

# Comment & Analysis

BUSINESS

## The wrong focus? How the race to meet targets can throw corporate America off course

While earnings predictions can give valuable insights into company performance, pressure to 'make the numbers' may conflict with the wider interests of shareholders, writes Francesco Guerrera

It is one of the rituals of American capitalism. Every three months, companies, investors and analysts eagerly await the word from the corporate version of the ancient oracles: the chief executive.

Like their Greek and Roman predecessors, these corporate titans are charged with predicting the future: no number is more eagerly awaited by Wall Street than "earnings guidance" companies' own performance forecast. Setting a recurring target for profit growth was intended to make companies more accountable to the market and focus management minds on achieving tangible results for shareholders. But in recent months, that part of the ritual appears to be losing its appeal.

Long-standing critics such as the veteran investor Warren Buffett have been joined by academics, politicians, regulators and, increasingly, chief executives and analysts in attacking a practice that forces companies to focus on narrow, short-term goals.

Some companies have already acted. Pfizer, Motorola, Intel, Ford, General Motors, McDonald's, Coca-Cola and The Washington Post – the last two part of Mr Buffett's portfolio – have stopped feeding analysts quarterly predictions. Google, a high-profile newcomer, has dared to incur the wrath of Wall Street by refusing any guidance at all.

According to the National Investor Relations Institute, just over half of US-listed companies offer earnings guidance every quarter, down from 75 per cent three years ago.

The question facing corporate America and its various stake-

Warren Buffett: he has criticised "operating acrobatics"



holders, however, is whether more and more companies will reject earnings guidance, fundamentally changing the relationship between Main Street and Wall Street – and bringing the US into line with the rest of the world.

In the UK and continental Europe quarterly earnings guidance has not caught on, mainly because financial reporting tends to take place every six months. Also, in a marked difference from the US, regulators on the other side of the Atlantic have traditionally opposed companies predicting their own performance.

The American anti-guidance camp argues that scrapping the practice could change for the better the way companies run themselves and lengthen the investment horizon of fund managers.

That, in turn, would alter the dynamics of the financial research industry, currently dominated by the short-term needs of fast-trading, big-paying hedge funds.

Supporters of earnings guidance, however, warn that depriving companies of the ability to communicate their earnings potential would hit smaller businesses and high-technology industries, whose funding rests on repeated contacts with the market and investors.

Yet the growing number of opponents to quarterly guidance warn that obsessive attention to short-term value compromises long-term profit growth.

Some even argue that being forced to hit quarterly targets may drive companies to take dubious short-cuts – what Mr Buffett, well before the latest wave of corporate scandals, dubbed "operating acrobatics" and "accounting games".

Indeed, many corporate governance experts believe that managers at companies such as Enron and WorldCom were tempted into crossing the line of legality partly out of a desperation to meet Wall Street's exceedingly optimistic expectations.

Today a report by the Business Roundtable Institute for Corporate Ethics, an offshoot of the powerful organisation that groups 160 chief execu-

tives of some of the largest US companies and the CFA Institute, the analysts' trade body, will add the influential voices of big business and investment professionals to the chorus of those clamouring for the end of quarterly guidance. "The obsession with short-term performance does not create value for shareholders and in many cases destroys value," says Dean Krehmeyer, executive director of the Business Roundtable Institute for Corporate Ethics, and one of the report's authors.

When guidance became popular in the 1990s – largely because of legal changes allowing companies to make forward-looking statements and shareholder demands for greater transpar-

'No company is going to grow at exactly x per cent quarter after quarter. Life just isn't like that' – STEVE ODLAND

ency – it was praised for its ability to boil down a company's prospects to a simple earnings per share number or range.

Nearly two decades later, chief executives protest that a company's essence cannot be captured, nor the vagaries of the business cycle acknowledged, in a single dollars and cents figure.

"No company is going to grow at exactly x per cent quarter after quarter," says Steve Odland, chairman and chief executive of the retailer Office Depot. "Life just isn't like that."

Setting a company's expected growth in stone puts pressure on management to "make the numbers", irrespective of the long-term interest of shareholders.

More than 80 per cent of some 400 executives questioned by the academics John Graham, Campbell R. Harvey and Shivaram Rajgopal admitted they would reduce spending in important areas such as research and development, maintenance and hiring in order to meet earnings targets. More than half said they would delay new projects even if it

meant sacrificing long-term value.

Corporate experts argue that this imperative to satisfy the market each quarter leaves companies' top management torn between two contrasting courses of action. "Companies are forced to ask themselves: do I manage to meet that [earnings] number or do I do what is best for the long-term interest of the business?" says Tim Koller, a partner at the management consultants McKinsey. In private, many chief executives acknowledge the negative effects of earnings guidance but say that, were they to abandon it, the share price would suffer.

Analysts and fund managers admit guidance makes their forecasting easier and avoids the embarrassment of overly optimistic or pessimistic predictions.

