Earnings pressure leads managers to take actions that improve short-term profitability but damage long-term competitiveness and performance of their firms. This research shows how corporate governance can help shape managers' long-term horizon and identifies ways that shareholders and board members could mitigate the short-termism often associated with earnings pressure. We define earnings pressure as the tension felt by management about meeting or beating analysts' earnings forecasts.

What action can be taken to help managers handle this pressure better? How can shareholders and board members design structures and systems that can help managers to be less affected by securities analysts?

A survey, by Graham, Harvey, and Rajgopal (2005), indicated that 80 percent of respondents (chief financial officers and financial executives) would decrease discretionary spending on R&D, advertising, or maintenance to meet an earnings target, and 60 percent would avoid initiating a positive net present value (NPV) project if it meant falling short of analysts' consensual earnings forecasts. This survey suggested that CFOs viewed earnings as the most important performance measure reported to outsiders. Seventy-three percent of respondents considered analyst consensus forecasts as an important benchmark, and over 80 percent believed that meeting earnings benchmarks helped to build credibility in the capital market and to maintain or increase their firm's stock price.

From a strategic point of view, this is a big problem. It is seen that earnings pressure leads companies to become less competitively aggressive, in order to exploit market power, to raise prices that can help in short-term profitability but hurts long-term competitiveness. For example in the winter of 2012, analysts expected negative results from Ryanair, and the big fear publicised was that they were going to have bad quarterly results. In response to this, Ryanair cancelled some flights, eliminated some discounts, etc., and they ended up doing better than they would have otherwise. However, the consequence of these decisions is that its reputation amongst competitors and customers now is that it is an airline who is more interested in making money than in gaining market share.

This is the tension - are you more focussed on maintaining or gaining market share, on being aggressive in the market, or are you more focussed on making money now even if it would hurt you more in the future?

Concerns about impact on competitiveness

In 2003, it was found that whenever Coca Cola was doing well, it spent money on advertising and when it wasn't, it cut it. So, they were using investments to buffer earnings pressures. Is this the right long-term strategy?
Managers are aware of the high stakes associated with missing earnings forecasts and try different ways to meet or beat earnings forecasts. Responses from managers could range from ignoring the pressures, managing expectations or engaging in ‘creative accounting’ by managing discretionary accruals. Yet another response could be to engage in ‘real earnings management’. This means changing real business decisions, such as the amounts spent on research and development, advertising, timing of new investment projects, changes in the intensity of competitive behaviour with the goal of increasing short-term earnings.

Some significant insights by successful leaders

Larry Page said, regarding Google’s IPO prospectus, “Many companies are under pressure to keep their earnings in line with analysts’ forecast. Therefore, they often accept smaller, but predictable, earnings rather than larger and more unpredictable returns. Sergey and I feel this is harmful, and we intend to steer in the opposite direction.”

Jeff Bezos, Wired, said, “If everything you do needs to work on a three-year time horizon, then you’re competing against a lot of people. But if you’re willing to invest on a seven-year time horizon, you’re now competing against a fraction of those people, because very few companies are willing to do that.”

Ted Turner, founder of CNN, commented: "When all companies are quarterly earnings-obsessed, the market starts punishing companies that aren’t yielding an instant return. This not only creates a big incentive for bogus accounting, but also it inhibits the kind of investment that builds economic value”

Can corporate governance factors mitigate the effect of earnings pressure?

If earnings pressure is really a problem of inappropriate short-term orientation, does it affect companies with long-term oriented owners and managers? Academic literature is not very clear on how companies react to earnings pressure and whether the decisions made are good or bad for the company. This is where our paper comes in. If earnings pressure was actually good for the company, you would expect that manager would make decisions around this regardless of whether shareholders are long-term or short-term oriented. But if we find that this behaviour tends to happen primarily when managers or shareholders have short-term orientation, but does not happen when they have long-term vision, then that provides evidence that this is not good in the long term for the company.

By looking at this dimension of corporate governance, which is related to whether the company’s actions are short-term or long-term oriented, we are able to tell whether earnings pressure might actually be bad for the company in the long term. The two dimensions we examine are the ownership structure of shareholders, i.e. institutional investors and the incentives for CEOs.

Impact of ownership structure

There are different kinds of institutional investors – transient investors are those that trade a lot, typically invest in around 500 firms and shares are sold quickly for gain. And then there are dedicated investors, like Warren Buffet, who invest in very few companies, understand them well and stay with them long-term. Obviously the latter are less likely to respond or react to earnings pressure.
Impact of CEO incentives

This is a more complicated and difficult argument. There is a lot of governance literature pertaining to bonuses and stock-based incentives. The latter are viewed as high-powered incentives to help align CEO’s interests with the improvement of a company’s shareholder value and to the shareholders’ wealth, with less incentive to deviate from long-term optimal competitive behaviour to meet analysts’ earnings forecasts. On the other hand, researchers have also argued that CEOs could also be more sensitive to changes in stock prices, and they may make business decisions to boost or maintain current prices instead of increasing future shareholder value.

So, we go to the next level that more clearly shows the influence of stock-based incentive and decision-making, as we examine whether a CEO can exercise the right to sell shares. If the incentive is restricted/unvested stock options, i.e. one cannot exercise his or her option for a period of time (say 1-2 years), then typically the CEO’s decision for the company is not motivated by the current stock prices. However, with vested stock options that can be exercised at any time, the risk is that the CEO would make decisions that damage his or her own wealth generation. From a corporate governance perspective, it is important to focus on vested or unvested stock options rather than just stock or not-stock based incentives.

Conclusion and research findings

Using data on competitive decisions by U.S. airlines under quarterly earnings pressure, we find that companies with long-term oriented investors and long-term unvested CEO incentives (restricted shares and un-exercisable stock options) are less sensitive to earnings pressure. In contrast, companies with more ‘transient’ investors and CEOs with vested, immediately exercisable stock-based incentives are more responsive to earnings pressure.

This research has multi-fold impact. For instance, an important finding related to governance, is that, besides board members and shareholders, there is a significant influence that securities analysts have on a managerial behaviour (and a firm’s stock prices). Managers can benefit by understanding the influence of earnings pressure on firms’ competitive behaviour and in particular, by understanding the contingent effects of different corporate governance structures. A better understanding of these effects can help managers to react more effectively to pressures from the stock market and to take advantage of competitors. For boards and investors, the kind of ownership structure and managerial incentives are relevant to keep the sound course of business actions. For regulators, the awareness of effect of earnings pressure on real business actions can help them see the possible spill-over effect of financial reporting.

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