

Quarterly Reports Can Do More Harm Than Help

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In today's stock market, CEOs live from one doomsday to another-the doomsday of quarterly accounts. It is only natural in the increasingly competitive environment their focus is not so much on "true and fair reflection" of company's financial position but management of figures to present them in the best possible way regardless of the fact that such a course is leading to disastrous consequences.

Here is yet another high profile corporate fraud caused by morbid addiction of the stock market for quarterly reports. Three former executives of Computer Associates International Inc. (CA) have pleaded guilty to securities fraud, as federal prosecutors continue to investigate the company. According to New York Times report Ira H. Zar, the former Chief Financial Officer, and Mr. David Kaplan and Mr. David Rivard, both former Vice-Presidents of finance at Computer Associates (CA) have entered their guilty plea. They are all cooperating with federal prosecutors in Brooklyn. Mr. Zar pleaded guilty to three counts of securities fraud and obstruction of justice. Mr. Kaplan and Mr. Rivard each pleaded guilty to one count of conspiracy to commit securities fraud and one count of conspiracy to obstruct justice.

Zar said he had met with two other senior Computer Associates executives on January 6, 2000, to discuss the company's sales for the previous quarter. The sales fell short of Wall Street analysts' forecasts, so the men decided to continue to book new sales as if they had taken place in the previous quarter, according to the plea. To hide the backdated sales from auditors, employees of Computer Associates deleted time stamps that showed when the contracts had actually been faxed to the company.

Earlier Calisto Tanzi, the founder of Italian giant Parmalat has admitted master minding fraud of 500 million Euros. Perpetration of fraud while reporting quarterly earning treated as fair game. Lynn Turner, Chief Accountant of the Security and Exchange Commission of US from 1998 to 2001 who earlier was a partner of Coopers and Lybrand had this to say about the accounting practices of Wall Street:

"All the Big Five accounting firms have a group of accountants kind of like a financial services group, and that group of accountants works with Wall Street. In my prior life, we actually had a retainer arrangement with each of the major wall Street investment banking firms under which we could help them financially engineer or structure hypothetical transactions for finding financing, keeping it off balance sheet, making companies look better than, quite frankly, they really were."

On 27 January 2003 Financial Times of UK published a letter from Pierre Bollon Director General AFG-ASFFI (Association Francaise de la Gestion Financiere) and Peter Montagnon, Head of Investment Affairs, Association of British Insurers which stated:

"Our organisations represent a wide range of European institutions. They attach great importance to transparency, but quarterly reporting is not a high priority. It has not helped to prevent corporate scandals in the US, and there is a risk that mandatory quarterly reports will encourage short-termism as management becomes overly focused on the next reporting deadline. What is vital for investors is the certainty of knowing that price-sensitive news is transmitted accurately and promptly to the whole market in an orderly way. Without this, markets will lack integrity and impose a risk premium that will add to the cost of capital. As investors, we believe this should have much greater emphasis than quarterly reporting in the unified single European financial markets. It is more difficult to regulate for, but compulsory quarterly reporting is not a substitute for reliable ad hoc announcement."

That quarterly reports can give a false sense of company's financial performance is evident even from a recent research conducted by an Indian fortnightly in collaboration with Stern Stewart, the firm that developed the concept of Economic Value added (EVA). In the research companies were ranked in the order of wealth creation using EVA during the five-year period from 1998-2003. Tatas & Birlas, two of India's iconic enterprises do not figure among the first ten in the list. What is even more surprising is that

HLL & ITC the other two icons of India, perceived to be creation of substantial wealth have actually destroyed wealth. HLL destroyed shareholders wealth to the tune of £1.8 billion and ITC destroyed shareholders wealth to the tune of £ 928 million during the period 1998 - 2003.

A study conducted by Skinner and Lynda Myers of Michigan University and reported in the Economist, looked at 399 firms with unusually smooth and consistent earnings growth found that (i) they all enjoyed high market valuations, (ii) there was evidence that they were smoothening bumpy earnings (iii) they eventually ended in an earning shock that had an unusually damaging effect on their share price.

Over emphasis on quarterly reports has spawned a culture of concealment. GE used to feature on university courses as a model of probity. These days, it crops up in the seminars about earnings-manipulation. Everyone agrees that GE practices one form of earnings management: it times one-off asset sales to coincide with one-off write-downs or restructurings. The sales and restructurings are not necessarily related. A sale at GE Capital, for instance, might prompt a hunt round the whole of the finance arm for looming restructuring costs. Beyond this, the amount of profits smoothening that GE indulges in is a matter of speculation.

GE also manages expectations about its earnings by managing its analysts. Analysts' estimates fall within an unusually tight range: every year, every analyst thinks GE is going to earn pretty much the same amount. In addition, the analysts' estimates all fall within GE's own range of earnings estimates, which is also unusually tight.

In an economy fired by innovation, it would be naïve to assume there will be no mistakes in making financial judgments. The key, therefore, is to create trust between the investors and management. Owning genuine mistakes and creating a reputation for honest and reliable reporting over time, therefore, is far more vital for the long term sustainability of the business than immediate market gain by manipulating figures. In the case of Shell the downfall of Sir Philip Watt was not caused by misstatement of oil reserves but his failure to personally address the shareholder meeting and explain the shortfall.

While it is time to educate investors to discount the importance of quarterly reports there are lessons for CEOs that manipulation of these reports can cause irretrievable damage to company reputation. It was Richard Nixon who said you could disobey all the Ten Commandments provided you abide by the 11th commandment – “thou shalt not be found out”. In the uncertain economy of Internet the only certainty is “thou shalt be found out”.

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