"Enhancing America's Long-Term Competitiveness: Ending the Quarterly Earnings Game"

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Introduction

Thank you. It's a pleasure to be here and to see the inner workings of our capital markets on display. Great ideas, great business plans, and great companies are discovered and given life at conferences such as this.

Analysts play a critical role in our capital markets system—providing an important link between companies that need investment and the investors who are looking for good companies.

We at the U.S. Chamber of Commerce understand that your industry has faced a great deal of change in recent years—with the distance between companies and the analyst community continually increasing.

We believe that we can play a role in improving the communication and cooperation between business and Wall Street and, at the same time, improve the quality and quantity of information being made available to the investing public.

I understand what you do, but some of you may not know about my organization. The U.S. Chamber of Commerce is the largest business federation in the world, representing some 3 million domestic and foreign companies.

We spend much more on lobbying than any other trade group in the world. We also have extensive policy operations as well as grassroots activists in just about every community in America.

The Chamber has the capacity to generate real change for the business community—be it on tort reform, free trade, bankruptcy, or a host of other issues.

We now have an intense focus on the challenges facing the U.S. capital markets. Today, I am going to discuss the changing political and regulatory environment for public companies and how the analyst and business communities need to work cooperatively to provide better, more complete information about the long-term performance of public companies.

Looking back over the past five years, I challenge you to name another period in American history in which business—and the markets that link those businesses with investors—have been buffeted by greater change.
We saw the stock market reach incredible new heights in the late 1990s, which, among other things, gave rise to the phenomenon of day trading and 24/7 financial news reporting and analysis.

Today, nearly half of all households—57 million in all—own stock either directly or through mutual funds. That's nearly double what it was just 16 years ago.

Further, we have attracted many billions of dollars in portfolio investment from overseas, adding liquidity to our markets and lowering the overall cost of capital.

With more people invested in the markets, elected officials have also started paying closer attention and have begun offering many more opinions about how our markets should be regulated.

After the dot-com era, we experienced the shocks of Enron and other corporate scandals—and the government's hasty responses to them—including Sarbanes-Oxley and the Global Settlement, which had a large impact on the nature and structure of your industry.

Even after the crash of '29, the federal government did not rush into action like it did after Enron. It took several thoughtful years to pass the '33 and '34 Acts.

While we think the structure provided by those acts needs to be revisited now, we should understand that it is sometimes better to slowly do the right thing than rush into the obvious thing …which is often wrong.

We have inflicted so many rapid and serious changes on our public markets that much of the new focus and excitement is on private capital. There are more small companies never wanting to go public—and private funds taking all or parts of large companies private.

Government and business must take a hard look at this reshaped environment and clearly identify risks to our continued prosperity.

Together, we must ask ourselves the difficult question of whether certain regulatory responses to events, however well-intentioned they may be, are inhibiting the performance of our public capital markets and the companies that rely on them.

Chamber's Capital Markets Initiative

To help answer these questions, the Chamber has just put together a Commission on the Regulation of the U.S. Capital Markets.

This commission will determine what impact our Depression-era capital markets regulatory structure and patchwork quilt of state and federal laws and regulations are having on today's markets.

It will focus on the proper balance between state and federal regulation, the desirability of globally compatible regulatory and accounting regimes, the proper role of self-regulating organizations, and the most appropriate enforcement structure.

This commission will be independent, bipartisan, and chaired by two people who are familiar to this audience—Bill Daley, former secretary of Commerce and now chairman of the Midwest Region of JP Morgan Chase, and Bob Steel, retired vice chairman of Goldman Sachs & Co.

However, the Chamber's work in the capital markets area did not begin and will not end with this commission. Where the SEC has broadly interpreted legislation and passed poorly considered regulations, we have answered with a number of lawsuits, many of which we have won. Case in point—the mutual fund rule that requires the chairman and 75% of a mutual fund board to be independent. The SEC didn't even follow its own rules when it passed that one.

