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TRACKING THE NUMBERS

Street Sleuth: Corner Office Thinks Short-Term

Managers' Focus Is to Hit Targets, Smooth Earnings, Sacrificing Future Growth

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Given the choice between hitting earnings expectations and missing them in order to improve their long-term financial health, most U.S. companies would go for the short-term target.

So say the results of a survey by professors at Duke University's Fuqua School of Business and the University of Washington.


In an effort to determine the degree to which companies will use legal accounting actions to smooth earnings and meet analyst estimates, professors Campbell Harvey and John Graham of Duke and Shiva Rajgopal of the University of Washington surveyed financial executives at 401 firms late last year and conducted extensive interviews with 20 senior executives. To the professors' surprise, the financial officers were eager to talk about how companies would forgo projects that would give them economic gain in order to put a finer gloss on earnings.

"The thing that stunned us was that they were so up front about taking these real economic decisions to manage earnings," Mr. Harvey says.

In one of their survey questions, the researchers presented the executives with a situation where earnings may come in below their company's desired target and presented them with a choice of actions they could take. Close to 80% said they would decrease discretionary spending on items like research, advertising and maintenance to meet the target, while more than half said they would put off starting a new project even if that meant a small sacrifice in value.

Another question presented a situation wherein a new opportunity arose late in the quarter that would generate a rate of return well in excess of a company's cost of capital -- in other words, it would boost long-term profitability -- but it would detract from earnings in the present quarter. If taking on the project meant earnings would slip to just meeting, rather than exceeding, analysts' consensus estimate, 80% of companies said they would pursue it. Apparently, beating estimates -- not just meeting them -- is a

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TARGETS VS. HEALTH

What would you do to meet analysts' earnings expectations for your company? [See how 401 financial executives responded](#)⁰ to a scenario posed to them by professors at Duke University's Fuqua School and the University of Washington.

priority at some firms. If taking on the project meant missing the estimate, rather than meeting it, just 59% of respondents would go forward with it.

In the interviews, conducted by Mr. Harvey and Mr. Graham, company executives gave concrete examples of ways in which they had sacrificed the long-term health of the company in order to meet analyst estimates. One spoke of having the financing available for six valuable projects, but only going forward with three in order to ensure that analyst earnings expectations were met. Falling short of expectations, this executive said, would put his job in jeopardy.

In another interview, an executive told of a situation where his company had an unexpectedly large gain on an investment. Taking the gain, the company surmised, might lead analysts to ratchet up future earnings forecasts to the point where it would be difficult to meet them. Rather than face that, the company went to an investment bank that designed investment vehicles that allowed it to smooth the gain over the following 10 quarters, according to the executive. Such a move is costly, points out Mr. Harvey. Traditional theory would hold that taking the gain up front would be more valuable.

Along a similar vein, some executives spoke of how they would put off or only do minimal maintenance in order to hit targets, even though this meant that equipment would wear out more quickly, entailing costly replacements down the road. A chief financial officer at a research-intensive firm spoke of how research and development spending is curtailed when there's a danger that earnings will come below what the company has indicated -- even if the R&D was adding to the company's net-present value. Conversely, if results were coming in ahead of expectations, R&D spending would get ratcheted up. Such tactics create a smoother earnings stream, which many investors equate with financial stability.

Such thinking is anathema to Mr. Harvey: "If something of value is on the table, you should take it, because that's what's good for shareholders, and that's what's good for the economy," he says.

In their forthcoming paper, Mr. Harvey and his co-authors point out that many executives feel that they are unhappily locked into a situation where the short-term focus of the market has affected their behavior. One CFO talked of how "analysts viciously turn on you when you fail to come in line with their projections." Mr. Harvey thinks that executives' frankness in detailing how they would give up economic gain to hit short-term targets may be tantamount to a cry for help -- that they're desperate for a change in the status quo.

Many in the investing community, too, decry what they see as an excessive focus on short-term factors within the stock market, even after a rash of accounting scandals.

