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**Just Say No to Wall Street: Putting A Stop to the
Earnings Game**

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JOSEPH FULLER

The Monitor Group,
Joe_Fuller@Monitor.com

MICHAEL C. JENSEN

Jessie Isidor Straus Professor of Business Administration, Emeritus, Harvard Business School
mjensen@hbs.edu

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Abstract

Putting an end to the “earnings game” requires that CEOs reclaim the initiative by avoiding earnings guidance and managing expectations in such a way that their stocks trade reasonably close to their intrinsic value. In place of earnings forecasts, management should provide information about the company's strategic goals and main value drivers. They should also discuss the risks associated with the strategies, and management's plans to deal with them.

Using the experiences of several companies, the authors illustrate the dangers of conforming to market pressures for unrealistic growth targets. They argue that an overvalued stock, by encouraging overpriced acquisitions and other risky, value-destroying bets, can be as damaging to the long-run health of a company as an undervalued stock.

CEOs and CFOs put themselves in a bind by providing earnings guidance and then making decisions designed to meet Wall Street's expectations for quarterly earnings. When earnings appear to be coming in short of projections, top managers often react by suggesting or demanding that middle and lower level managers redo their forecasts, plans, and budgets. In some cases, top executives simply acquiesce to increasingly unrealistic analyst forecasts and adopt them as the basis for setting organizational goals and developing internal budgets. But in cases where external expectations are impossible to meet, either approach sets up the firm and its managers for failure and in the process value is destroyed.

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Just Say No to Wall Street: Putting a Stop to the Earnings Game

by Joseph Fuller, The Monitor Company, and Michael C. Jensen,
The Monitor Company and Harvard Business School¹

"We do not want to maximize the price at which Berkshire shares trade. We wish instead for them to trade in a narrow range centered at intrinsic business value... [We] are bothered as much by significant overvaluation as significant undervaluation."

—Warren Buffett, Berkshire Hathaway Annual Report, 1988

First there were whispers and informal advisories to favored analysts of what to expect in coming earnings announcements. Then the conversations became more elaborate, engendering a twisted kind of logic. No longer were analysts trying to understand and analyze a company so as to predict what it might earn; instead the discussion revolved around the analysts' forecasts themselves. Will expectations be met? What will management do to ensure that? Rather than the forecasts representing a financial byproduct of the firm's strategy, the forecasts came to drive those strategies. While the process was euphemistically referred to as "earnings guidance," it was, in fact, a high-stakes game with management seeking to hit the targets set by analysts—and being punished severely if they missed.

Last year, the Securities and Exchange Commission recognized that private conversations between executives and analysts had become extensive, with analysts gaining access to critical data not otherwise broadly available to shareholders. The new regulations on fair disclosure addressed the mechanics of the conversation, but did little to change its underlying logic. The result has been blizzards of filings and dozens of press releases, and many more company-run conference calls. But such changes in the outward forms of corporate disclosure have done little if anything to deflect the underlying momentum of the earnings guidance game.

Nevertheless, there are some encouraging signs. In the past few months, a few courageous CEOs—notably, USA Networks' Barry Diller and Gillette's Jim Kilts—have attempted to put a halt to the earnings game by simply saying no. In a recent SEC filing, Diller balked at the sophisticated art form known as managing expectations, saying publicly what many have said privately for a long time: "The process has little to do with running a business and the numbers can become distractingly and dangerously detached from fundamentals."²

An Overvalued Stock Damages a Company

Witness the part that Wall Street's rising expectations played in the demise of once high flyers like Enron, Cisco, and Nortel. With analysts pushing these companies to reach for higher and higher growth targets, the managements of the companies responded with actions that have generated long-term damage. To resolve these problems, managers must abandon the notion that a higher stock price is *always* better and recognize that an overvalued stock can be as dangerous to a company as an undervalued stock. The proper management of investor expectations means being willing to take the necessary actions to eliminate such overvaluation when it occurs.