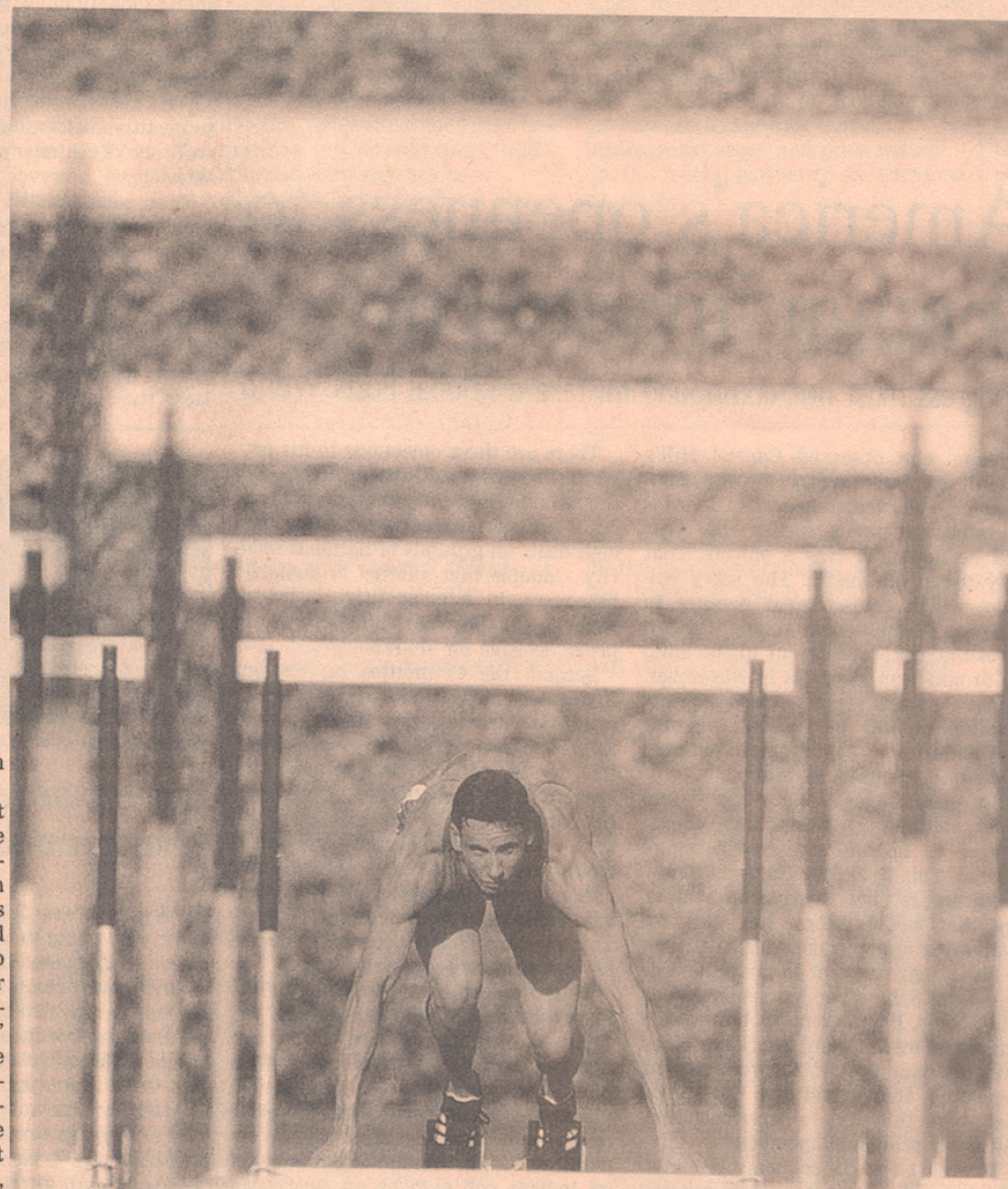
Yet there is evidence that both groups would be prepared to live without guidance if companies made the first move. More than three-quarters of the 80,000-plus investment professionals who are members of the CFA Institute said they wanted companies to

move away from quarterly guidance and would prefer more information on their long-term plans.

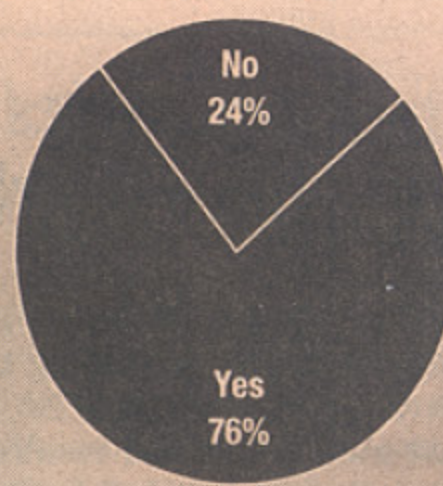
"Most investors want to talk about the business as opposed to asking management whether they are going to make it by a cent," says Jeffrey Diermeier, a former chief investment officer at UBS Global Asset Management and head of the CFA Institute.