"It's a phenomenon that's gathered steam," says Steve Henningsen, a financial adviser at the Wealth Conservancy in Boulder, Colo.

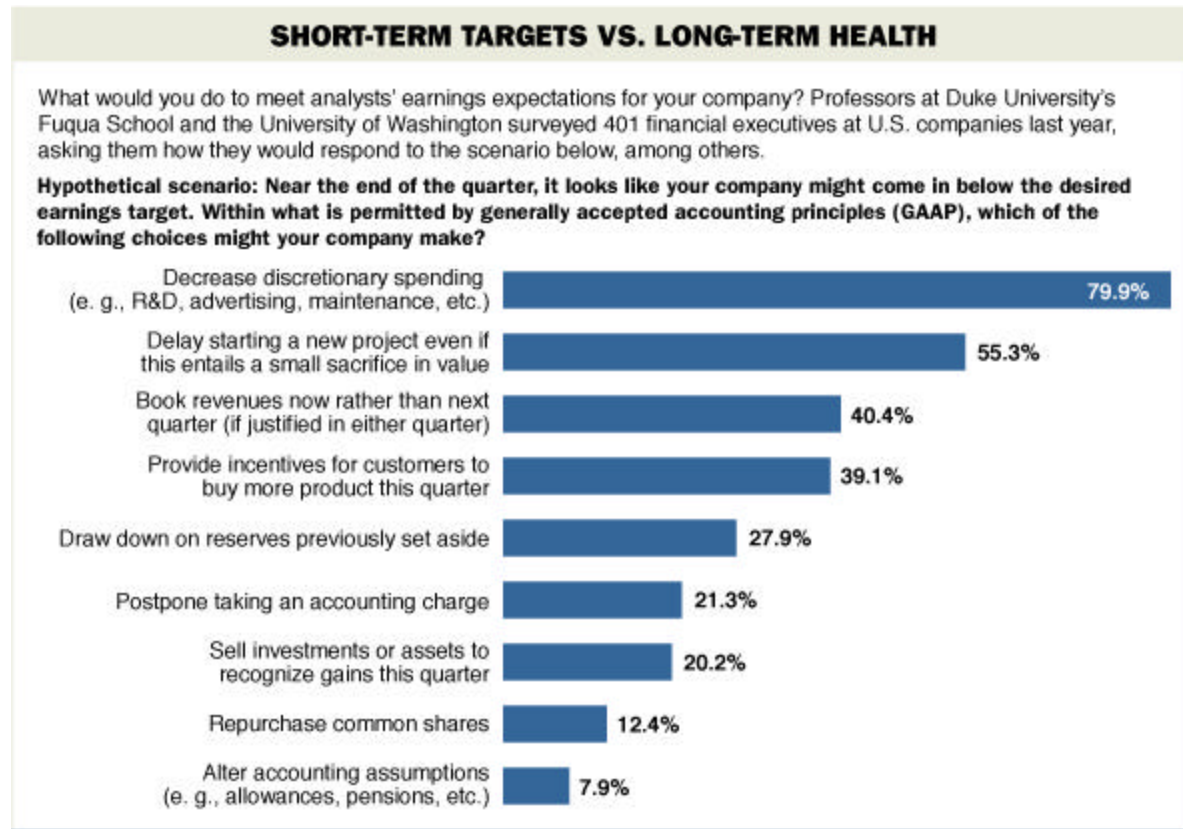
Mr. Henningsen believes that it's mostly professional investors, such as fund managers, themselves increasingly guided by quarterly performance, who are responsible for this. In the fight to keep up with their peers and their benchmarks (not always the same thing as delivering consistent returns), managers tend to sway with the crowd rather than think for the long term.

But Jeff Bronchick, chief investment officer at Los Angeles money-management firm Reed Conner Birdwell, believes that companies are complicit in the market's short-termism and that it's their

responsibility to break the cycle.

"If companies get trapped in near-termism, they will attract shareholders that are looking at the near term," he says. "Treat shareholders like they were business partners. Who wants to run a business where your business partner is going to dump you for missing [earnings] by 1%?"

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