

Value Destruction and Financial Reporting Decisions

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The comprehensive survey reported here allowed analysis of how senior U.S. financial executives make decisions related to performance measurement and voluntary disclosure. Chief financial officers were asked what earnings benchmarks they cared about and which factors motivated executives to exercise discretion—even sacrifice economic value—to deliver earnings. These issues are crucially linked to stock market performance. The results show that the destruction of shareholder value through legal means is pervasive, perhaps even a routine way of doing business. Indeed, the amount of value destroyed by companies striving to hit earnings targets exceeds the value lost in recent high-profile fraud cases.

Based on a survey of 401 senior financial executives of U.S. companies and in-depth interviews with an additional 22 executives, we document a willingness of corporate executives to routinely sacrifice shareholder value to meet earnings expectations or to smooth reported earnings. Whereas much previous research has focused on the use of accounting, such as accrual decisions, to manage earnings, we provide new evidence of the widespread use of “real” earnings management. Real earnings management, which might include deferring a valuable project or slashing research and development expenditures, is almost always value decreasing.

The survey, administered in the fall of 2003, contained 10 questions, most with subsections, and explored in some depth both earnings management and voluntary disclosures. In addition, from the fall

of 2003 to early 2005, we interviewed 22 chief financial officers (CFOs), which added depth to our understanding of corporate decision making.

We explore which metrics CFOs believe are important to investors and other outsiders and how those beliefs affect their decisions. Finding a myopic emphasis on quarterly earnings measures, we also explore how the malaise of the excessive short-term focus (“short-termism”) that we found can be fixed.

Survey Techniques and Sample Characteristics

Believing that the most important aspect of survey research is designing a survey instrument that asks clear and relevant questions, we took several steps to achieve this design goal. We developed an initial survey instrument and solicited feedback from academic researchers, CFOs, and marketing research experts to minimize biases induced by the questionnaire and to maximize the response rate. After extensive beta testing of the survey, we made several changes to the wording of some questions. The final survey contained 12 questions, and the paper version was five pages long.¹

We e-mailed the survey to 3,174 members of an organization of financial executives. We also contacted executives attending CFO forums at two universities and administered a paper version of the survey at a conference of financial executives conducted on 17 and 18 November 2003 in New York City. Our overall response rate of 10.4 percent falls close to the rates reported by several recent surveys of financial executives.² The companies from which we received responses range from small (15.1

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percent of the sample companies had sales of less than \$100 million) to very large (25.6 percent had sales of at least \$5 billion). Approximately 8 percent of the companies did not have any analyst coverage, whereas 16.7 percent were covered by at least 16 analysts. We also collected information about CEOs (implicitly assuming that the executives that we surveyed acted as agents for the CEOs). The survey included executives of 46 companies that we can confirm are private and 312 companies that we can confirm are public. Relative to the average public company in the United States (proxied by companies in the Compustat database), the companies in our sample are fairly large and profitable.

Before we discuss the results, we would like to point out that, like all other survey research, our results represent CFO beliefs, not actions. The two may not coincide. Also, executives may make (close to) optimal decisions without knowing it or articulating it in language used by economists designing survey questions. Of course, we worked to minimize these concerns when designing the survey.

Short-Term Focus on Reported Earnings

We report here our findings about the measures of value that executives believe are most important and the role that benchmarks play in executives' thinking and behavior.

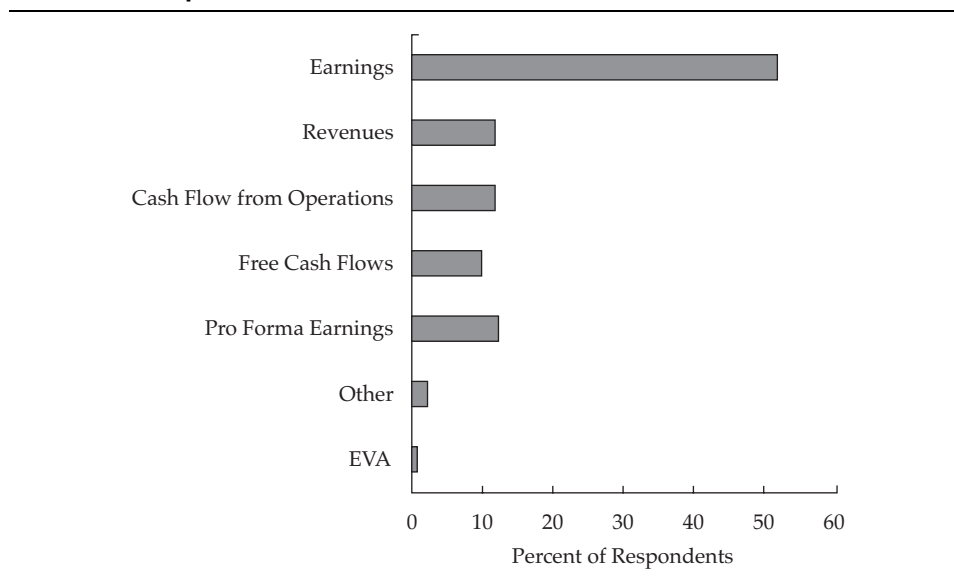
The Importance of Earnings. Financial professionals and some equity analysts emphasize

cash flows as drivers of firm value, but many accountants argue that earnings are a better measure of firm value. We asked CFOs to rank-order the perceived importance to outside stakeholders of several competing measures of value: earnings, pro forma earnings, revenues, operating cash flows, free cash flows, and economic value added (EVA). Earnings are king. As **Figure 1** reports, CFOs picked earnings as the overwhelming favorite measure. Nearly two-thirds of the respondents ranked earnings as the #1 metric; fewer than 22 percent chose revenues or cash flows from operations. This finding could reflect that earnings data provide informational content that is superior to the information provided by other metrics, or it could reflect myopic managerial concern with earnings.

Additional analysis of the responses revealed that the unprofitable and younger companies ranked earnings as relatively less important. Young companies and companies that do not provide much earnings guidance considered cash flows the more important metric. Interestingly, the executives of private companies placed more emphasis on cash flow from operations than did those of public companies, which suggests that perhaps capital market motivations drive the focus on earnings. Unprofitable companies, companies with young CEOs, and companies with high earnings guidance and analyst coverage emphasized pro forma earnings.