The Chamber has also successfully taken on Reg FD, the calculation of damages in securities matters, and a number of other issues of central importance to our capital markets.

We are also working to vigorously protect the sacred, constitutionally guaranteed right of due process and a key element of that right, the attorney-client privilege. In a democracy, there are good and important reasons for an adversarial judicial system—no matter what politically ambitious prosecutors may say. Last year, the U.S. Sentencing Commission put in place a measure that is being used to essentially force companies, directors, managers, and employees to waive attorney-client privilege whenever the government demands it. This pressure also comes from the Thompson memo, state attorneys general, the Department of Justice, and the SEC.

We have a big problem with that. So we've joined with groups such as the American Civil Liberties Union, the American Bar Association, and the National Association of Criminal Defense Lawyers to fight this assault on the fundamental rights that are guaranteed to every U.S. citizen.

This is a fight that we are going to take to Congress, the White House, the Department of Justice and, if necessary, the courts.

We are also focused on the challenges to the auditing profession.

Auditors are being pushed to do more and more and are being regularly second-guessed by their new regulator—the Public Company Accounting Oversight Board—and the tort bar.

At the same time, companies feel that they are receiving less advice and paying a lot more for it. Shareholders are getting stuck with a big bill—and there is no evidence to suggest that any of these changes will prevent future fraud. There was a study released just today indicating that most fraud is discovered by chance.

We're also troubled with the unintended impact of Section 404 on corporate leadership and the use of company resources. Section 404, in spite of its positive values, has discouraged participation on corporate boards and audit committees and has damaged relationships between auditors and their clients.

Every component of the Chamber's capital markets initiative will be carried out with a single goal in mind—efficient, fully optimized, ethical, and competitive capital markets capable of attracting capital in a highly competitive global environment.

Even though we are a Washington-based organization, our concerns about the U.S. capital markets extend well beyond the Beltway. I am here today because many in the business community are very worried about changes that have taken place right here on Wall Street in just the last five years. Of particular concern is the earnings guidance game and the short-term ?mind-set it creates.

Challenging the Culture of Short-Term Thinking

Wall Street has always been a place where people try to make money every day of the week. Billions of shares trade hands every day to make those things happen. You know better than anyone that a lot of money can be made or lost in one hour in this city, and there is nothing wrong with that. Short-term financial drivers can help spur long-term performance.

But there is something fundamentally out of balance when short-term considerations become so dominant—and so ingrained not only on Wall Street but in corporate America—that the long-term view is lost.

Now, I'm not the first person to voice this concern, and I certainly won't be the last. For 30 years, people have suggested that short-term thinking is damaging American business. However, I would argue that, today, short-term thinking has been driven to dangerous new heights by the excesses of the tech bubble, the explosion of financial news media outlets with up-to-the-minute news on who's up and who's down, and the reaction by government, business, and Wall Street to the corporate scandals of 2002.

The rules have now been changed to favor a culture of immediate financial gratification without regard to long-term costs. We've created an environment where a company's long-term value and health are all too easily sacrificed at the altar of meaningless short-term performance. We focus on a company's numbers and ignore its business—and that philosophy poses a significant threat to our future competitiveness.

While many U.S. CEOs are worried about the next three months, our global competitors are making long-term investments in their companies and in their economies. This is particularly of emerging competitors such as China and India.

No one can be entirely blamed or absolved from responsibility for the increasingly short-term view on Wall Street and in corporate executive suites and in boardrooms. Together, we have all allowed a system where everyone's incentives—those of analysts, management, and investors—are designed to produce results today at the expense of tomorrow.

The Impact of Quarterly Earnings Projections

There is no better illustration of the short-term thinking game than quarterly earnings and the raising and lowering of expectations about what a public company will earn over each three-month period.

Warren Buffett and others have very publicly voiced concern about this focus on quarterly earnings and, in particular, guidance about future EPS. But they speak for themselves and their companies.

