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Why Rigging Your Earnings Calls Is a Bad Idea

By Tony Chapelle October 21, 2013

Back in April, senior officials at **Amazon** forbade a stock analyst who had been bearish on the online retailer to join its quarterly earnings call. It's part of an age-old practice of companies rigging their earnings calls by taking questions only from analysts who have a favorable outlook on the company's stock.

It's a strategy that hasn't gone unnoticed.

And a recent study by **Harvard Business School** and the **London School of Economics** shows that the practice is actually hurting the companies that employ it.

According to the study, which examined more than 70,000 public company earnings calls held between 2003 and 2011, companies that manipulate their earnings calls are likely to lag other companies' returns by a percentage point per month. Those are fat, predictable stock-price decreases that could make such firms targets for short sellers.

"My suggestion to boards, investor relations people, CEOs or CFOs is to be cognizant that you equitably call on the analysts who want to ask questions about the firm," says **Lauren Cohen**, an associate finance professor at Harvard Business School who co-authored the study.

Every year, between 55% and 60% of firms "stage" a conference call, says Cohen. And the fewer the analysts that follow a company, the greater the likelihood it will try to rig the questioning. Those same firms, the study says, are more likely to have engaged in earnings manipulation or accounting accruals preceding these calls. They're also more apt to issue stock in the quarter immediately following, as well as to engage in significantly more insider selling.

"Firms that manipulate their conference calls in this way appear to be hiding bad news, which ultimately leaks out in the future," Cohen and her team write in the paper, "Playing Favorites: How Firms Prevent the Revelation of Bad News." "The negative information that is hidden is information important for fundamental firm value."

In Amazon's case, **Colin Gillis**, a bearish analyst, was locked out of the quarterly earnings call, and notified the *Seattle Times*, which reported about it. Sure enough, the study reports, Amazon missed analysts' estimates in its next earnings announcement in July. The company fell short of Wall Street expectations for both earnings per share and revenues. Amazon also had to lower its projections for future profits. Amazon's spokespersons did not respond to a request for an interview.

Paul Hodgson, a partner at corporate governance consulting firm **BHJ Partners**, takes a hard line on the subject. “If a CEO and CFO are prepared to conceal information from analysts, they’re probably concealing it from directors as well. If I were a board member, I’d much rather analysts were asking hard rather than soft questions because the board member’s reputation is also on the line.”

Hodgson, formerly managing director and chief communications officer at **GovernanceMetrics International**, advises boards to instruct chief executives and financial officers not to cast earnings calls, citing his “three rules of governance: disclosure, disclosure, disclosure.” Hodgson says accounting issues that get brought out in the open are more likely to receive management’s attention.

Cooking The Call

Firms that cast their conference calls to use only bullish analysts tend to display five negative characteristics.

1. They engage in significantly more earnings management leading up to the call. So they may not want to answer questions about discretionary accruals on the call.
2. They’re significantly more likely to just beat, or to miss, forecasts. There’s evidence that they manipulate accounting to achieve this (i.e., by booking revenues early, or by pulling revenues forward).
3. They’re significantly more likely (+14%) to have future earnings restatements.
4. They’re significantly more likely to issue stock.
5. They’re more likely to engage in net insider sales. It’s hard to know when this is illegal because of other factors.

Source: “Playing Favorites” study

The **CFA Institute**, which administers the Chartered Financial Analyst certification, considers freezing out analysts as a form of retaliation that can inhibit the flow of investment information to the market as well as impair the accuracy of research. The institute’s official position is that investment managers and securities issuers should adopt voluntary rules, or regulators should establish fines and sanctions, to discourage companies from taking retaliatory actions against analysts and firms that write negative reports.

Matt Orsagh, director of capital markets policy at the CFA Institute, says he’s not at all surprised by the report’s findings.

“I’ve heard from our members that this was a problem,” he says. “And ... the markets are beginning to understand this.”

The **National Investor Relations Institute** recently collaborated with the CFA Institute on a booklet of best practices for how analysts and corporations should interact. The guidelines specifically state that corporate issuers must not deny company information to analysts due to their prior research, recommendations or earnings estimates.

“If a company has an analyst who’s constantly negative, I can understand their not wanting to hear his questions, but it’s a bad practice [to ban him from the call],” says Orsagh. “A better practice is to prepare for these questions with well-thought-out factual defense of your position. And you can control the call to some extent. If I’m an analyst with difficult questions, no one expects the company to allow the person to take over the call and monopolize the time. But they expect that analysts will be allowed to ask their question. Then the company can move along to the next question.”

Under current SEC rules, public companies have to announce quarterly earnings and other significant news. The common practice is to schedule conference calls with equity analysts to explain the company’s financial statements and highlights. Since the 2002 establishment of Regulation FD, companies have been required to make such calls open to

the public.

So it's ironic that with all of the SEC's efforts enacted to create a level playing field for all investors, corporate management can still control the flow of facts.

To be sure, most company officials say they aren't partial to particular viewpoints, while many analysts say they don't feel left out of the so-called batting order, or lineup of questioners on earnings calls.

"We take all questions from our equity analysts in the order that they queue up to ask," writes **Julie Creed**, vice president of investor relations at **Heidrick & Struggles International**.

Creed says that in her eight years on the job she can't recall ever blackballing an analyst or an investor from asking a question on a call. Meanwhile, she points out that although the audit committee reviews the scripts before the executives go on the calls and can comment on them, the board does not actually get involved in the preparation for the events.

Richard Bove, vice president of equity research at **Rafferty Capital Markets**, whom **Zacks Investment Research** often ranks among the top five analysts overall, says that when he started out in the business 45 years ago he had difficulty getting access.

"But in the last 15 years, I can't think of any company that's refused to provide me with information. In my case, I've not had any difficulty."

Ray Soifer, who was a banks and brokerages analyst for 17 years at **Brown Brothers Harriman**, says it's not uncommon for companies to try to get an analyst fired for their reports. Yet he has never suffered from being frozen out. Soifer, who now advises financial institutions, attributes that to the fact that he was fairly well known in the industry. Analysts at large sell-side firms on Wall Street, or large buy-side firms such as mutual fund families, tend to get selected because their employers have large client followings or own significant holdings in the stocks in question.

Yet **Dipak Shah**, CEO of audit management consulting firm **Reliant Solutions** and the former head of the technology banking group at **Morgan Keegan** says he's seen corporate managers lean toward certain analysts who are favorable to them on calls to "use them as the mouthpiece to Wall Street." But, he adds, analysts who were more critical didn't get to engage as much.

"In reality, good management should embrace those guys because they provide the opportunity to fix their problems," he says.

Cohen has a recommendation for boards that want their companies to stay clear of casting. He advises that the investor relations person instruct all analysts to announce their most recent recommendation on the company's stock before they ask a question. That way, everyone who's listening in will hear whether the company is only calling on the most positive people.

"That's in line with the spirit of transparency and full disclosure, which we think is good for markets," he says.

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