How do we explain the overwhelming emphasis on reported earnings? The world is complex, and many financial metrics are available. Investors, however, need a simple metric that summarizes

Figure 1. Distribution of #1 Rating of the “Three Most Important Measures Reported to Outsiders”



corporate performance, is easy to understand, and is relatively comparable across companies. The market appears to believe that the earnings per share number satisfies these criteria. Moreover, the EPS metric gets the broadest distribution and coverage by the media. Furthermore, a focus on one number facilitates the analyst's task of predicting future value. The analyst assimilates all the available information and summarizes it in one number: EPS. Finally, *ex post* evaluation of a company's progress is often based on whether a company hit the consensus EPS or beat the EPS for the same quarter in the previous year. Investment banks can also assess analysts' performance by evaluating how closely they predict the company's reported EPS.

Earnings Benchmarks. Of the four common benchmarks that we suggested financial officers might use, the benchmark *earnings in the same quarter last year* was viewed by 85.1 percent of CFOs as the most important. This benchmark was followed by the analyst consensus estimate (which 73.5 percent viewed as most important), profit reporting (65.2 percent), and previous-quarter EPS.

We had thought that the analyst consensus estimate would be considered more important than it was, and in interviews, the CFOs told us that missing the consensus number leads to the largest stock price reaction. Moreover, for companies with substantial analyst coverage and for companies that provide substantial earnings guidance, we found that the consensus earnings number was considered as important as the four-quarters-lagged number. Interviewed CFOs noted that the

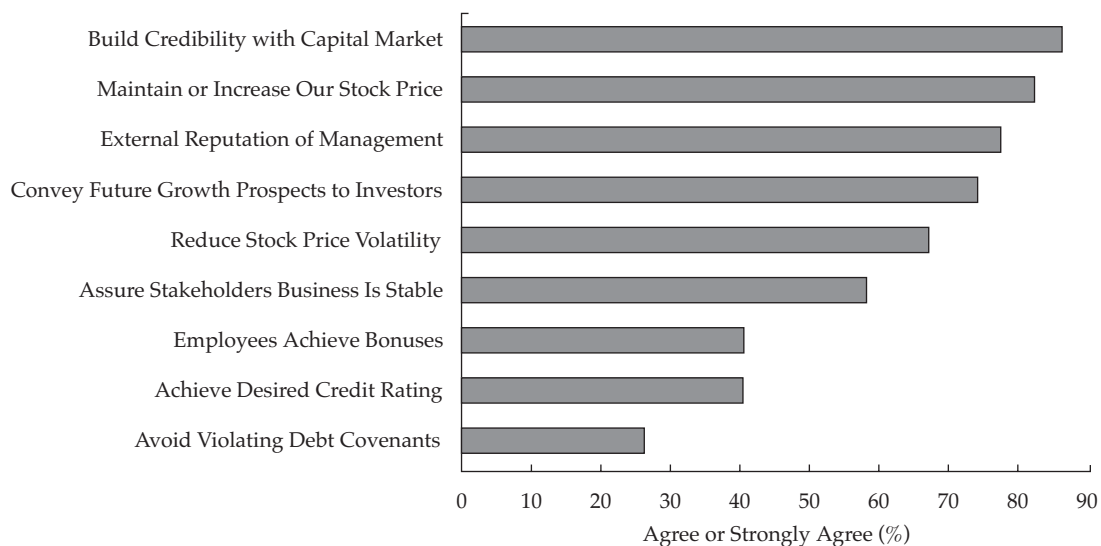
first item in a press release, however, is often a comparison of the current quarter's earnings with four-quarters-lagged earnings. The next item mentioned is often the analyst consensus estimate for the quarter. Interviewed CFOs also mentioned that analysts' forecasts can be guided by management but the last year's quarterly earnings number is difficult, if not impossible, to manage after the 10-Q has been filed with the U.S. SEC.

Meeting Earnings Benchmarks. The financial press is replete with cases in which a company misses an earnings benchmark (such as the analyst consensus estimate) by only a cent per share and yet has its stock price hammered. Thus, CFOs are likely to have strong incentives to meet or beat earnings benchmarks. We asked CFOs specific questions about such incentives.

The results, shown in **Figure 2**, strongly suggest that the dominant reasons to meet or beat earnings benchmarks relate to stock prices. An overwhelming 86.3 percent of the survey participants agreed that meeting benchmarks builds credibility with the capital market. More than 80 percent agreed that meeting benchmarks helps maintain or increase the company's stock price. Consistent with these results, managers also believe that meeting benchmarks conveys future growth prospects to investors.

More than three-fourths of the survey respondents agreed or strongly agreed that a manager's concern about her or his external reputation (and external job prospects) helps explain the desire to

Figure 2. Responses to the Question "Meeting Earnings Benchmarks Helps . . .?"



hit the earnings benchmark. The interviews confirmed that the desire to hit the earnings target appears to be driven less by short-run compensation motivations than by career concerns. Most CFOs believe that their inability to hit the earnings target is seen by the executive labor market as a “managerial failure.” Repeatedly failing to meet earnings benchmarks can inhibit the upward or intra-industry mobility of the CFO or CEO because it labels these managers as not being able to deliver on promises. According to one executive, “I miss the target, I’m out of a job.”

Apart from stock price and career concerns, a statistically significant majority of the respondents wanted to meet or beat earnings benchmarks to enhance their reputations with stakeholders, such as customers, suppliers, and creditors, and hence get better terms of trade. Somewhat surprisingly, we found that maintaining employee bonuses and lowering the expected cost of debt were relatively unimportant motivations for meeting or beating earnings benchmarks. This finding is in contrast to the disproportionate academic attention devoted to bonuses and debt as important motivations for managing accounting earnings (e.g., Watts and Zimmerman 1990).