As the head of the nation's largest business organization, I can tell you that CEO frustration with earnings expectations is widespread and rapidly growing. A lot of that frustration stems from the fact that 1 or 2 cents of earnings per share in any quarter, especially for any public company that has taken years to build, doesn't have any real meaning, even though Wall Street gives it a lot of meaning. We are talking about a small part of the past that rarely tells you much about the future.

Imagine the headline in today's paper: "Knicks win the first quarter in game against the Wizards." Not only would that not tell you who won the game, it wouldn't tell you that the Knicks picked up 10 fouls in the quarter.

While there is value in understanding the direction of earnings over time, what happens in any one quarter is rarely important in understanding a whole business. In fact, the argument is often made that quarterly earnings are only important because they are so unimportant—management should always have a few acorns in the basement to support 1 or 2 cents of earnings on a rainy day. But in the current accounting environment, there are no acorns and anyone who tries to create some is just asking for trouble.

It may have been that corporate leaders were for decades lauded for their ability to balance earnings over time. But today any executive who tries to twist himself into knots to meet a quarterly guidance expectation is making a serious, long-term mistake—no matter how Wall Street may feel about it.

The era of earnings management has changed, and everyone has to get used to it.

Risk and reward go together. Hurricanes and oil crises happen. If you want smooth, predictable returns, then buy a bond.

A central reason that quarterly earnings are, and have always been, meaningless is that they represent a precise measurement based on the imprecise accrual accounting system. Companies are punished by Wall Street for "missing" guidance by amounts that are well within the margin of the accounting model.

The dot-bomb era should have taught us that core business attributes—like having customers and a sound strategy—are much more important than what the financial statements say from quarter to quarter.

A company's financial statements include a number of educated guesses about intangible liabilities and assets—pensions, oil reserves, and bad debt, to name just a few. But Washington and Wall Street felt obligated to buy into the view that accounting should be made into a precise science. GAAP is being treated like 2+2 arithmetic instead of broad guidelines requiring judgment.

Aside from misrepresenting a company's financial strength, the quarterly numbers game also encourages poor business decision making. Research shows that companies sacrifice creating long-term value if it means missing quarterly earnings projections. Some managers forgo making investments and cut expenditures on R&D and marketing to ensure that they hit quarterly numbers, even if they believe that the cuts are destroying business value over the long term.

We also know that earnings guidance contributes to the growing number of class action securities lawsuits. In the ten years since the Private Securities Litigation Reform Act was enacted to provide some legal protection for companies reporting earnings, settlements from securities class actions have exceeded $25 billion.

The mere filing of a class action securities lawsuit results, on average, in an immediate 3.5% drop in a defendant company's stock price, on top of whatever drop gave rise to the litigation in the first place.

Earnings projections are a fool's game for management. Companies want to project numbers that will please Wall Street, their shareholders, and all of the bloggers and talking heads on cable TV. But then they get trapped in the expectation of delivering those numbers even as GAAP, as interpreted by the SEC and the trial bar, seems to change every day.

But the absurd world of quarterly earnings guidance is really just a symptom of some larger problems on Wall Street and in Washington that have become worse in our reactions to the post-Enron events.

First, after the Global Settlement, it became harder and harder for independent analysts to sell in-depth research—and fewer companies are being covered. There is redundant research on Fortune 100 companies, even while small companies with great prospects go uncovered. Two-thirds of NASDAQ companies are covered by one or no analysts. Small companies then feel obligated to play the quarterly earnings game simply to get attention.

Further, while the quantitative aspects of research are becoming more sophisticated, we are losing the qualitative analysis. Looking at financial ratios is great, but where are the incentives for independent analysts to take a long look at leadership and strategy?

A second issue is one of corporate disclosures—who gets it and how they get it. Reg FD, while a well-intentioned attempt to level the playing field of information, has ended up chilling corporate speech.

Faced with the SEC's hyper-enforcement regimes, corporate lawyers advise their management to say as little as possible about what is happening at the company.

