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Year-end reporting: a tyranny of targets

By Andrew Hill

Companies must not let the pressure of quarterly figures lead them into malpractice

You have two weeks until the end of the quarter – which, for many companies, is also the end of the financial year. Instead of developing strategy, or working on long-term plans – let alone buying gifts or dressing the Christmas tree – you're locked in a windowless office. Your sole objective: to hit your targets for 2012.

Under the circumstances, you may agree with this industrialist: "We've chosen some new high priests and called them accountants. They too have a holy day – the 31st of December – on which we're supposed to confess . . . But if you're really working on great ideas, you can't supply these on schedule and expose yourself to view. The December ceremony isn't really a law of the gods, it's just something we've invented. All right, let's conform, but don't let's do it in a way that will spoil our plans. And some day people will realise that every balance sheet is wrong because it doesn't contain anything but figures. The real strengths and weaknesses of an enterprise lie in the plans."

The repercussions of the tyranny of the quarter-end are well known, from irritating but innocuous travel bans and spending freezes to earnings manipulation and management myopia. The colourful array of year-end tricks – window-dressing, book-squaring, channel-stuffing, trade-loading and the alluring concept of "smoothing" – can have real consequences. Surges of orders booked prematurely cause whiplash along the supply chain, turning what should be a business process, with seasonal variations, into a volatile stop-start journey.

In one of the most notorious instances, Sunbeam salespeople, under pressure from their terrifying boss "Chainsaw" Al Dunlap, strained to meet 1997 targets by flogging home appliances – including an improbable quantity of that well-known winter bestseller, the gas-fired barbecue grill – for delivery in the new year. Next-quarter sales were predictably dismal. Investigations, lawsuits and a ban on Mr Dunlap serving as officer or director of a public company ensued.

One suggested remedy is to switch off – or step off – the earnings treadmill. John Kay, my fellow FT columnist, recommended ending mandatory quarterly reporting in his recent review of equity markets and long-term decision-making for the UK government. “High-quality, succinct narrative reporting” should also be encouraged, he added.

Another solution is for companies to scrap ill-fitting incentives. Stock option promises fuelled aggressive end-quarter behaviour at Sunbeam, and, since then, have contributed to systemic weaknesses that led to the financial crisis. Sensible companies warn off channel-stuffers. “I don’t want to sound like Genghis Khan,” the chief executive of one multinational told me last week, “but it’s no bad thing to have a few public hangings. If people have pushed a trade, or loaded the distributors, you’ve got to fire them.”

Yet the compulsion to meet short-term targets still pollutes accounts: chief financial officers told researchers from Duke and Emory universities recently they thought a fifth of US companies misrepresented results, by an average of 10 per cent of reported earnings per share.

In search of more radical remedies, one governance expert asks: “Why not move to three-year reporting?” But ignoring the calendar’s demands would be an unkeepable new year resolution. As Elizabeth Corley, chief executive of fund manager Allianz Global Investors, told me recently: “Quarterly and annual cycles are incredibly valuable disciplines – provided they don’t become dictators of how to behave.”

To avoid an end-of-quarter switchback ride, managers must instead have systems in place to monitor and regulate the behaviour of sales, inventories and, yes, human beings through the accounting cycle; they must be ready to brave short-term investor criticism; and they must have enough good sense not to try to smooth the unsmoothable.

As for giving more weight to corporate narratives, be careful what you wish for. According to John Byrne’s book *Chainsaw*, “few executives could rival Dunlap as a master at telling a story”. Bear in mind, too, that the wise-sounding long-termist quoted earlier was Ivar Kreuger, “the Match King”. He built his empire in defiance of pressure for regular accounts but also cajoled and bribed auditors, who were unable to spot a huge fraud until it was too late. In 1932, it all ended with his exposure, suicide and disgrace. Some deadlines simply can’t be put off.

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