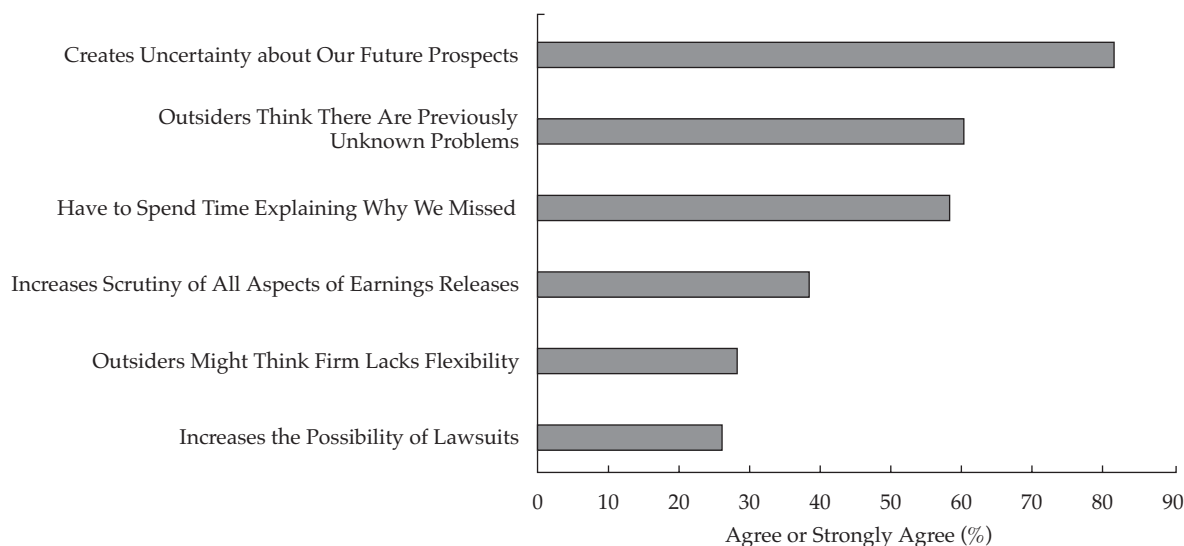
Failure to Meet Earnings Benchmarks. We explicitly asked CFOs about the consequences of failing to deliver expected earnings. **Figure 3** summarizes the results. The top two consequences of a failure to meet earnings benchmarks are believed to be an increase in uncertainty about the company’s future prospects (80.7 percent) and a perception among outsiders that there are deep,

previously unknown problems at the company (60 percent). The importance of these concerns increases with the degree of earnings guidance the company provides.

In the interviews, one CFO stated, “You have to start with the premise that every company manages earnings,” and many other interviewees made similar statements. One CFO characterized tactics to meet earnings targets as being similar to fine-tuning with a screwdriver: “You turn the screw just a little bit so that it fits.” So, the common belief is that a well-run and stable company should be able to “produce the dollars” necessary to hit the earnings target, even in a year that is otherwise somewhat down. In other words, because of the common belief that everyone plays the earnings game, missing earnings indicates that a company has no available slack to deliver earnings. Therefore, the market assumes that missing the target means the company is potentially facing serious problems and must have already used up its cushion. As one CFO put it, “If you see one cockroach, you immediately assume that there are hundreds behind the walls, even though you may have no proof that this is the case.” Corporations, therefore, have great incentive to avoid the “cockroach” of missing an earnings benchmark.

The other significant factor motivating managers to avoid missing earnings benchmarks relates to the time spent in explaining, especially in conference calls to analysts, why the company missed the target. Executives would rather use the time talking about the company’s long-run strategy.

Figure 3. Responses to the Question “Failing to Meet Benchmarks . . .?”



Sacrificing Value to Meet Earnings Benchmarks. Meeting and beating earnings benchmarks are clearly important to CFOs. But what actions do CFOs take to hit such benchmarks? Do they take real economic actions to be able to report a higher earnings number? Or do they use accounting adjustments?

Results summarized in **Figure 4** indicate that 80 percent of survey participants would decrease discretionary spending (e.g., R&D, advertising, maintenance) to meet an earnings target, even though many CFOs acknowledge that suboptimal maintenance and other spending can be value destroying. More than half of the CFOs (55.3 percent) said they would delay starting a new project to meet an earnings target, even if such a delay entailed a sacrifice in value. This evidence is interesting because CFOs appear to be willing to burn “real” cash flows for the sake of reporting desired accounting numbers. In contrast, CFOs do not appear to rely on accounting maneuvers (e.g., allowances, pensions) to meet earnings benchmarks.

To gauge more clearly the degree to which managers are willing to alter investment decisions to meet earnings targets, we asked the following hypothetical question:

Suppose your company’s cost of capital is 12 percent. Near the end of the quarter, a new opportunity arises that offers a 16 percent

internal rate of return and the same risk as the company. The analyst consensus EPS estimate is \$1.90. What is the probability that your company will pursue this project in each of the scenarios shown in **Table 1**?

Note that

- the project has a positive net present value (NPV) in each scenario because the internal rate of return exceeds the cost of capital by 4 percentage points;
- undertaking the project in the first earnings scenario enables the company to meet the consensus estimate;
- in the second scenario, the company will miss the consensus estimate by undertaking the positive-NPV project; and
- in the third and fourth scenarios, the company is not projected to meet the consensus estimate *and* adopting the project will drop the company’s EPS further below the consensus.

The survey responses are reported in **Figure 5**. In the first case, although adopting the positive-NPV project will not cause the company to miss the consensus estimate, the probability of accepting the project is only 80 percent. More significant is the finding that only 59 percent would take the project in the second scenario. Thus, many managers would evidently reject a positive-NPV project simply to meet the analyst consensus estimate! Responses to

Figure 4. Responses to the Question “Which of the Following Choices Permitted by GAAP Might Your Company Make If It Looks Like Your Company Might Not Meet Its Desired Quarterly Earnings Target?”

