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Value Destruction and Financial Reporting Decisions

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Abstract

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 U.S. financial executives and in-depth interviews with an additional 22 executives, we document a willingness to routinely sacrifice shareholder value to meet earnings expectations or to smooth reported earnings. Whereas much previous research focused on the use of accounting for earnings management, such as accrual decisions, 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, explored both earnings management and voluntary disclosures in some depth. In addition, from the fall of 2003 to early 2005, we interviewed 22 chief financial officers (CFOs), which added to our understanding of corporate decision making.

Our results indicate that CFOs believe that earnings, not cash flows, are the key metric watched by investors and other outsiders. They consider the two most important earnings benchmarks to be quarterly earnings for the same quarter last year and the analyst consensus estimate.

CFOs believe that hitting earnings benchmarks is very important because such actions build credibility with the market and help maintain or increase the company’s stock price in the short run. To avoid the severe market reaction to a failure to deliver on the earnings expectations of analysts and investors, CFOs are willing to sacrifice long-term economic value (such as delaying a valuable project). In contrast, executives say that they are hesitant to use legal—that is, within GAAP—accounting adjustments to hit earnings targets, perhaps as a consequence of the stigma attached to accounting fraud in the post-Enron environment.

Not surprisingly, almost all CFOs prefer smooth earnings, but a surprising 78 percent of the surveyed executives would destroy economic value in exchange for smooth earnings. The executives believe that unpredictable earnings—as reflected in a missed earnings target or volatile earnings—command a higher risk premium. In short, CFOs argued that the system (that is, financial market pressures and overreactions) encourages decisions that at times destroy long-term value to meet earnings targets.

We also explore how the malaise of excessive short-termism can be fixed. We argue that a greater emphasis on principles-based rather than rules-based accounting standards, reduction in quarterly earnings guidance, disclosure of how accrual estimates are settledex post, a focus on integrity in the financial reporting process, proactive boards of directors working to balance short-term and long-term goals, and a more active role for investors would mitigate the myopic emphasis on quarterly earnings measures.

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.