

After Ericsson (and after and before how many?). The case for interim reporting –and against quarterly profit warnings.

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What happened -and is happening- to the Swedish company Ericsson, which is, lest some forget, the world's leading maker of wireless telecom infrastructure equipment to network operators, illustrates once again the tyranny of **short-termism**. And its serious damage to a company shareholders, management, reputation, and sometimes business as a whole, as well as the collateral damage often caused to the broader economic (and social) environment. Yes, those “**stakeholders**” to whom so many companies claim to be accountable.

In a review of a book written by Lawrence E. Mitchell, a law professor at the George Washington University, published in December 2007, and titled “*The Speculation Economy*” (1), Business Week magazine (2) commented: “*over time, the expectations of the investor class brought a radical switch in how managers of public corporations operated. No longer could they solely focus on maximizing plant efficiency or besting competitors. Instead, investors' lust for ever-higher share prices meant the stock market ceased being a mere financing vehicle and became an institution "whose insatiable desire for profit demanded satisfaction from even the most powerful corporations." By spawning this culture of "short-termism," finance had trumped industry, and U.S. business would never be the same.*” Replace U.S. with international, and you get a gripping summary for a symptom of one of today's capitalism sicknesses.

This brings us back to **the Ericsson story**.

Mid-October, the company issued a severe profit warning and reported that operating income would be down in the third and fourth quarters. Net result: a quarter of the **market value** -or \$15 billion- wiped out in one single day. The

Financial Times (3) wrote: *“Ericsson plunges on warning”*. CEO Carl-Henric Svanberg commented that he was “disappointed” but didn’t consider resigning. If a CEO must resign just because the company announces a profit (mind it, not even a loss) lower than expected -and sometimes just lower than market (who does this stand for?) expectations (sometimes dubbed as the “consensus”) for one or two consecutive quarters, how can the continuity of business -and the long-term interests of shareholders- be assured?

However, under the short-term pressure of funds and those cherished analysts (yes, the same who had not seen it coming), the CEO also said that the strategy would shift from market share to profit margin. Market facts and figures will tell is this is a smart move or just about overreacting to market overreaction. Time permitting...

One month later, the company lost another 11% of its market value, because current quarterly earnings *“would come in at the lower end of expectations.”* And this in spite of the fact that meanwhile, a new CFO had been appointed... in the wake of a profit warning. The CEO said *“he would monitor operations closely to try to ensure there was no repeat.”* Gee, how many companies post decreases in earnings over time and how many can ensure these will not happen again?

Anyway, CEO’s point that long-term prospects were healthy and a vice-president remark that the group was *“the only profitable company in the industry”* passed almost unnoticed. So much that a number of U.S. law firms have since then filed class-action suits against the company. The reason? A collapse in market value. Yes, neither more nor less than that. And just caused by an announced decrease in operating profit. It took more time to some lawyers to move against Enron and others, didn’t it? And these were real cases of lie, deception and fraud, which have nothing to do with Ericsson’s example, as far as we know.

To cap it all (pun not intended), Goldman Sachs (otherwise busy in growing its hedge fund platform) downgraded the stock.

More about Ericsson and many other similar cases coming soon at your newsdealer.

Don't get us wrong, our point is not to say that **pressure** is bad as such. Market (and stock market) pressure, competition, customer demands, investors' expectations are not unhealthy as such -far from that- and are intrinsic to the free-market capitalist economy. They help avoid a "*Business as usual, day after day*" (4) routine job that may hurt stakeholders' interests in the long run.

The point is that pressure has to be dealt with and, as much as possible, managed in a longer perspective than just "**Making the quarter**", which has become an **obsession** (not to say an obsessive-compulsive disorder) for so many people from the trading floor to the boardroom. And this is the problem: quarterly results, which have increasingly turned into day-to-day highs and lows in nowadays minute-market culture, tend to much to set the agenda of top executives instead of staying where they are best (or least worst) placed, i.e. among brokers and market analysts. Conclusion: sacking a CFO (or a higher placed executive) for poorer quarterly performance is close to nonsense. Or is it just about giving a scalp to nervous fund managers and speculating analysts? Consider what Thor Udenaes, a fund manager at SEB Asset Management said about the Ericsson case (Financial Times, November 20): "*They have to question their business model and explain thoroughly what happened in the last quarter and why*". Right: explaining thoroughly what happened in the quarter or a longer period is what quarterly reporting is all about. Some companies excel at doing that interim reporting exercise and putting it in a **strategic perspective**. By the way, Swedish and Scandinavian listed companies don't lag behind on this, Volvo and a few others standing as best in class. Wrong: why should a problem faced in the last quarter automatically lead to questioning a business model? Sure this can happen, but is this visible over one quarter only? Jumping to the conclusion so quickly reflects where the excesses of short-termism are now leading.

Does that imply that a forecasting exercise should be left out at corporate level to give some guidance to markets and investors? Certainly not, setting **targets** and measurable **objectives** is a major raison d'être of serious reporting. Internally and externally. Even though a recent survey conducted by KPMG among UK companies showed that "*more than three-quarters of companies admit to*

forecasting errors of over five percent” and “only one percent of 539 companies could lay claim to having provided completely accurate forecasts” (5), forward-looking analysis and numbers should keep on being provided. Bearing in mind that, contrary to what the head of financial management at KPMG UK says, forecasting is an art rather than a science.

To avoid more short-term market abuse –and a number of heads rolling as a collateral damage of what would of course be just “friendly fire” from the sake of shareholder value, our **recommendations** would be:

- to strengthen internal reporting and take corrective action when needed;
- to skip quarterly reports as a mandatory practice (some renowned companies did it in the aftermath of the Enron fallout);
- to leave interim (quarterly) reports as a free practice;
- to report fairly about forecasts and explain corrections in the annual reports;
- to scrap quarterly profit warnings;
- to teach a number of analysts, fund managers, investors that long-term business fundamentals matter as much -and even more- than short-term market fundamentalism.

(1) *“The Speculation Economy. How Finance Triumphed Over Industry”*, by Lawrence E. Mitchell (Berrett-Koehler, 2007).

(2) *“The Making of a Stock Market Society”*, BusinessWeek, December 3, 2007.

(3) The main source for facts and figures in this article is the Financial Times (<http://www.ft.com/world/europe>).

(4) Freely quoted from The Eagles on *“Long Road Out Of Eden”* (Eagles Recording, 2007).

(5) <http://www.kpmg.co.uk/news/detail.cfm?pr=2983>

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