In his first meeting with analysts after taking over Gillette, James Kilts stood firm against the tide, refusing to

1. © Copyright 2002, The Monitor Company and M. C. Jensen. Excerpts of this article were published in the *Wall Street Journal* "Manager's Journal" column under the title "Dare To Keep Your Stock Price Low," December 31, 2001, and in the *Financial Times*, Jan 22, 2002 under the title "End the Myth-Making and Return to True Analysis." We thank Nancy Nichols, Pat Meredith, Jennifer Lacks Kaplan, Hardy Tey, Stephanie Mayer, and Shibane Verma, who con-

tributed to this effort. This paper can be downloaded without charge from the Social Science Research Network Electronic Library at: <http://papers.ssrn.com/abstract=297156>.

2. USA Networks. 2001. "USA Provides Internal Budget to Investment Community." SEC Form 425.1: October 24, 2001.

be forced into making predictions for his company. *The New York Times* reports that, in a June 2001 meeting with analysts, Kilts remained silent when Wall Street analysts repeatedly asked him for a more specific estimate of the company's performance: "Mr. Kilts stood on the stage, crossed his arms and refused to give it."³ By taking positions that we believe will benefit all the players in this game, Kilts and Diller have seized an important opportunity—even an obligation—to reshape and reframe the conversation for a new era.

Over the last decade companies have struggled more and more desperately to meet analysts' expectations. Caught up by a buoyant economy and the pace of value creation set by the market's best performers, analysts challenged the companies they covered to reach for unprecedented earnings growth. Executives often acquiesced to increasingly unrealistic projections and adopted them as a basis for setting goals for their organizations.

There were several reasons executives chose to play this game. Perhaps the most important was favorable market conditions in many industries, which enabled companies to exceed historical performance levels and, in the process, allowed executives and analysts alike to view unsustainable levels of growth as the norm. Adding to favorable conditions and exceptional corporate performance was a massive, broad-based shift in the philosophy of executive compensation. As stock options became an increasing part of executive compensation, and managers who made great fortunes on options became the stuff of legends, the preservation or enhancement of short-term stock prices became a personal (and damaging) priority for many a CEO and CFO. High share prices and earnings multiples stoked already amply endowed managerial egos, and management teams proved reluctant to undermine their own stature by surrendering hard-won records of quarter-over-quarter earnings growth. Moreover, overvalued equity "currency" encouraged managers to make acquisitions and other investments in the desperate hope of sustaining growth, continuing to meet expectations, and buying real assets at a discount with their overvalued stock.

Parallel developments in the world of the analysts completed a vicious circle. Once analysts were known to a handful of serious investors and coveted a spot on *Institutional Investor's* annual All-American team. In recent times, analysts became media darlings. An endless parade appeared on an increasing array of business programming. The views of celebrity analysts were accorded the same weight as the opinions of leading executives. Analysts Mary Meeker and Jack Grubman were quoted in the same breath and, more

important, credited with the same insight as Cisco's CEO John Chambers and Qwest's Joe Nacchio. With the explosion in the markets came an explosion in analyst compensation, as leading analysts shared in the bonus pools of their investment banking divisions and thus had incentives to issue reports favorable to their banks' deals. Analysts with big followings, a reputation built on a handful of good "calls," and an ability to influence large investment banking deals sold by their firms commanded multi-million dollar salaries. In sum, analysts had strong incentives to demand high growth and steady and predictable earnings performance, both to justify sky-high valuations for the companies they followed and to avoid damage to their own reputations from missed predictions. In too many instances, too many executive teams and too many analysts engaged in the equivalent of liar's poker.⁴

Many will say, "So what? If overly aggressive analysts drove executives to create more shareholder value faster, what's the harm?" What they fail to recognize is that this vicious cycle can impose real, lasting costs on companies when analyst expectations become unhinged from what is possible for firms to accomplish. As the historic bankruptcy case of Enron suggests, when companies encourage excessive expectations or scramble too hard to meet unrealistic forecasts by analysts, they often take highly risky value-destroying bets. In addition, smoothing financial results to satisfy analysts' demands for quarter-to-quarter predictability frequently requires sacrificing the long-term future of the company. Because the inherent uncertainty in any business cannot be made to disappear, striving to achieve dependable period-to-period growth is a game that CEOs cannot win. Trying to mask the uncertainty inherent in every industry is like pushing on a balloon—smoothing out today's bumps means they will only pop up somewhere else tomorrow, often with catastrophic results.

More important, we have witnessed the consequences of executives' futile attempts to record growth rates that consistently and materially exceed growth in primary demand in their markets. Stated simply, companies participating in markets with 4% underlying growth in demand cannot register 15% growth in earnings quarter over quarter, year over year, indefinitely.

