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# Impact of strategy on analyst information

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A B S T R A C T

In this paper, we investigate the impact of firm strategy on the properties of analyst' information. We argue that analysts' total information (common and idiosyncratic information together) about a firm depends on how clearly evident the chosen strategy of a firm is. Second, we argue that financial analysts will see more opportunities for value addition in differentiators, and hence, will gravitate more towards such firms. Analysts add value by gathering private information and, thus, individual analyst's private information will be a greater percentage of total information for a firm pursuing a differentiation strategy than for a firm pursuing a cost leadership strategy. Our results confirm our hypotheses.



## 1. Introduction

In this paper, we investigate the impact of firm strategy on the properties of analysts' information. Analysts' information, reflected in their forecasts, is a mix of the common (or public) information available to all analysts and the idiosyncratic (or private) information gathered by individual analysts. We argue that as the strategies followed by firms become more clearly evident, analysts' total information (common and idiosyncratic information together) improves. The complexity of a firm's business will depend greatly on its strategy, as will the accounting treatment of a firm's operations. Therefore, we argue that the improvement in analysts' total information arises in different ways depending on the particular strategy followed by a firm. A differentiation strategy relies on innovative products and branding; therefore, it is associated with more intangible assets, uncertain cash flows, greater information asymmetry, and accounting rules that create greater mismatch between revenues and expenses. Thus, analysts following a differentiator will have to generate more private information. On the other hand, a firm following a cost leadership strategy has more fixed assets, and accounting rules provide for a better match between revenues and expenses. Hence, there is more public information available for cost leaders. Therefore, the individual analyst's private information will be a greater percentage of total information for a firm following a differentiation strategy and a smaller percentage for a firm following a cost leadership strategy. Our results confirm our hypotheses and show that the analysts' total information improves as the strategy followed by a firm becomes clearer, but that improvement is due to an improvement in common information of analysts following cost leaders; whereas it is due to an improvement in idiosyncratic information of analysts following differentiators.

Firm decisions regarding investing and operating activities are determined by the strategy the firm adopts. Porter (1980) suggests that profit maximization can be accomplished by being the lowest cost producer in an industry (cost leadership strategy), or by developing some point of differentiation which will enable the firm to charge higher prices than its competitors (differentiation strategy). Firm strategy is chosen early on in the life of the firm. Commitment to a particular strategy involves a substantial investment in physical, financial and intellectual capital; hence firm strategy remains comparatively steady over time (Snow & Hambrick, 1980; Bentley, Omer, & Twedt, 2013). Therefore, being a fundamental and constant characteristic of a firm, firm strategy becomes an important determinant of the firm's information environment (Bentley et al., 2013) while providing a unique means of assessing the same.

In addition to the type of strategy followed by the firm, the extent to which a firm's strategy is clearly evident will also affect analysts' information. If a firm has a clearly defined and communicated strategy, it will provide a framework for analysts to evaluate and process new information. Thus, a firm's commitment to a clearly evident strategy should improve analysts' total information.

The information environment of a firm is a joint function of the firm's strategy, the investment decisions made by firms in the pursuit of that strategy, financial accounting rules, voluntary disclosures, and coverage by information intermediaries (Fernando, Schneible, & Tripathy, 2016). Firms pursing a differentiation strategy make investments in more intangible assets and have expected cash flows with

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higher uncertainty, resulting in greater information asymmetry (e.g., Himmelberg & Petersen, 1994; Aboody & Lev, 2000; Barth, Kaznik, & McNichols, 2001; Boone & Raman, 2001). In addition, financial accounting rules for intangibles which create a mismatch between expenses and the revenues that they generate may lead to greater information asymmetry (Lev & Zarowin, 1999). Furthermore, Asdemir, Fernando, and Tripathy (2013) and Fernando et al. (2016) show that the earnings of differentiators are more complex resulting in financial markets taking a longer time to fully assimilate information contained in their earnings.

However, more financial analysts tend to follow firms with poorer information environments where their intermediation adds more value. Research shows that firms that may have an intrinsically poorer information environment due to significant investments in intangibles such as R&D and advertising attract more analysts (Barth et al., 2001; Lehavy, Li, & Merkley, 2011; Lobo, Song, & Stanford, 2012). In many settings, analysts' forecasts have demonstrated superiority to those from time-series models because analysts have the ability to gather private information (Kothari, 2001; Healy & Palepu, 2001). Therefore, we argue that more financial analysts will follow differentiators compared to cost leaders due to a greater ability to add value from private information gathering. We also argue that since there is a greater incentive to gather private information about differentiators, analysts will have more idiosyncratic information about these firms compared to cost leaders.

In this paper, we first examine the relation between analysts' total information and the degree to which a firm's strategy is clearly evident. Next, we examine the relation between the particular strategy followed by a firm and analysts' following. Finally, we examine the relation between the particular strategy followed by a firm and the proportion of common to idiosyncratic information in analysts' information.

