price. Where is the power? As the person responsible for investor relations, to whom should you be tending? Where is the return for the effort?

At Yayblocks, the owners.

Where should your time be spent? In essence, in your own words, why choose to focus on the customers who knew and cared the least, had a lack

of appreciation for your strategic initiatives, often focused on the wrong things, and had conflicting incentives?

Real value in IR can be added here in two ways:

1. Help management get the message that for this toy company, at this time, it's all about the owners—and about locating more prospective owners.
2. Naturally, flowing from that, the equally hard part is to develop and execute a plan—now—to go directly to the owners. Hard work. Tailored message. Relationship-building. These steps are not revolutionary. What it takes is to return calls, make new ones, do visits, meetings, more-than-usual care and feeding, direct e-mail, fax, voice mail, information flow, analysis, travel, management interaction and so on. Focus on the company's strategic initiatives.

In this instance, put the sell side in the headlights of the buy side. They are a powerful ally in demanding better work by better players.

The game is changing—no news there. We all know and appreciate great analysts who are hard-working and professional and who still can sway opinions. But you cannot create those analysts, and it is a flat-out mistake to make them your No. 1 priority. In Yayblocks' case, Sandra has all the facts to lead her to the real opportunities for her company now: Educate management, and focus on its owners.

*Tim Cost, a former NIRI chairman, most recently served as senior vice president, corporate affairs, at Pharmacia Corporation.*

## NEW STRATEGY MAY OPEN DOORS

I certainly don't envy Sandra's situation. She has a number of major issues to address. Not only does she have to contend with a re-engineered strategic direction for a company in a niche industry but she also faces a growing problem for many small-cap and mid-cap companies in the current market environment—the struggle to attract sell-side coverage.

Although small-caps' and mid-caps' potential to grow earnings faster than their large-cap counterparts can make them appealing investments in the early stages of an economic recovery like the one we're in now, the reality is that there are fewer sell-side analysts to attract. And the ones who do follow your industry may be hamstrung by smaller budgets and management directives to cover only those stocks with sizable floats that can generate larger trades that translate into more revenues.

On the plus side, Sandra and Yayblocks have an opportunity to hit the reset button with the sell-side community. Because the company has a new business model, it also has a new story to tell. However, with Yayblocks' specialty focus in the toy industry, Sandra must decide whether the company wants only industry experts to follow the stock or if generalists would be acceptable to help expand the coverage.

Fortunately Sandra has several ways to identify potential coverage.

If she has the resources, she can subscribe to one or several Web-based investor relations databases that can produce lists of possible analysts.

If her resources are more limited, she can still review brokerage firms' Web sites and conduct key-word searches on competitors or industry trends to see which analysts are talking or writing about those topics. The same potential lies in major business publications, such as *The Wall Street Journal*, as well as industry trade publications, which frequently quote sell-side analysts.

And Sandra should not forget about getting suggestions from existing

institutional shareholders, especially those that have maintained their positions in Yayblocks throughout the company's transition. Portfolio managers and buy-side analysts often consult the sell side to get additional perspectives on a company or industry.

While new-coverage opportunities will still be limited for the reasons mentioned earlier, I would highly recommend to Sandra that Yayblocks avoid paid research and focus instead on analysts at independent research houses and brokerage firms that have no ties to the company. Because institutional shareholders recognize paid research and probably do not give it much credibility, it is important that the company's coverage have as much integrity as possible. (In fairness, I must point out that roughly 11 percent of the stocks covered by my firm's research department are investment-banking clients, a fact that we disclose in our research reports and marketing materials. None of the analysts who follow my own firm's stock, however, have any investment-banking ties to us.)

The broad range of earnings estimates may require Sandra—within the bounds of Reg FD, of course—to get more feedback from the analysts or re-examine their reports to see what specifics they focus on when making their projections. Perhaps one analyst has spoken with some of Yayblocks' distributors to get a better sense of how business is doing. Another may not like the amount of debt on the company's balance sheet. And a third may feel that the economic environment is not conducive to a toy company's earnings, no matter how attractive Yayblocks' new business model appears. It is important that Sandra have a grasp on the details of each analyst's model so that she and senior management can address shareholders' questions accordingly and determine the best ways to approach individual analysts.