The technology and telecommunications sectors provide good examples of the effects of sustained pressure from analysts. In the last decade, analysts' expectations consistently and vastly exceeded what high-tech and telecom companies were capable of achieving. Managers collaborated in this fiction, either because they themselves had unrealistic

3. Barnes, Julian E. 2001. "Gillette's Chief Is Critical of the Company's Misstep." *New York Times*, June 7, 2001. <http://college2.nytimes.com/guests/articles/2001/06/07/852365.xml>

4. Evidence of the distortion of information provided to investors by companies, and of the collaboration of some financial intermediaries and analysts in this distortion, has grown considerably. For an excellent compilation and analysis of this evidence, see the paper by Gene D'Avolio, Efi Gildor, and Andrei Shleifer. 2001. "Technology, Information Production, and Market

Efficiency." Harvard Institute of Economic Research Discussion Paper Number 1929, September 2001. Cambridge, MA. This paper can be downloaded without charge from the Social Science Research Network eLibrary at: <http://papers.ssrn.com/abstract=286597> and at <http://post.economics.harvard.edu/hier/2001papers/2001list.html>.

expectations for their companies or, worse yet, because they used analysts' expectations to set internal corporate goals. The resulting destructive effects of overvaluation of corporate equity manifested itself in ill-advised actions aimed at fulfilling these unrealistic expectation—notably, value-destroying acquisitions and greenfield investments. When the fiction finally became obvious, the result was massive adjustments in earnings and growth projections and, consequently, in equity valuations. In many cases, the very survival of the affected companies came into question. Enron is perhaps the most dramatic example.

The Case of Enron

Enron was in many ways an extraordinary company. It boasted significant global assets, genuine achievements, dramatic innovations, and a promising long-run future. Taking advantage of a rapidly deregulating market and capitalizing on its deep knowledge of the industry, Enron had seized what was probably a once-in-a-corporate-lifetime opportunity to reinvent itself as a market maker in natural gas and energy.

Wall Street responded to this and other innovations by Enron with a series of positive reports and ever-higher valuations, eventually labeling Enron one of the best companies in the economy, even comparing it to Microsoft and GE.⁵ However, the aggressive targets that Wall Street set for Enron's shares made the company a captive of its own success. To be sure, it was a game that Enron willingly played—but it's one the company clearly lost, with considerable consequences for not only the company's stockholders, but for its creditors, customers, employees and other major stakeholders.

To begin to see what went wrong, consider that Enron's peak valuation of \$68 billion (in August 2001) effectively required the company to grow its free cash flow at 91% annually for the next six years, (and then to grow at the average rate for the economy)—a pace that required it to continuously come up with what were, in effect, one-time-only innovations. As if to confirm these expectations, one analyst blithely predicted that Enron would come to "dominate the wholesale energy market for electricity, natural gas, coal, energy derivatives, bandwidth, and energy services on three continents."⁶ And Enron, to its own detriment, took up the challenge. In seeking to meet such expectations, it expanded into areas, including water, broadband, and even weather insurance, in which it had no specific assets, expertise, or experience.

Yet it didn't have to be this way. Had management not met Wall Street's predictions with its own hubris, the result could have been very different. As Gillette's Kilts is demonstrating, managers can refuse to collude with analysts' expectations when they don't fit with their strategies and the underlying realities of their markets. They can decline to bow to analysts'

demand for highly predictable earnings.

If Enron's management had confronted the analysts with courage and conviction and resisted their relentless focus on outsized earnings growth, the company could have avoided questionable actions taken to please the analysts and markets. The result may well have been a lower-valued company, but a stable and profitable one with a promising future. And, as in other companies, these questionable actions went beyond the decisions to launch unwise investments and acquisitions, and included apparent manipulation of the information it provided to Wall Street. Some of these practices are currently being investigated by the SEC, including aggressive revenue recognition practices, off balance-sheet financing that reduced Enron's apparent debt, and partnerships that allowed the company to show higher earnings.

When discovered, such practices—coupled with missed earnings expectations—first stirred Wall Street's concern and eventually caused the crisis of confidence that destroyed the company's most valuable asset—its ability to make markets in energy. As a result, by January of 2002, Enron's stock price had fallen by more than 99% from its peak just four months earlier. While the partnerships brought to the forefront issues of credibility for Enron and the integrity of their financial reporting, they also served to highlight the importance of Wall Street analysts and the nature of their relationship with the companies they cover.

