Just say no to Wall Street: Putting a stop to the earnings game

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The process of earnings guidance seems to have been carried too far. Rather than forecasts representing a financial by product of the firm's strategy, forecasts have begun to drive strategies. It has become a high stakes game with management seeking to hit the targets set by analysts and being punished severely if they missed.

Managers must abandon the notion that a higher stock price is always better. An overvalued stock can be as dangerous as an undervalued one. Managers should be prepared to take the action needed to eliminate over valuation when the situation arises.

Favourable market conditions made executives and analysts view unsustainable growth rates as the norm. With stock options becoming an important part of executive compensation, improvement of stock prices in the short term, became an overriding priority. Overvalued currency encouraged firms to make acquisitions to sustain the growth rate. The growing clout of analysts and their increasing visibility in the media, also contributed to this phenomenon.

When companies encourage excessive expectations, or become too desperate to meet the unrealistic forecasts of analysts, they may end up making highly risky value destroying decisions. Smoothing earnings to meet guidance quarter after quarter, requires sacrificing the long-term future of the company. Smoothing today's bumps only means that they will pop up somewhere else tomorrow.

Enron's peak valuation of $68 billion in August 2011 effectively required the company to grow its free cash flow at 91% annually for the next 6 years. To meet analyst expectations, Enron moved into businesses such as water, broadband and weather insurance in which it had no assets or expertise or experience. By January 2002, Enron's price had fallen by 99% from its peak.

Nortel Networks reached a total capital value of $ 277 billion in July 2000. To meet analysts' growth expectations, the company made acquisitions worth $ 32 billion, mostly in stock. In July 2001, the company announced a loss of $ 19.4 billion in the second quarter, followed by a loss of $ 3.6 billion in the third quarter. This was a clear case of shareholder value being destroyed by acquisitions and massive over investment. At the end of 2001, the company's valuation had fallen by 90% from its peak in September 2000.

Putting an end to this destructive cycle will require a new approach towards disclosures based on a few simple rules of engagement:

Managers must not bow to analysts' demands for highly predictable earnings.

Managers must only promise results that they are reasonably likely to deliver.

An overvalued stock can also lead to problems and wrong decisions, like acquisitions paid with overvalued stock.

Managers must work to make their organizations more transparent to the investors and the markets.

Managers must be able to explain clearly how and why they will be able to outperform the market. Not doing so under the guise of competitive secrecy is not acceptable.

Analysts are not always wrong. If they undervalue a company, managers should not become defensive.

Stock prices are not just abstract numbers, completely distanced from the real world of companies. Stock prices affect a firm's strategic decisions, drive a firm's cost of capital, its borrowing capacity and its ability to make acquisitions.

A dysfunctional conversation between Wall Street and Main Street is not good for the company, the investors, employees and other stakeholders.