*Justin J. Gioia is director of investor relations at St. Louis-based A.G. Edwards, Inc.*

## **IR IS MORE THAN SELL-SIDE RELATIONSHIPS**

Sandra has some real investor relations challenges that are not limited to completing a post-earnings report or to sell-side coverage.

Let's summarize the operating and financial issues to be considered in analyzing the situation at Yayblocks Corp.:

- The company is in the process of executing a new corporate strategy
- It has made an acquisition that was at variance with the company's new strategy as initially planned
- The reported financials are messy because of the acquisition and write-offs
- The capital structure has changed because of issuance of debt
- Implementation of the new strategy has not met management's deadlines
- Management is disappointed with the number of analysts on the conference call

Given the scandals that we have been living with for the past year and a half, investors are cautious when a company changes its strategy or fails to meet any timetable. They have learned from bitter experience that any sign that things are not going as planned frequently is followed by evidence that things are seriously wrong. As we have seen, confusing financials can hide operating problems and sometimes even obscure fraudulent practices.

While corporate America and accounting firms are being exposed for misdeeds and fraud, Wall Street also is being scrutinized. The role of sell-side analysts in investment banking deals has been challenged. The environment is forcing brokerage firms to reassess their research coverage.

Because the costs of research can no longer be covered by analysts' work in investment banking, coverage for many smaller firms is being terminated and analysts are being laid off. In fact, the role of all sell-side research is being questioned.

As Sandra considers what action she should recommend to her management, she should keep the following points in mind:

- A strong communications program does not overcome weak fundamentals
- If a company is complicated, difficult to analyze or has reported disappointing earnings, investors have little incentive to analyze or buy the stock
- Paid-for research frequently is viewed as company hype and has limited credibility with the financial community
- With the changes in Wall Street, many companies will have less sell-side research

Sandra has taken the important step of expanding the press release and conference call to include a detailed explanation of the numbers and to emphasize the functions that are now considered core operations.

We recommend that she consider the following additional actions, some aimed at her external audiences and several at her management audience:

- Make rebuilding credibility the primary goal of the investor relations program
  - Ensure that any projections are realized
  - Lobby for more transparent accounting

- Continue to focus on specifics of the strategy
  - Its benefits
  - How management measures its success
  - Why the acquisition changed its implementation
  - Goals for the capital structure
- Provide investors with a reasonable timeline for further implementation of the strategy
- Provide investors with realistic metrics that they can use to measure the company's progress
- Carefully analyze the current shareholder base and determine the specific investment styles and objectives of all major holders
- Focus on building a strong shareholder base composed of retail investors and managers of private wealth
- Ensure that management understands recent and emerging changes in the financial community, including the role of sell-side research
- Develop a Web page that provides all investors with the information required to understand the company's strategy and its benefits, the financials and the strength of the management team
- Informally survey existing investors concerning the value of paid-for research in order to provide empirical evidence to management concerning the credibility attached to such work

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The timing is right for Sandra to change the focus of Yayblock's investor relations program. An important step in implementing this change should be educating her management team concerning the realities of the current environment. With their understanding and support, she can then focus her efforts on developing a proactive program through which the company assumes responsibility for marketing its stock to appropriate investor groups.

*Pamela A. Jameson, CFA, is principal of Communication Analytic.* ■

# Big Issues for Small Caps

## THE COST OF BEING PUBLIC

LANCE JON KIMMEL

**T**he rapidly rising cost of compliance with corporate governance reform is falling disproportionately on small-cap public companies—and even more cost increases are on the way for public companies already facing double-digit increases in audit fees, director and officer insurance, and legal expenses.

These are among the findings of a study by Foley & Lardner that reviewed proxy statements, interviewed service providers and questioned senior managers to quantify the cost of being public and determine how much corporate governance reform might add to that total. In the course of our study, our law firm reviewed the total cost of being public, focusing on the biggest expenses—accounting fees, directors and officers insurance, and directors' fees.

### ACCOUNTING FEES

The review of 450 proxy statements showed that the mean audit and audit-related fees for S&P SmallCap 600 companies—those with market capitalization of \$250 million to \$900 million—

increased 28 percent to \$554,000 in fiscal 2002 from \$433,000 the previous year, more than double the mean 12 percent increase in fiscal 2001 over 2000.

Interviews with accounting firms pointed to additional time and personnel required for audit and ongoing financial reporting services as the primary reasons for the increase. Accounting firms expect further significant increases in audit and audit-related fees in fiscal 2003 in part because new rules require accountants to attest to financial statements.