The Case of Nortel Networks

The story of Nortel is similar. Nortel's CEO, John Roth, launched a strategy in 1997 to transform the company from one dependent on its traditional strength in voice transmission into one focused on data networking. Nortel acquired 19 companies between 1997 and early 2001. And as its stock price soared (to reach a total capital value of \$277 billion in July 2000), it came under pressure to do deals to satisfy the analysts' growth expectations. Ultimately, it paid over \$32 billion—mostly in stock—for these companies. Most of those acquisitions have now been sold off for modest amounts or shut down and written off entirely.

The quest to transform Nortel clearly damaged this former mainstay of the telecommunication sector. With a year-end 2001 valuation of just \$24 billion, the company's stock has fallen by more than 90% from its peak in September of 2000. In July 2001 it reported a record \$19.4 billion second-quarter loss followed by a \$3.6 billion loss in the third quarter. Its CEO resigned effective November 1, 2001 but remains as vice-chairman until the end of 2002. Employment has shrunk from 72,900 people when Roth took over (and from a high of 94,500) to a projected 45,000 by the end of this year. As of the end of 2001, Nortel's (adjusted)

5. Fleischer, David N. 2001. "Enron Corp. Gas and Power Convergence." Conference Call Transcript, Goldman Sachs, July 12, 2001. New York.

6. Tirello, Edward J., Jr. 2000. "Enron Corporation: The Industry Standard for Excellence." Analyst Report, Deutsche Banc Alex. Brown., September 15, 2000. New York.

stock price was 44% lower than its level of \$13.16 on Oct. 1, 1997 when Roth took over as CEO.⁷ As these numbers make clear, the decline suffered by Nortel involved far more than the elimination of its overvaluation; it involved a significant destruction of value, mainly, again, through acquisitions and massive overinvestment. It is this kind of damage that can be stopped if managers can just say no to the pressure to fulfill unrealistic market expectations.

A number of factors encouraged Nortel's managers to collaborate in the fiction of a \$270 billion valuation. One was the incentive to maintain the value of managerial and employee stock options. Another was the understandable reluctance of top management to admit they were not as good as analysts were projecting. And a third was management's unwillingness to give up the overvalued equity currency that gave them the leeway (and purchasing power) to make unwise, value-destroying investments. In sum, management's reluctance to bear the unpleasantness associated with correcting the market sooner led to far greater pain down the road.

This cycle is not without its costs for the financial community. Of course, many stockholders have incurred huge losses. Analysts, too, have taken their lumps. Their integrity has been called into question in congressional hearings. The press has pilloried many of the most prominent analysts, contrasting their earnings projections with actual results. Many unhappy clients have terminated long-standing relationships. One even went so far as to sue a prominent analyst in federal court.⁸ And though that action proved unsuccessful, extensive coverage of the suit in the popular press reflects the depth of disillusionment. Where there is smoke from the public having been burned, political fire soon follows. If the SEC has been willing to spend years and significant political capital pursuing restrictions on accounting firms providing consulting services to their statutory audit clients, it cannot be long before regulators become interested in the potential conflict of interest between the investment banking and the security analysis sides of investment banks.

Restarting the Conversation

Putting an end to this destructive cycle will require a new approach to disclosure based on a few simple rules of engagement.

- Managers must confront the capital markets with courage and conviction. They must not collude with analysts' expectations that don't fit with their strategies and the underlying characteristics of their markets. They must not bow to analysts' demands for highly predictable earnings. The art of analysis includes the capacity to understand phenomena like seasonality, cyclicity, and random events. Companies

do not grow in a constant fashion with each quarter's results better than the last. In the long run, conforming to pressures to satisfy the market's desire for impossible predictability and unwise growth leads to the destruction of corporate value, shortened careers, humiliation, and damaged companies.

- Managers must be forthright and promise only those results they have a legitimate prospect of delivering, and they must be clear about the risks and uncertainties involved. They must dispel any air of unreality that settles over their stock and highlight what they cannot do as readily as they trumpet their prospects. While this can cause the stock price to fall, the associated pain is slight compared to colluding in myth-telling. This reflects more than the good conscience of a Boy Scout. It is, in fact, an act of self-preservation.