Despite that, chief executives argue that guidance can help reduce share price volatility and boost valuations. "There is a perception that public companies need quarterly earnings guidance as part of their marketing process," says Kurt Schacht, managing director of the CFA Centre for Financial Market Integration. Indeed, companies such as General Electric have built a reputation and a considerable market capitalisation on consistency in meeting their own demanding EPS growth targets.

In February, when Google shares fell sharply after it unveiled results below market expectations, observers blamed the company's failure to manage Wall Street's forecasts.

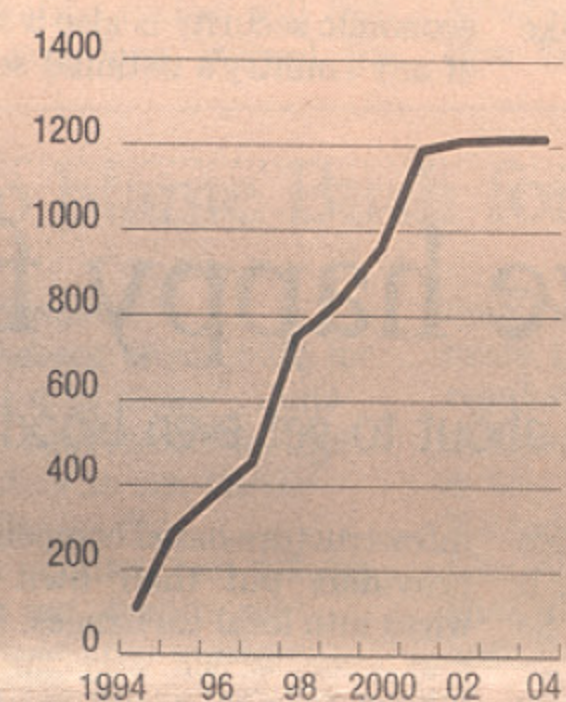


Should companies move away from focused quarterly earnings guidance?



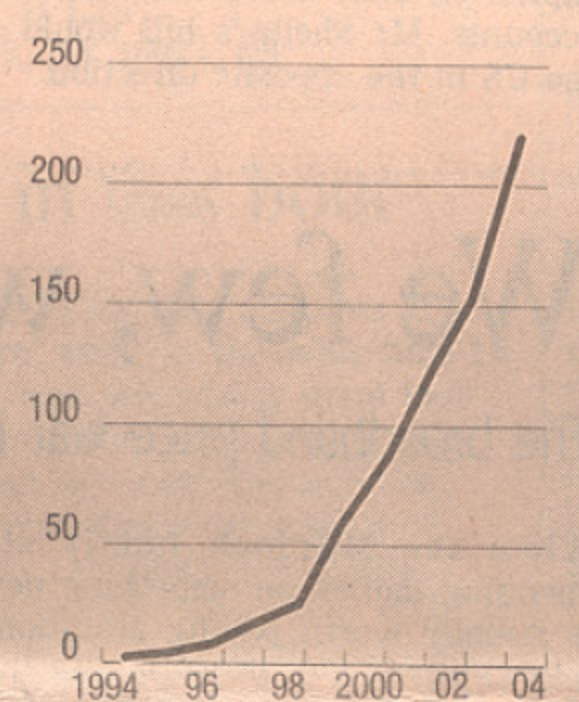
Source: CFA Institute survey of investment professionals

US companies\* providing earnings per share guidance



Source: McKinsey

US companies\* discontinuing earnings per share guidance



\* Companies with real revenues over \$500m at any time from 1990 to 2004

Nevertheless, there is little empirical evidence that offering guidance benefits the share price. When McKinsey examined 4,000 companies with revenues of more than \$500m (€394m, £269m) it found "no evidence that [guidance] affects valuation multiples, improves shareholder returns or reduces share price volatility". In fact, many hedge funds make no secret of the fact that they make large profits by "shorting" companies whose announced earnings fall shy of their guidance.

"Earnings guidance causes more problems than it solves," says Rob Markey, a partner at the management consultants Bain & Company. "By giving guidance, the management team increase the level of disappointment and anxiety when un-

expected events invariably occur."

Although corporate America's disenchantment with earnings guidance is undeniable, there are powerful obstacles to change.

For a start the salaries, and even the jobs, of both analysts and fund managers are heavily dependent on quarterly performance. And with trading volumes rising sharply in recent years, the average time investors hold a stock is down to a mere nine and half months, heightening the market's need for rapidly delivered information on the short-term outlook.

"The dilemma is [that] we as the American investing public have a short investment horizon," says John Castellani, president of the Business Roundtable.

The same is true for America's business leaders. With the typical chief executive of a large US company expected to last no more than five years, few can be expected to set their sights on the long term.

Some politicians and activists believe attitudes could be changed by tax laws that penalise investors who trade in and out of stocks. But given regulators' limited say on issues such as earnings guidance and investment decisions, legislative fiat would be unlikely to curb the focus on the short term.

In the words of Louis Thompson, chief executive of the National Investor Relations Institute: "If you want to get away from the short-termism chains you have to break all the links."

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