However, audit and audit-related fees represent only part of the story. Despite the increased attention given to consulting fees paid to accountants in recent years, nonaudit fees still represented approximately half of small-cap companies' total accounting firm expenses in 2002.

Mean total fees paid to accountants by small-cap companies increased 14 percent to \$1,051,000 in fiscal 2002 from the year-earlier \$924,000. The two-year increase—2002 compared with 2000—was a whopping 44 percent.

## **D&O INSURANCE COSTS**

Insurance brokers have reported premium increases for directors and officers liability coverage ranging from 50 percent to more than 300 percent over the last two years, regardless of the size of the client company. The insurance industry's losses mushroomed from \$760 million in 1996 to \$5.6 billion in 2001, the last full year for which figures are available, and underwriters have passed those costs on to their clients.

Good corporate governance scores, such as a high rating on Institutional Shareholder Services' Corporate Governance Quotient, so far have not translated into D&O insurance premium savings. It is too soon to tell whether good corporate citizenship as reflected in these scores will mitigate spiraling insurance costs. For the time being, industry experts caution that insurance budgets will just have to expand to reflect the new environment.

## **LEGAL FEES**

Even small-cap companies are experiencing double-digit increases in legal fees directly associated with corporate governance reforms. New or revised committee charters, establishing whistleblower procedures, new disclosure and internal control procedures, and similar projects may be one-time events. However,

expenses related to situations such as more disclosure in SEC reports, more frequent Form 8-K filings, and accelerated Section 16 filings by directors, officers and large shareholders represent a permanent increase in legal costs. In addition, totally new legal costs, such as independent counsel for the audit committee, may not be far off.

These increases may hit small-cap companies especially hard because they often do not have the resources to hire in-house counsel. Large law firms have the resources to stay abreast of rapidly changing and highly technical developments. But their fees are higher than those of smaller law firms to which many small public companies have turned in the past.

## **DIRECTOR FEES**

Foley & Lardner's study revealed that most public companies have not yet begun to review compensation paid to their outside directors. That finding comes at the same time that director recruiting and compensation consultants are predicting that the forces of supply and demand will push director compensation dramatically higher. One reason is the tighter definition of independent director, along with the additional requirement of defining who among

that group qualifies as a financial expert to chair the audit committee. Another factor is how much more time directors will need to discharge their increased responsibilities. Some experts estimate that their time commitment will double.

Our firm's proxy statement review showed that small-cap companies' fees for outside directors increased 7 percent in fiscal 2002 compared with fiscal 2001. A closer review of 135 additional proxy statements found that about 20 percent of the smaller group, almost all of them large-cap companies, had recently reviewed compensation for outside directors and increased their fees between 25 percent and 35 percent.

Thus, director fees may well be a leading-edge expense that the majority of small-cap companies have not yet addressed. As those companies reorganize their boards and committees, they may well find that recruiting is more difficult and much more costly.

## **HIGHER COSTS TO COME**

Working through an independent national research consulting firm, Foley & Lardner mailed a blind survey about the cost of being public to several thousand companies. The questionnaire focused on a dozen detailed budget items.

On a line-by-line basis it asked for historical costs before corporate governance reform and estimates for the same costs after reforms are fully phased in.

Based on the reports of 32 middle-market respondents, the mean cost of being public before reform was \$1.3 million. The responses projected a mean of \$2.5 million when the reforms are in place—a 90 percent increase in costs directly associated with being public.

## **CONSEQUENCES**

Based on percentage of revenue, small-cap companies are bearing the greatest burden of enhanced corporate governance compliance. This may be a significant factor in 56 percent of the survey's participants saying that corporate governance reforms are too strict.

Without exception, small public companies supported the principle of good corporate citizenship. Many respondents volunteered that they have always complied with all Securities and Exchange Commission and exchange reporting requirements. But a number of respondents also bemoaned the one-size-fits-all approach of recent corporate governance reforms that has led to high fixed costs regardless of the size of the company.

A small percentage of companies reported that they have begun to consider

going private. The talk about that complex and costly transaction may represent nothing more than an expression of frustration, but it also may represent an emerging trend among small public companies trying both to increase shareholder value and to contain spiraling costs. Our interviews indicated that unless or until investment bankers convince small public companies that they will have greater access to the capital markets and higher valuation by being private, the majority will opt to remain public.

