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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 ... e value lost in recent ...

Based o... rviews with an a... e shareho... nings. Whereas ... ings manage... idespread 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 ... We argue that a gr... nting standard... ual estimat... process, proa... goals, and a more ac... terly earnings...

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.