



INVESTOR RELATIONS MEETINGS

The analysts sought to make the best qualitative judgment on the company. Factors of particular interest about the company which were said to make a strong contribution to this qualitative judgment may be summarized as:

- quality of management
- performance indicators
- quality of assets
- verification and assurance.

What was clear from the analysts' comments was that relatively little of this information came directly from the annual report. Company meetings were the key source of qualitative information and the annual report was the confirmation in terms of financial outcomes.

Source: ICAS, Corporate Communications: Views of Institutional Investors and Lenders (Research Committee, Institute of Chartered Accountants of Scotland, 1999)

Income smoothing

There is a basic problem in financial reporting that the net earnings of a company are likely to vary from year to year because they are the result of many different factors, whereas the financial markets want earnings to increase progressively from year to year. This means that company financial executives are under some pressure to 'manage' the reported earnings so that they meet analysts' expectations.

Let us look at this proposition in more detail. First, why are earnings important to analysts? Second, why do they fluctuate? Third, how are they managed?

We talked in Chapter 9 about the price/earnings (P/E) ratio. This is a ratio that reflects the degree of risk which the market considers inherent to a particular company within a particular business sector. The relationship is expressed:

$$\text{P/E ratio} = \frac{\text{Market price of share}}{\text{Earnings per share}}$$

This relationship is fundamental to the stock market. When investment managers are looking for shares to buy, what they are seeking is a share which is *undervalued*, i.e. whose market price is below its real value. The current market price is determined by analysts as a function of the historic P/E for that company multiplied by forecast earnings per share. If the share is undervalued, that means that the market is either underestimating future earnings or overestimating the riskiness of the company (the higher the risk, the higher the return necessary to compensate investors for running the risk, and so the lower the P/E and price).