The sobering reality is that the dramatic increase in costs that small-cap companies already have absorbed is a burden that is not likely to ease and, in fact, will increase further in many areas. That may well leave even more directors and officers struggling with the cost-benefit analysis of complying with the new regulations—which means ever-higher percentages of revenue spent to remain public without, at least so far, the corresponding benefit of increased shareholder value reflected in stock price and access to capital. ■

# Disclosure Topics and Issues

## REG FD LESSONS LEARNED

JONATHAN V. HUBBARD

**E**ffectively communicating with investors without violating selective disclosure guidelines is one of the most challenging issues in the practice of investor relations.

The adoption of Regulation Fair Disclosure in August 2000 significantly affected the ground rules for financial communications. However, more than two years passed before the Securities and Exchange Commission announced its first fair disclosure enforcement cases, all of which involved well-known firms dealing with relatively commonplace disclosure issues. This article summarizes the four cases and offers best-practice recommendations based on the SEC's findings.

### CONFERENCE COMMENTS

The SEC initiated an administrative proceeding against Siebel Systems, Inc. after its CEO disclosed material, non-public information at an invitation-only sell-side conference in November 2001. The conference was not webcast. In response to an analyst's question, the

CEO made optimistic remarks about improving market trends, although he had characterized the market environment as "tough" during Siebel's public third-quarter conference call three weeks earlier. On the day that the CEO spoke at the conference, Siebel's stock closed up approximately 20 percent, and trading volume was more than double the daily average.

The SEC imposed a cease-and-desist order on Siebel against future violations of Reg FD, and the company neither admitted nor denied the SEC's findings. It agreed to pay a \$250,000 fine.

At 10 pages, the Siebel order is the longest of the four cases reviewed in this article. The order methodically documents that Siebel's disclosures were made to covered persons (investment professionals), were material and nonpublic, and were intentional within the meaning of Reg FD. The order distinguishes between intentional and non-intentional disclosures and sets forth the concept of materiality.

## TALKING WITH AN INVESTOR

Secure Computing Corp.'s case, like Siebel's, involved an executive's optimistic material statements and a restricted audience.

In March 2002 Secure's CEO conducted a conference call from his home with a buy-side portfolio manager, a sell-side salesperson and the company's investor relations officer. The CEO disclosed a promising agreement with a company that intended to incorporate Secure's software into its own product. After the call, on the advice of the IRO, the CEO contacted a partner of the sell-side firm to ask that the news be kept confidential, but the stock rose 8 percent and trading volume was double the level of the previous day.

The next day, the business partner refused to allow Secure to announce the agreement publicly, but the CEO talked about it with at least one other portfolio manager. At the end of the day, which saw a 7 percent stock price increase and heavier-than-usual volume, Secure issued a press release disclosing the agreement.

The SEC's cease-and-desist order against Secure and its CEO noted that the CEO's selective remarks on the first

day were material and nonpublic but non-intentional. The company could have met the requirement for prompt public disclosure with an announcement that day. But by waiting and again making material nonpublic disclosures selectively on day two, the company and the CEO intentionally violated Reg FD, the SEC said.

## INFLUENCING EARNINGS ESTIMATES

Unlike the two preceding cases that involved positive developments for the companies, the cease-and-desist order against Raytheon Company and its then-CFO involved selective disclosure of negative news.

In February 2001, after a public, fourth-quarter earnings webcast that provided earnings per share guidance for all of 2001 but not for interim periods, Raytheon's CFO contacted individual analysts whose first-quarter numbers exceeded the company's internal estimate. He advised them that their figures were too high or aggressive.

Following the one-on-one calls, the analysts lowered their first-quarter and six-month estimates. After one such revision, the value of the company's two classes of shares dropped 6 percent and

3 percent, respectively. When a news service reported the conversations, the CFO stopped making calls, leaving two analysts who had not yet been contacted with too-high first-quarter estimates.

In the Raytheon order the SEC specifically called attention to a key paragraph in Reg FD that warns against earnings-related selective disclosure to securities analysts.

## **MORE DETAIL**

Unlike the preceding three cases, the SEC did not issue a cease-and-desist order against Motorola, Inc. Instead, the agency issued a report of investigation, finding that the company's disclosure was inconsistent with Reg FD.