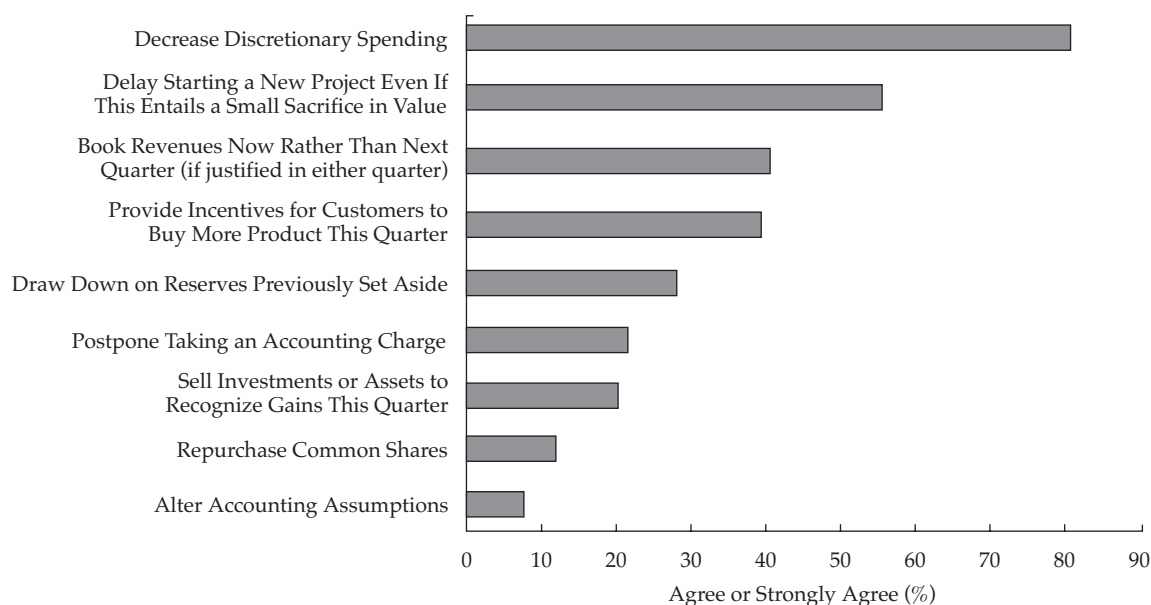


Table 1. Table for Hypothetical Scenario

Actual EPS if you <i>do not</i> pursue the project	Actual EPS if you <i>pursue</i> the project	The probability that the project will be pursued in this scenario is . . . (check one box per row)					
		0%	20%	40%	60%	80%	100%
\$2.00	\$1.90	☐	☐	☐	☐	☐	☐
\$1.90	\$1.80	☐	☐	☐	☐	☐	☐
\$1.80	\$1.70	☐	☐	☐	☐	☐	☐
\$1.40	\$1.30	☐	☐	☐	☐	☐	☐

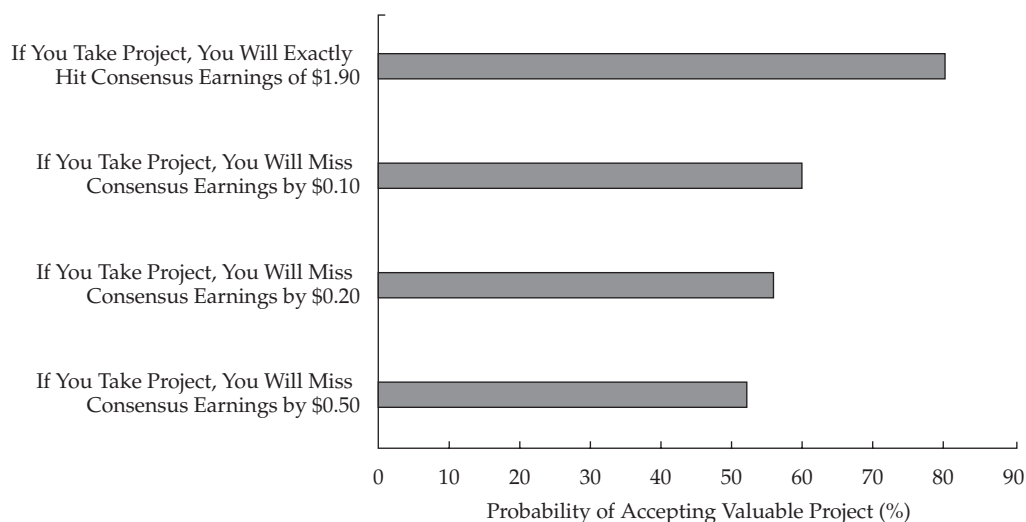
the fourth scenario indicate that when the EPS without taking the project is expected to be \$1.40, a full 50 cents below consensus, about 52 percent of the managers would, nevertheless, take the project and thus incur another 10 cent earnings hit. The fourth scenario result was surprising because we expected more managers, given that they are not on track to hit the consensus estimate anyway, to accept the project. Our results strongly suggest that managers are willing to alter investment decisions in an attempt to deliver expected (or at least the best possible below-expectation) earnings.

Our interviews with CFOs revealed that the aftermath of accounting scandals at Enron Corporation and WorldCom and the certification requirements imposed by the Sarbanes–Oxley Act of 2002 may have changed managers' preferences for the mix between taking accounting actions and taking real actions to manage earnings. An alternative explanation is that managers are simply more willing to admit to taking real actions than to making accounting adjustments. An interviewed CFO argued that, although auditors can second-guess

the company's accounting policies, they cannot readily challenge real economic actions (to meet earnings targets) that are taken in the ordinary course of business. Another executive emphasized that companies now go out of their way to assure stakeholders that there is no accounting-based earnings management in their books.

Several interviewed CFOs candidly acknowledged that they have made real economic sacrifices to hit an earnings target. For example, an executive of a prominent company acknowledged that his company had had the opportunity to pursue four valuable long-term projects. Although each project required substantial investment, there was no capital constraint. The company chose to pursue only two of the projects, however, because the CFO was worried about missing the next few quarters' earnings targets. The opinion of 15 of 20 interviewed executives was that every company would/should take actions such as these to deliver earnings, as long as the actions are within GAAP and the real sacrifices are not too large.

Many of the accounting actions listed in Figure 4 eventually unwind and adversely affect earnings in future periods. Why, then, do CFOs undertake such actions? Most CFOs we interviewed explained that in a growing company, the hope is that future earnings growth will offset reversals from past earnings management decisions. One CFO explained that when the overall economy is down, the company makes choices that boost earnings. The reversal of this action does not kick in until the economy recovers and earnings are increasing. When the economy recovers and the company is

Figure 5. Responses to the Statement and Question “Suppose Your Company’s Cost of Capital . . . What Is the Probability That Your Company Will Pursue This Project in Each of the Following Scenarios?”

relatively flush in cash, the company can increase discretionary expenditures without the “catch-up” being painful or obvious to investors.

