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Are all analysts created equal? Industry expertise and monitoring effectiveness of financial analysts ☆

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ABSTRACT

We examine whether analysts' prior industry experience influences their ability to serve as effective external firm monitors. Our analyses of firms' financial disclosure quality, executive compensation and CEO turnover decisions portray a consistent picture that related pre-analyst industry experience is of critical importance for analysts to play an effective monitoring role. Coverage by analysts with such experience is associated with reduced earnings management, lower probability of committing financial misrepresentation, less CEO excess compensation, and higher performance sensitivity of CEO turnover. We also provide evidence on several plausible mechanisms through which industry expert analysts exert monitoring efforts and limit managerial opportunism.

"*… management has not historically been the most committed to capital returns, but is seemingly willing to adjust senior ranks going forward. The current CEO's contract is down to under 10 months.*" — Jamie Baker, JP Morgan analyst, on JetBlue[1]

1. Introduction

The notion of analyst monitoring goes at least as far back as Jensen and Meckling (1976, p. 354–355), who suggest that security analysts possess comparative advantages in monitoring firm management and thus can play a large role in reducing agency costs. As the quote above illustrates, analysts can be vocal critics of management policies, which can ultimately influence firm behavior. A few months after Jamie Baker's call, Jetblue announced that its CEO would be resigning at the end of his contract.[2] In this paper, we focus on analysts' industry expertise and examine its effect on their monitoring

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[1] Media outlets attributed the pressure to oust Jetblue's then-CEO Dave Barger to Jamie Baker's upgrading of the firm while noting that management turnover was likely. Source: https://www.thestreet.com/story/12885110/1/why-jetblue-ceo-dave-barger-was-chased-out-by-wall-street.html.

[2] http://fortune.com/2014/09/18/jetblue-ceo-david-barger-to-take-off/. For more examples of analyst monitoring activities, see http://www.wsj.com/articles/noble-promises-more-transparency-1429664102 (questioning accounting methods and demanding more transparency) and http://www.broadcastingcable.com/news/news-articles/bernstein-research-criticizes-media-ceo-pay/110241 (criticizing CEO pay).

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effectiveness. Industry expertise is a critical component of analysts' human capital. Analysts are assigned to and specialize in few industries to take advantage of economies of scale in information production (Boni and Womack, 2006; Kadan et al., 2012). Surveys of financial analysts and institutional investors consistently indicate that industry expertise is the most important attribute for analysts (Brown et al. (2015) and the annual polls of *Institutional Investor* magazine). The limited academic attention to analysts' industry experience has so far been confined to their earnings forecasts and stock recommendations (Boni and Womack, 2006; Kadan et al., 2012; Bradley et al., forthcoming). Whether industry expertise affects analysts' effectiveness in their other functions remains unknown.

We measure analysts' industry expertise based on whether they have prior work experience in industries of the firms they cover. To do so, we manually collect analysts' employment history from *LinkedIn.com*, the largest professional networking service.[3] As elaborated below, despite its positive effect on traditional metrics of analyst performance, the ramifications of industry expertise for the monitoring and corporate governance role of analysts are more complex and difficult to determine ex ante. On the one hand, it is possible that analysts with industry experience in the firms they cover can provide more effective external monitoring because their prior industry experience may allow them to develop a better understanding of the firm's industry. Richer and more in-depth industry knowledge can enhance analysts' ability to analyze firms' financial information and evaluate the strategies and decisions proposed or implemented by firm management. Therefore, analysts with related industry expertise, i.e., industry expert analysts, are better equipped and thus more likely to identify and bring attention to firm policies that do not serve shareholders' best interests. In addition, these analysts also contribute to a more transparent information environment through their more efficient information production and more accurate earnings forecasts (Bradley et al., forthcoming). As a result, industry expert analyst coverage can have the dual effects of reducing managers' latitude and incentives to engage in self-serving behavior as well as providing an impetus for boards of directors to demand higher accountability of managers for their actions. We term this view the *effective monitor hypothesis*.

On the other hand, prior work experience in a firm's industry may reduce analysts' incentive to monitor firm management in subtle, but potentially important ways. For example, having worked in the firm's industry increases the likelihood that the analysts and the firm's managers know each other if their career paths have crossed or they have met at work functions such as industry trade shows or conventions. Likewise, related industry work experience also increases the chance of professional connections being developed between the analysts and firm management through common friends or acquaintances from within the industry. These professional ties can potentially cloud analysts' views, making them more likely to agree with rather than disapprove of the decisions made by managers. Together, these different channels imply that related industry experience can impair the incentives of analysts to monitor firm management, allowing corporate insiders to indulge more in activities that benefit themselves at shareholders' expense. We term this view the *impaired monitor hypothesis*.

We test these hypotheses by examining the effects of industry expert analyst coverage on several major corporate policies including financial disclosure quality, CEO compensation, and CEO turnover. A large part of an analyst's job entails the perusal and analysis of financial information disclosed by firms to capital markets and the use of such disclosure as a basis to evaluate managerial decision making and forecast future performance. Therefore, we start our analysis by relating analyst industry expertise to a number of observable outcomes of the choices made by managers in firms' financial disclosure. This is also in keeping with earlier studies by Yu (2008) and Irani and Oesch (2013) that examine the effect of analyst monitoring on corporate financial reporting quality.

We first examine the impact of analyst industry expertise on earnings management through discretionary accruals, which are estimated using the method suggested by Owens et al. (2015). Earnings management is considered as a manifestation of the agency problems between managers and shareholders, because managers are able to extract various forms of private benefits and personal gains by manipulating reported financial results (e.g., Perry and Williams, 1994; Bergstresser and Philippon, 2006). Shareholders, on the other hand, bear significant costs when aggressive earnings management leads to financial misreporting that results in earnings restatements, shareholder lawsuits, and regulatory/legal sanctions against the firm (e.g., Dechow et al., 1996; Karpoff et al., 2008). Analysts have incentives to be vigilant about aggressive earnings management. Dyck et al. (2010) find that failure to detect accounting fraud at covered firms increases an analyst's probability of being demoted.

As Dichev et al. (2013) point out, it is difficult for outsiders to detect earnings manipulation, but large deviations from industry and peer norms can serve as a red flag for potential financial misreporting because a substantial portion of a firm's financial reporting choices is driven by operations and economic conditions specific to its industry. Therefore, relevant industry expertise and knowledge are essential for the evaluation of many aspects of corporate financial reporting. Consistent with the *effective monitoring hypothesis*, we find that coverage by analysts with related industry experience is significantly and negatively associated with firms' earnings management. In contrast, coverage by other analysts is not related to earnings management behavior. These results are robust to controlling for a wide range of analyst and firm-specific attributes.

[3] For instance, Jamie Baker, the analyst mentioned in the opening quote of this paper is an example of an analyst with related pre-analyst industry experience. According to his *LinkedIn* profile, he worked for two airline companies prior to becoming a sell-side analyst. See Section 2 for complete details on our data collection procedure.