The Motorola situation involved its investor relations officer's one-on-one calls to analysts after a press release and public webcast that included discussion of projected weakness in orders and sales. During the follow-up calls the IRO provided more specific, quantitative information about the degree of weakness. With the additional guidance, the analysts who had been contacted revised their earnings models. Over the calling period, the stock price dropped more than 15 percent, and trading volume increased

significantly at most of the sell-side firms.

The SEC found that the IRO acted in good faith, having been wrongly advised by in-house legal counsel that the one-on-one calls would not violate Reg FD. Importantly, however, the agency warned that future reliance on counsel would not necessarily provide a successful defense in cases where executives knew, or should have known, that they were selectively disclosing material nonpublic information to securities professionals.

The nine-page Motorola report is about the same lengths as the Siebel order, and both are good primers on how the agency is likely to interpret potential fair disclosure violations.

## **BEST PRACTICES**

As these four cases make clear, even knowledgeable executives at blue chip companies can violate Reg FD.

Moreover, a company can get in trouble even if the SEC commissioners do not agree on all the aspects of the enforcement case. In the Siebel situation, two commissioners dissented against the monetary penalty imposed on the firm. One commissioner dissented against the lack of penalties imposed on Secure Computing and Raytheon. Yet these

disagreements did not stop the SEC from imposing cease-and-desist orders on all three firms.

To avoid similar consequences, executives should keep three basic questions in mind when communicating financial information:

- Is the information I'm communicating material and nonpublic?
- Am I communicating it selectively—in other words, are there investors who will not have this information?
- If the audience is restricted, does it include securities or investment professionals?

If the answers to these questions are yes, the executive and the company may well be in violation of Reg FD. If the action was inadvertent—perhaps the speaker did not realize that the information was material or thought it had already been made public—then the company should promptly correct the disclosure by making it public through a press release, Form 8-K or both.

Caution about earnings guidance does not automatically mean that you should stop giving it. But exercise care that you do not provide it selectively. The

more information that you can provide in earnings releases and conference calls, the less pressure you may feel to provide it in one-on-one conversations, all other things being equal.

Here are some practices that can help you avoid selective disclosures that run afoul of Reg FD:

- Carefully script webcasts, conference calls and other presentations to ensure that they offer sufficient and clear information. If you want to communicate precise financial information, do not use vague terms that may mean different things to different people and may need additional explanation later.
- Draft Q and A and talking points before important presentations so that spokespeople are well-prepared and stay on message.
- Remember that a sell-side conference that is not publicly webcast is not a public audience.
- If you are not sure whether certain information is material, err on the side of caution. By SEC definition, information is material if there is a substantial likelihood that a reasonable investor would consider it important in making

an investment decision or if the information would significantly alter the total mix of available information. If you have a question about materiality, check with legal counsel, as did the IRO at Motorola. That step helped save the company from a cease-and-desist order.

- Review confidentiality agreements with vendors and customers to avoid the kind of press-release restriction that Secure Computing faced when news about its new contract began to spread.
- Be particularly cautious about reviewing analysts' reports or earnings models. In the Raytheon report of investigation, the SEC cited the Reg FD guidance paragraph, which says that an issuer official who engages in private discussion with an analyst who is seeking guidance about earnings estimates takes on a high degree of risk under the regulation. If the official communicates nonpublic information that anticipated earnings will be higher than, lower than or even the same as what analysts have been forecasting, the company may well be in violation of

Reg FD, whether the guidance is communicated expressly or indirectly if the meaning is apparent even though it is implied.

- If you notice unusual price and volume changes in your stock, it may be appropriate to check if you or another company spokesperson might recently have selectively disclosed material nonpublic information.
- It's also helpful to have a corporate disclosure policy that clearly describes information or metrics that company spokespersons should and should not disclose. Review the policy regularly and ensure that all spokespeople understand Reg FD as well as the company's disclosure guidelines. Coach the spokespeople and keep a record of disclosures so that spokespeople know whether the information that they are communicating is already public knowledge.

Finally, consider the four cases summarized in this article as must-reads. They're all available on the SEC Web site, [www.sec.gov](http://www.sec.gov). The Raytheon, Secure Computing and Siebel cases can be

found in the administrative proceedings section, listed by the date of the agreements, November 25, 2002. The Motorola report is listed by the same date in a subcategory of the litigation section called reports of investigation.