Smooth Earnings

We asked CFOs whether they prefer a smooth earnings path or a bumpy earnings path that keeps cash flows constant. An overwhelming 96.9 percent of the survey respondents indicated that they prefer a smooth earnings path. CFOs talk about “running the business” in a manner to produce smooth, attainable earnings every year. For this reason, one interviewed CFO said, “Businesses are much more volatile than what their earnings numbers would suggest.”

As **Figure 6** shows, a chief motivation for working for a smooth earnings path is that survey respondents (88.7 percent) believe smooth earnings are perceived by investors to be less risky than bumpy earnings. Another popular explanation among those interviewed (79.7 percent) is that smoother earnings make it easier for analysts and investors to predict future earnings whereas unpredictable earnings lead to a lower stock price. Executives believe that the market rewards predictability. About half of respondents believe that smooth earnings result in lower costs of equity and debt because investors demand a smaller risk premium for smooth earnings. Smooth earnings paths are also thought to achieve and preserve a higher credit rating.

We directly asked executives how much they would sacrifice to avoid volatile earnings. **Figure 7** reports that an astonishing 78 percent admitted that

they would sacrifice a small, moderate, or large amount of value to achieve a smooth earnings path. This finding is consistent with previously reported evidence that CFOs will give up economic value to meet an earnings target. The conditional analyses we performed indicated modest cross-sectional variation in the responses. Technology companies are more prone to make small sacrifices than non-technology companies, and insider-dominated companies are willing to make moderate sacrifices. Companies that provide much guidance are also likely to give up much value to report smoother earnings paths.

Interviewed CFOs cited a number of stock price motivations for their desire to smooth earnings. They believe that the stock market values earnings predictability. Many CFOs fear that their P/E multiples will drop if the earnings path becomes volatile (even if cash flow volatility stays the same). Why should earnings volatility matter over and above cash flow volatility? A few CFOs stated that the market is skeptical of the underlying cash flows when earnings are volatile. Even if two companies have the same volatility of underlying cash flows, executives believe that the company with the more volatile earnings is perceived as riskier.

Related to the predictability point, CFOs believe that volatile earnings throw analysts’ spreadsheets “out of gear,” catch them off guard, and undermine their trust in the company and its numbers. Executives pointed out that the culture of “predictability in earnings” goes deep down in the

Figure 6. Responses to the Question and Statement “Do the Following Factors Contribute to Your Company Preferring a Smooth Earnings Path? A Smooth Earnings Path . . .”

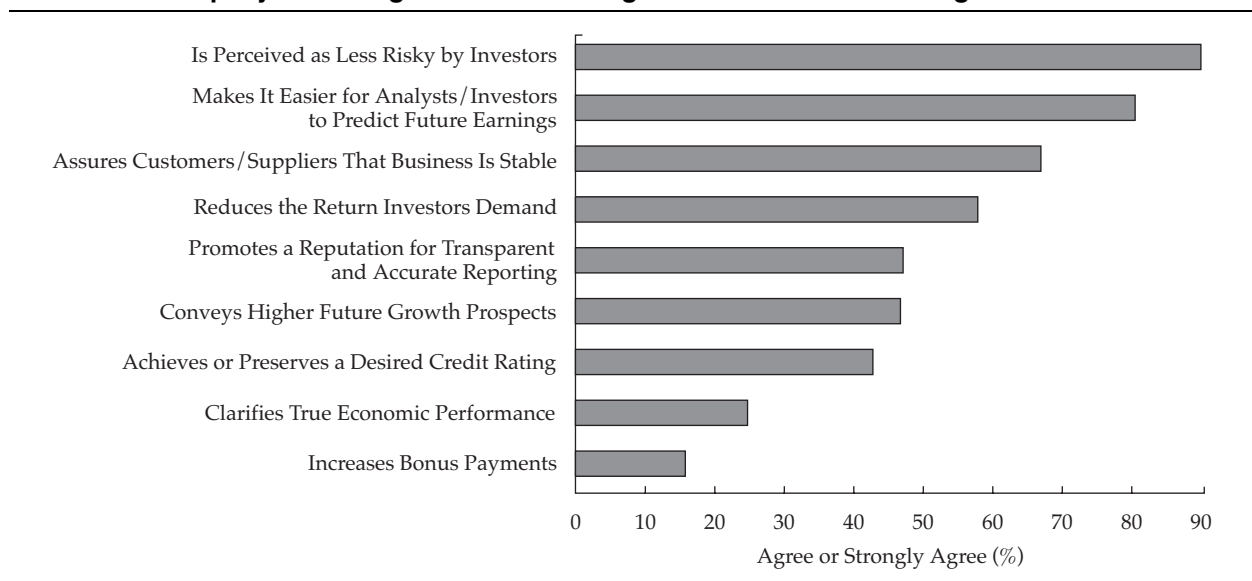
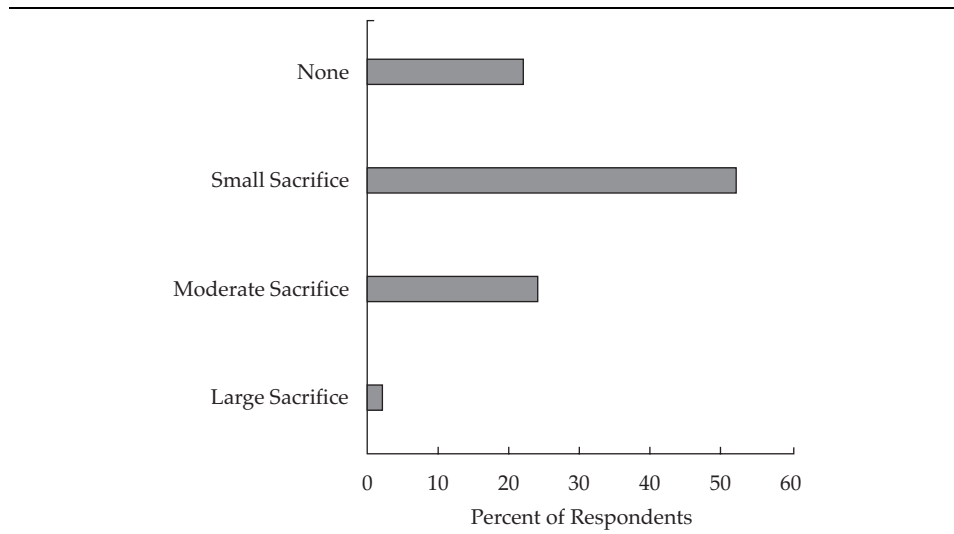


Figure 7. Responses to the Question “How Large a Sacrifice in Value Would Your Company Make to Avoid Volatile Earnings?”

organizational hierarchy. Divisional managers develop reputations as “no-surprise guys” by creating cushions in their revenue and spending budgets. These dependable managers are rewarded in the company for the “sleep well” factor because they deliver earnings.