- Managers must recognize that an overvalued stock can be damaging to the long-run health of the company, particularly when it serves as a pretext for overpriced acquisitions. As the experience of companies like Nortel and Worldcom demonstrates, buying overpriced companies with overvalued stock not only fails to add value, but can end up demoralizing once successful organizations. While leveling with the markets can cause the stock price to fall to a sustainable level, the associated personal and organizational pain is slight compared to that arising from colluding in myth-telling.

- Managers must work to make their organizations far more transparent to investors and to the markets. USA Network's Diller, for example, has chosen to provide analysts with actual business budgets broken down by business segments. At the very least, companies should state their strategies clearly, identify associated value drivers and report auditable metrics on both. They should also address the "unexplained" part of their firm's share price—that part not directly linked to observable cash flows—through a coherent description of the growth opportunities they foresee *and be willing to tell the markets when they see their stock price as overvalued.*

- Similarly, to limit wishful thinking, managers must reconcile their own company's projections to those of the industry and their rivals' projections. Analysts develop models of an industry's growth. If the company's expectations lie outside what is widely viewed as the industry's growth rate, its managers must be able to explain how and why they will be able to outperform their market. Some executives will be concerned or complain that making this all clear to the analysts will reveal valuable information to their competitors. To this we have a simple response: *If your strategy is based on your competitor not knowing what you are doing, as opposed to not being able to do what you can do, you cannot be successful in the long run no matter who knows what.*

Finally, managers would be wise to remember that

7. The breakeven share price for Nortel investors as of 12/31/2001 was \$21.33 assuming a 12% cost of equity capital net of dividends. This implies the breakeven total value of Nortel at the end of 2001 was \$68.5 billion. Thus investors lost a total of \$44.5 billion as a result of the failed strategy.

8. Regan, Keith. 2001. "Lawsuit Against Noted Internet Analyst Tossed." *www.EcommerceTimes.com*: August 22, 2001, <http://www.newsfactor.com/perl/story/13001.html>.

analysts are not always wrong. In fact, analysts have a vital monitoring role to play in a market economy. While recent history may have obscured that role, managers should not simply presume that analysts are wrong when disagreement occurs. It is worth noting that during the 1970s and 1980s managers regularly complained that analysts were undervaluing their companies. Yet, analysts were generally correct that managers of that era were not making effective use of corporate resources. They continued to invest in industries and activities with substantial excess capacity and consequent low returns, refused to downsize and distribute free cash flow to shareholders, and pursued inefficient value-destroying conglomerate mergers. In response to such value destruction, there emerged an active market for corporate control, as reflected in the wave of hostile acquisitions and LBOs, in which competing management teams took over and replaced the managers and directors of underperforming companies and created vast new value.

Contrasting the decades of the 1970s and 1980s with the recent era thus yields an important lesson: managers and analysts must pay close attention to each other's views. Both analysts and managers bring important information and important perspectives to the conversation and both sides benefit when each does their task well. Managers for their part must stop encouraging analysts to reach for ever higher

valuations and return to managing their companies. Analysts must stop making Nostradamus-like predictions and instead return to their true roots—the creation of original research and analysis. The Securities Industry Association issued an excellent statement entitled “Best Practices for Research” in 2001 that lays the foundations for resolving many of the conflicts of interest on the part of analysts. We look forward to its early and widespread implementation.⁹

Stock prices are not simply abstract numbers that exist apart from the reality of corporate enterprises. gyrations initiated by Wall Street or managers have real effects on companies and society. The price that Wall Street puts on a company's securities and the trajectory of those prices affect the nature of the strategies firms adopt and, hence, their prospects for success. Stock prices also drive a company's cost of capital, its borrowing capacity, and its ability to make acquisitions. Ultimately, the viability of the companies themselves is at stake.

A dysfunctional conversation between Wall Street and Main Street is not the esoteric stuff of business school classroom discussions. It can rob investors of savings, cost employees their jobs, erode the nest eggs of retirees, and undermine the viability of suppliers and communities. Clearly, it is time to restart the conversation on a new, stable, and enduring footing.

9. Securities Industry Association. 2001. “Best Practices for Research.” <http://www.sia.com/publications/pdf/best.pdf>.

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