The cases are short, clearly written and interesting because they involve real situations and real people. In showing us how not to disclose information, they serve as a guide for how we should practice our profession. ■■■

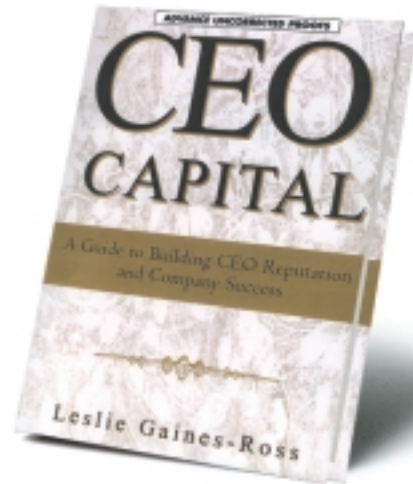
## CAPITALIZING ON THE CEO'S REPUTATION

TIMOTHY MCKENNA

The first few pages of *CEO Capital*—a book which purports to explain how the CEO's reputation is a bankable quantity and is crucially linked to a company's success—leaves the reader with two strongly negative impressions.

The first is that the book was written to promote the research capabilities of public relations firm Burson-Marsteller, where the author is employed as something called chief knowledge and research officer. The second is that the author conceived the book in the giddy stock market environment of a few years back and neglected to take a hard look at the assumptions underlying that era before proceeding to publish in this more sober period.

Dr. Gaines-Ross isn't the first consultant to write a book to promote an employer's capabilities. But it is a serious shortcoming to be publishing a book based on the idea that a CEO's reputation can be equated with real capital now that we have seen, for example, how real value was destroyed by technology analysts who tried to justify inflated stock prices with empty notions such as intellectual capital or first-mover advantage.



**CEO Capital**  
A Guide to Building CEO  
Reputation and Company Success

LESLIE GAINES-ROSS

JOHN WILEY & SONS, INC., NEW YORK  
ISBN: 0471268070

Consider a few sentences from the first chapter. The author laments that, in the past, “Scholars ignored the link between CEO reputation and corporate performance.” Back then, she continues, “The value of a company's worth historically depended primarily on concrete or tangible assets—assets associated with finance and manufacturing, buildings, equipment and product inventories. Largely excluded from the balance sheet or other financial statements were intangible assets such as relationships with

customers, company or brand reputation, human capital, marketing savvy and company know-how.” In the cold light of lost value and jobs, one wonders whether we all would have been better off had investors in the late 1990s kept their focus on real assets such as “buildings, equipment and product inventories.”

Although the author repeatedly speaks of CEO capital as if it is quantifiable, she does not adequately define the concept. She describes CEO capital as “the asset created” when a CEO’s reputation is “harnessed to advance a company’s success.” She further calls it the “composite of perceptions that a company’s stakeholders hold” and “the collective esteem that significant others ... hold for the company’s chief executive and, as a consequence, for the company.” In addition to being awkward prose that made me wonder whether the author was referring to the CEO’s girlfriends, those definitions failed to explain how an analytical person could assign a value to her concept.

The book presents chapter-length outlines of actions that CEOs should take at various stages of tenure — first 100 days, first year, etc. Some of this is valuable, such as the need for visible impact early on. However, most of the concepts are common sense with a window dressing of academic charts and jargon. The ideas

could have been presented better in a tightly written magazine article than in a book-length treatment.

The book does explain that the author’s firm spent “the past five years studying the factors that build equity in a CEO’s name.” In what may be the few valuable pages of the book she outlines her research — conducted among CEOs, investors, and people in government and the media. It confirmed that the five factors most critical to establishing a CEO’s reputation are what experience tells us should matter: credibility, having a code of ethics, communicating internally, the ability to attract and motivate quality management, and the ability to motivate and inspire employees. Unfortunately the author mars the presentation by labeling the qualities the “CM” factors (“c” for credibility, code and communicating and “m” for management and motivation) in a clumsy attempt to make it easier to remember the traits.

Without explicitly praising traditional virtues, the book affirms that old-fashioned qualities such as character, honesty and ethical behavior are essential in a leader. Sadly, after the recent history of dishonesty and arrogance among leaders at Enron, Tyco and even the vaunted GE, we no longer need a book-length treatment to make that clear. ■

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