Finally, predictability of earnings makes it easier for investors to get a sense of the portion of earnings that will be paid out versus the portion to be reinvested.

CFOs equate the idea of smooth earnings with the desire to avoid negative earnings surprises (relative to earnings targets). In their minds, missing the consensus estimate and volatile earnings are commingled, and both increase uncertainty in investors’ perceptions about the company. Several CFOs indicated that they would work aggressively within the confines of GAAP to reduce the perception of uncertainty about their companies’ prospects. When one executive’s company realized a \$400 million unexpected gain on the sale of a business, instead of reporting the gain in the quarter that it occurred, the company purchased collars to smooth the gain into \$40 million of income in each of the next 10 quarters. A collar costs money, so this behavior indicates a willingness to pay real cash flow to report smooth accounting earnings.

Who Is the Marginal Investor?

We asked CFOs whom they perceived to be the marginal price setter for their stock—that is, what person or group is the most important when the company is establishing policies on voluntary disclosure and earnings recognition. The survey evidence in **Figure 8** shows that CFOs view

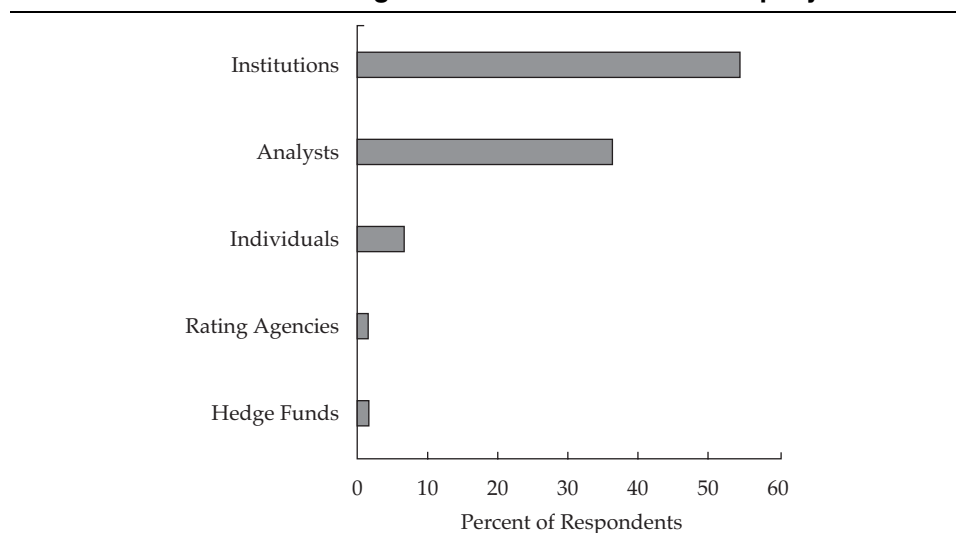
institutional investors, followed by analysts, as the most important marginal investors in their stock. Individual investors are a distant third.

When asked why “sophisticated” investors, such as institutions and analysts, would not (particularly if long-run prospects for the company are relatively unaffected) look beyond a short-term earnings miss or a bump in the earnings path, the CFOs interviewed responded in three ways. First, some pointed out that many players in the market today, especially youthful equity analysts, do not have a sense of history about “the long run.” They may not have even experienced a full business cycle. Referring to young equity analysts, one agitated CFO remarked, “I don’t see why we have to place these disclosures in the hands of children that do not understand the information.” Lacking a sense of history, analysts are prone to overreacting when the company misses an earnings target or when a new kink appears in the earnings path.

Second, fund managers also are compensated on the basis of how their funds have done relative to peer managers. Relative performance evaluation (RPE) of fund managers is believed to promote “bandwagon” investing and reduce willingness to hold a stock for the long run. If one fund starts selling the company’s stock when the company misses an earnings target, fund managers at peer firms have an incentive also to sell that company to protect their compensation.

Third, the number of traders who try to profit from day-to-day movements in stock prices (e.g., hedge funds) has increased in recent years. If a company misses an earnings target, it might trigger automatic “sell” programs, which will drive the

Figure 8. Responses to the Request “Rank the Two Most Important Groups in Terms of Setting the Stock Price for Your Company”



stock price down. One CFO pointed out that many investors “sell first and ask questions later.”

Finally, when we asked CFOs to explain why earnings misses and the related negative reactions of individual companies matter to a diversified investor, one responded that “these investors diversify by holding less of our stock and more of someone else’s,” indicating, again, that CFOs believe that idiosyncratic risk matters.

Fixing Short-Termism

We found new evidence that companies are willing to burn economic value, not simply manage accounting accruals, to achieve desired reporting outcomes. In addition, research has shown that real earnings management affects a stock’s volatility as well as its long-term returns (see Wang 2006). In this section, we discuss the obstacles in the path of defeating the short-term fixation on earnings data. Then, we propose measures to reduce the obsession with managing financial reporting outcomes.

Rules-Based vs. Principles-Based Accounting Standards. Several accounting standards include precise *rules* or formulas that determine the reporting of particular transactions. In particular, explicit rules are given for determining whether the transaction should involve a charge to earnings, appear as an asset or a liability on the balance sheet, or be disclosed in a footnote to the financial statements. Examples include the “3 percent outside ownership” rule for special-purpose entities and Financial Accounting Statement No. 13, *Accounting for Leases*, the standard used to determine whether a lease is a capital lease (in which

case, the leased asset and the lease liability have to be reflected on the balance sheet) or an operating lease (in which case, the balance sheet reflects neither a leased asset nor a lease liability). The U.S. SEC report on off-balance-sheet activity, which was commissioned by Congress as part of the Sarbanes–Oxley Act and released in June 2005, estimated that only about 22 percent of public companies use capital leases whereas 63 percent use operating leases.³ Even more interesting is that the estimated total cash flows related to noncancelable operating leases outweigh the cash flows related to capital leases by more than 25 to 1.