We use a measure of the total amount of, as well as the relative amounts of, common and idiosyncratic components of total information suggested in Barron, Kim, Lim, and Stevens (1998), (hereafter BKLS). We relate these measures of the properties of analyst information to Balsam, Fernando, and Tripathy's (2011) two-dimensional mapping of firm strategy, which in turn is based on the generic strategy framework posited by Porter (1980).

Using two measures of analysts' total information, mean forecast error and uncertainty (BKLS), we find that the degree to which a firm's strategy is clearly evident is directly proportional to measures of analysts' total information, supporting our first hypothesis. Next, and consistent with our second hypothesis, we find that more analysts follow firms that pursue a differentiation strategy compared to those that follow a cost leadership strategy. Finally, our results also confirm our third hypothesis by showing that, compared to cost leaders, firms that follow a differentiation strategy have less consensus among analysts, indicating greater idiosyncratic information.

Our study makes several contributions to existing literature. First, we add to the extant literature (Asdemir et al., 2013; Fernando et al., 2016) on the effect of firm strategy on analysts' information by showing that strategic clarity improves analyst information while the choice of strategy affects the relative amount of private information gathered by analysts. Second, we highlight the effect of firm strategy on the analysts' choice to follow a firm. Our results also highlight the value of multiple analysts following of a particular firm and the aggregation of forecasts from those analysts in improving the information environment of a firm. Finally, we show another aspect of a firm that is impacted by its strategy and show the usefulness of accounting based measures in identifying such strategy (Balsam et al., 2011; Asdemir et al., 2013; Schneible, 2015).

The rest of the article is structured as follows. Section 2 provides the literature review and hypotheses development, while Section 3 discusses the research methodology and data. Section 4 discusses the results and Section 5 concludes.

## 2. Literature review and hypotheses development

### 2.1. Literature review

#### 2.1.1. Firm strategy

As discussed earlier, the operating decisions and investments made by firms are aligned to pursue their strategies, which in turn help them achieve competitive advantages. Porter (1980) posits a paradigm for evaluating firm strategy based on two generic strategies, namely cost leadership and differentiation. A firm can be successful by effectively implementing either strategy. This paradigm is popular, both in practice and academia (e.g. Dess & Davis, 1984; Porter, 1985; Miller & Dess, 1993; Porter, 2000; Porter, 2001; Allen, 2007; Balsam et al., 2011; Asdemir et al., 2013; Brenes, Montoya, & Ciravegna, 2014; Fernando et al., 2016; McAlister, Srinivasan, Jindal, & Cannella, 2016).

A cost leadership firm achieves success by becoming the lowest cost producer in the market (Porter, 1980, 1985). Customers will prefer the firm's products if they care primarily about price. This preference will enable the firm to achieve higher returns than competitors. A firm pursues a cost leadership strategy by pursuing economies of scale through large-scale manufacturing and continuous emphasis on process improvement and cost reduction. A cost-leadership strategy focuses on achieving high turnovers as opposed to higher margins.

A differentiation strategy strives to differentiate a firm's product from competitors through unique features, excellent after-sales service, and creating brand-image (Porter, 1996). Customers will prefer the firm's products if they care more about the features of the product than its price. Compared to a cost leader, a differentiator is an innovative firm that relies on a combination of innovative products and innovative means of marketing these products to achieve success. A firm pursues a differentiation strategy through expenditures on R&D, advertising, product quality, post-sales service and other intangibles. Thus, a differentiator attempts to achieve high unit margins.

Porter (1980, 1985) also identified a third group of firms that he called 'stuck in the middle'. 'Stuck in the middle' firms do not have a clearly articulated (nor implemented) strategy. They try to muddle along with partial and unsuccessful implementations of elements of either or both cost leadership and differentiation strategies. Porter claims that such firms will lose clients at both ends of the market. They cannot keep high-margin customers since they will defect towards differentiation firms providing more innovative products. They also cannot keep price sensitive customers, since 'stuck in middles' do not have market share and economies of scale to be the least cost producer (Porter, 1980). Such firms try to be 'everything to everyone' and fail to be successful. Empirical research (Dess & Davis, 1984; Thornhill & White, 2007) shows that firms that follow at least one generic strategy outperform firms that are unable to clearly define a strategy (i.e. the stuck in middles). A *Forbes* articles claims that American Airlines bankruptcy and the Chrysler and GM auto bailouts of 2009 were necessitated by those firms being unable to articulate a well-defined strategy (Bruner, 2012).

The investments undertaken by firms in pursuit of a particular strategy will affect the uncertainty of the cash flows and the accounting treatment of those cash flows. Differentiators' investments in intangibles typically result in both greater uncertainty regarding future cash flows and greater mismatch between revenues and expense. Consequently, while differentiators often have more growth options available to them, this growth is highly variable (Miles & Snow, 1978, 2003). GAAP requires the immediate write-off of R&D investments and investments in other intangibles, due to the uncertainty of the returns. However, this gives rise to distortion, since investments in R&D and intangibles have many aspects of capital investments and are important to understanding accounting information. Thus, the earnings of differentiators are likely to be less informative than those of cost leaders. Cost leadership firms that rely on large investments in capacity have