Interviewed executives opined that numerical rules and formulas for determining the accounting treatment of transactions let auditors off the hook. Instead of exercising professional judgment about whether the treatment of a transaction is consistent with the economic flavor of the transaction (that is, a principles-based approach), the auditor evaluates whether the reporting of the transaction complies with the letter of the accounting standard (a rules-based approach). Moreover, rules-based standards provide incentives to investment bankers to market products to CFOs that produce a desired accounting or reporting outcome—typically, to satisfy short-term objectives—even if the product is not positive for the cash flows of the company.

These executives believe that progress toward principles-based accounting standards will (1) reduce the incentives of investment bankers to market products that produce accounting earnings without cash flows and (2) create incentives for auditors to insist on reporting the economic spirit of a transaction regardless of the form that a transaction takes.

Quarterly EPS Guidance. Several interviewed executives named the demand for quarterly EPS guidance from analysts as a catalyst in corporate managers' short-termism. Perhaps to combat this situation, Warren Buffett has asked companies to stop providing quarterly earnings guidance and change the focus of their disclosure policies to long-term indicators of value. The Coca-Cola Company, on whose board Buffett sits, stopped providing quarterly EPS guidance on 13 December 2002. Several other prominent companies, such as AT&T and McDonald's Corporation, followed suit. Recent research by Chen, Matsumoto, and Rajgopal (2006), however, that investigated the antecedents and consequences of 76 announcements of the end of quarterly EPS guidance concluded that poor past stock return and operating performance, not a desire to get the market to focus on the long term, was the driver behind the average company's decision to stop guiding. Also interesting is that only 76 companies explicitly announced the cessation of EPS guidance during the four-year period studied (the period was October 2000 through December 2004, the post-Regulation Fair Disclosure period) despite several calls to give up quarterly guidance (e.g., Jensen, Murphy, and Wruck 2004).

Quarterly Reporting. Pressures to meet short-term goals will persist as long as companies release and emphasize short-term numbers. Compensation schemes and market participants that reward consistent growth in short-term numbers also contribute to managerial myopia.

Companies could alter their disclosure policy to deemphasize the importance of quarterly earnings numbers for valuation and concentrate, instead, on reporting long-term trends and nonfinancial measures. Buffett's annual notes on the state of Berkshire Hathaway are an example of such disclosures. Jensen (2006) recommended providing analysts with the company's strategy and a clear set of auditable metrics of the company's progress in meeting its strategic goals.

Ex Post Settlement of Accrual Estimates.

Accounting accruals typically anticipate future cash flows from transactions entered into during an accounting period. Commentators often cite the "reversing" nature of accruals as a barrier to earnings management. That is, if corporate managers pump up earnings by, for example, understating the allowance for doubtful debts, such a shortfall will catch up with them later when more than the "allowed for" customers default.

We asked CFOs why they would take income-increasing accruals when they know full well that

(1) these accruals will reverse in the future and (2) they will then have to take even higher income-increasing accruals to offset the earlier reversals and still maintain their earnings growth rates. A few interviewed CFOs suggested that growth in the business helps mask accrual reversals. If the actual (although unobserved by the market) growth rate in earnings is 15 percent, accrual reversals can eat up 4 percent and the company can still report an 11 percent earnings growth rate. Of course, market participants and analysts do not know how the company arrived at the 11 percent growth rate.

The current financial reporting model does not reveal the accuracy of the estimates underlying the accruals. Instead, current accruals are mixed together with reversals of prior accruals. Lundholm (1999) proposed that the financial reporting model be amended to report on the *ex post* accuracy of a company's prior estimates. Doing so would identify companies that have abused their reporting discretion in the past and provide valuable information about the probable credibility of the company's disclosures in the present. Companies would also have a greater incentive to make accurate estimates of accruals if they knew that opportunistic estimates would be explicitly revealed in the future.

In discussing the obsession with short-term earnings, Rappaport (2005) suggested several solutions. With respect to accruals, he argued that corporate reporting should be improved by clearly separating accruals from cash flows and by disclosing the extent of uncertainty with which accruals are likely to convert to future cash flows.

Kwag and Shrieves (2006) showed that analyst forecast errors are persistently positive or negative for a long period of time. Persistently positive forecast errors ($EPS > \text{forecast}$) might motivate corporate managers to smooth earnings by "reserving" some of their EPS for later. Persistently negative forecast errors ($EPS < \text{forecast}$) might encourage CFOs to dampen analyst expectations and "talk" the forecasts down (called "walkdowns"). Either way, CFOs tend to attach undue importance to analyst forecasts of quarterly earnings and respond to pressure from such forecasts via earnings management or via management of analysts' expectations.

Integrity in Reporting. In our interviews, we asked each CFO a question about integrity. The preface to the questions was as follows:

Suppose you were going to miss the earnings consensus by a few cents and you made it clear in the conference call that there were five different accounting actions that you could have taken within GAAP to exactly hit the target and

five different real actions that you could have taken to hit the target but your company chose not to take these actions because you believe the company is better off avoiding such actions.

Not a single CFO thought this idea was credible. Some were worried about seeming too arrogant. Furthermore, they noted that failure to meet or exceed targets on a consistent basis usually means the CFO loses his or her job. On a related note, we found that several CFOs thought that to “deliver earnings” is an important part of running a business. In addition, a number of CFOs mentioned that the failure to deliver earnings that meet market expectations could negatively impact their job mobility if they left their current company.

Jensen (2006) suggested that the language of business has to be modified to reintroduce integrity into financial reporting. He argued that increasing corporate integrity will contribute to increasing company value. He noted that when we use terms other than “lying” to describe “earnings management” behavior, we effectively condone manipulation of financial reports because, then, it never occurs to corporate managers that manipulation is lying. It seems to be simply a regular part of doing business.

Jensen (2006) attributed the general lack of integrity in financial markets to the tendency of investors to reward and punish corporate managers in ways very similar to what happens in the corporate budget systems that pay managers to lie. In particular, the stock price of the company gets hammered when the reported EPS is away from the analyst consensus forecasts by as little as a penny (Skinner and Sloan 2002).

The stock market’s reception of earnings misses, however, may already be changing. A recent study by Koh, Matsumoto, and Rajgopal (2006) found that the tendency of companies to exactly meet or just beat analyst-set EPS targets has fallen in the post-Enron world. The authors also found that the stock market premium for exactly meeting analyst consensus EPS has disappeared.

Changes in Corporate Governance. Our research reveals a fundamental breakdown in corporate governance. Boards of directors approve projects, but they don’t usually get to see the projects that were rejected by management—even though these projects might be valuable. We believe that many board members have no idea that the earnings game is going on behind their backs. Indeed, some CFOs said there was a second and a third level to the game. Divisional leaders take real actions to make sure they make the corporate-level target earnings.

Moreover, when evaluating the performance of the CEO and the CFO, board members may themselves consider the company’s track record in meeting and beating analyst consensus estimates. In our interviews, CFOs said that their boards expect them to meet or beat analyst estimates. Board meetings often focus on short-term performance (which is easily measured) rather than longer-term measures (which are often more ambiguous).

Although much progress has been made in the past decade in realigning managerial compensation away from short-term incentives toward medium- and long-term incentives, our research suggests that this realignment has failed to deflect the focus from the very short run. Rappaport (2005) recently called for reform in managerial compensation to encourage management focus on long-term performance targets by increasing the extent of RPE and increasing vesting periods of stock options.

The culture of boards of directors must change to mitigate excessive short-termism. Managers must be convinced that board members are focused on the long-term strategic goals for the company. Boards must be proactive in balancing the long-term goals with short-term performance. Boards must, to some degree, shield managers from the short-term pressures from capital market participants that may arise when targets are not achieved in a particular quarter.

But more than a change in culture is necessary. Boards must demand to know what large projects were analyzed, which were turned down, and why. Boards need to make sure that the budgeting process at the divisional level does not foster next-level-down earnings management.

We emphasize that we are *not* advocating a myopic focus on long-term performance. In the end, the long term is the sum of many short-term events. The key is to change the balance between the short run and long run. Boards must learn to understand whether a decrease in earnings is a deliberate result of a longer-term strategy, a transitory phenomenon (perhaps a result of timing or exogenous events), or an indication of more permanent problems. If the board can create such an atmosphere, it will reduce management incentives to engage in value-destroying activities to manage earnings.

Active Institutional Investors. Figure 8 suggests that among our respondents, institutional investors play the dominant role in setting a company’s stock price. Why do not large investors, such as the California Public Employees’ Retirement System, make it clear to corporations that they do not want companies to manage earnings? Part of the reason is the performance compensation of

institutional investors. They are evaluated on the basis of the short-term performance of their portfolios. Hence, they reinforce, rather than repel, short-term actions. Rappaport (2005) suggested that compensation schemes of investment managers could be improved by extending performance measurement periods to three to five years, by paying annual bonuses on rolling three-year to five-year periods, and by requiring fund managers to hold meaningful personal investments in their funds. All of these steps would help shift the focus away from the very short term.

Although it is unlikely that any one large investor could reduce the prevalence of real earnings management, large investors could help change a corporate culture in which real earnings management is an accepted part. If a large institutional investor or group of investors made it clear that these real actions are not acceptable, people inside and outside the corporation might rethink the current culture.

Empowering Retail Investors. Retail investors are often long-term holders of a company's stock. They are scattered, however, and other than the odd question at an annual meeting, they are relatively inconsequential to corporate management. In this issue of the *Financial Analysts Journal*, Holton (2006) suggests setting up a proxy exchange through which investors could conveniently transfer aggregate voting rights to an organization of the investor's choosing. This arrangement would address two problems: (1) Individual holdings are too small to justify the effort required to vote the shares (and most individuals lack the expertise to constructively vote the shares) and (2) investors who own shares through institutions, such as mutual funds or pension plans, are often denied the right to vote these shares.

Conclusion

The findings of our survey on financial reporting practices are startling. That participation in the earnings game is pervasive may not be surprising, but that the majority of companies are willing to

sacrifice long-run economic value to deliver short-run earnings is shocking. Yet, these actions are not even considered to be a problem by many CFOs. Companies sacrifice long-term value in response to intense pressure from the market to meet expectations and to avoid the severe negative market reaction when earnings are not on target. Moreover, managers are aware that the long-term value that is sacrificed goes beyond the negative returns associated with short-run stock volatility.

Our findings are ironic. If companies must play the earnings game, shareholders would prefer that CFOs manage earnings through accounting actions that are allowed by GAAP. Recognizing some revenue one month early, if allowed under GAAP, is far better than delaying or canceling the construction of a valuable plant. The real action has a real effect on the company's prospects and cannot be reversed.

What is the magnitude of the problem? We found that 78 percent of public companies would sacrifice value to smooth earnings and 56 percent would knowingly defer valuable long-term projects to meet targets. Suppose the level of value sacrifice is 1 percent. Given current equity market capitalization, the sacrifice amounts to about \$120 billion. We found similar results for private companies, however, so a 1 percent value haircut probably costs the economy more like \$150 billion—the equivalent of two Enrons.

Breaking out of the current earnings game will require a combination of actions to change the current culture. We believe the main levers for change are boards of directors, which should have the long-term interest of the company as the main priority, and institutional investors, who are negatively affected by loss in long-term shareholder value.

Destroying value to hit some short-term earnings target hurts shareholders in the long term. For the economy as a whole, our results suggest that capital investment may not be at its optimal level because of pressures to play the earnings game. Less investment means less employment. Less investment also negatively affects the ability of companies to compete in the global economic arena.

This article qualifies for 1 PD credit.

Notes

1. The survey is posted at <http://faculty.fuqua.duke.edu/~jgraham/finrep/survey.htm>.
2. Examples include a 12 percent response rate reported by Trahan and Gitman (1995) and a 9 percent response rate reported by Graham and Harvey (2001).
3. This report may be found at www.sec.gov/news/studies/soxoffbalancerpt.pdf.

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