This has made it harder for companies to tell complex stories about their business and strategy. Management communication becomes a very limited discussion about simple things—like quarterly earnings per share.

In September, the U.S. District Court for the Southern District of New York agreed with our sentiment that Reg FD is being unfairly enforced. It dismissed the SEC's lawsuit against Siebel Systems for alleged violation of Reg FD. This represents a small movement in the right direction, but much more needs to be done.

Finally, there are a lot of new players who all want a piece of the capital markets. Ten years ago, would you have predicted that state attorneys general and tort lawyers would be working cooperatively on securities litigation, pulling billions of dollars out of the system every year? How about the role of the financial media, which is dependent on stories of companies soaring and crashing, hopefully all within the same daily news cycle?

None of these new players care about long-term performance. They are all primarily interested in getting a paycheck or news story today and pulling everyone else along for the ride.

Solutions—Creating New Measures for Predicting Future Success

So how should we respond?

Every stakeholder in the system—analysts, management, investors, and regulators—has a role in steering the emphasis on short-term performance toward long-term, sustainable growth.

Companies must better communicate their strategies and objectives and define the benchmarks that will show whether they are meeting their goals. In spite of Reg FD, companies need to put in the effort to divulge better and more relevant information and help people to understand when business success isn't necessarily reflected by quarterly earnings per share.

We hope that initiatives such as XBRL will make this easier for management, and we will continue to press for regulatory and legislative action, such as reconsideration of Reg FD and securities litigation reform, which will allow companies to speak more freely.

All company executives, especially those of large public companies, should follow the lead of others who have stopped issuing earnings guidance. Short of that, companies should never offer a single figure instead of a wide range.

I am going to do my level best to start a stampede away from quarterly earnings guidance altogether.

As for analysts, they need to be willing to devote the time to listen carefully to how companies define success and communicate to their clients that there are better ways to uncover the good companies. I understand that this is hard to do given the current state of the research business, but ultimately the only way out of that mess is to provide a better, more valuable research product that uncovers intangible things that other analysts don't see.

I do understand that you are rated in the trade press by the accuracy of your earnings predictions and even that your compensation may be based upon it. However, I maintain that the better analyst isn't the one who more accurately predicts quarterly earnings per share. The better analyst is the one who can tell when quarterly EPS doesn't matter.

Policymakers in Washington and investors around the country also need to face some hard truths about accounting and the auditing profession. Accounting is as much art as science—and the auditing profession is at tremendous risk from lawsuits from people who don't understand that.

The SEC and the Public Company Accounting Oversight Board are obligated to better educate people both inside and outside the Beltway about what financial statements really tell you and, more importantly, what they don't.

And the SEC should take another crack at Reg FD so that it gives companies a broader scope for private conversations about forward-looking strategy. Almost everyone agrees that more information, not less, is better.

Finally, the Chamber is going to continue to highlight the role played in all of these events by politically ambitious prosecutors, tort lawyers, and others who are looking to use the capital markets—and the information conveyed from companies to investors—for their own purposes.

The people who really care about the long-term interests of shareholders aren't the ones looking for big checks on the courthouse steps.

Conclusion

Ladies and gentlemen, in closing, let me say that American-style capitalism is still the standard by which all other systems are judged. Historically, we have had the most transparent and best regulated capital markets in the world. We have attracted investment from around the globe because of it.

However, regulatory overreach, unfair enforcement, excessive litigation, and the demands of the media are taking us down a dangerous path. Executives who pretend that they can pinpoint their companies' next quarter earnings down to a penny or two per share will spend the next three months attempting to manage those earnings instead of managing their businesses. That is not how great companies are created.

So I challenge all of you to join with management and lead the transition to a new, improved level of communication that enables companies and analysts to determine real long-term value.

We at the Chamber stand ready to support these efforts—and we will continue to be very active in the fight to protect the overall health and competitiveness of the U.S. capital markets.

That means that we are going to move forward with our commission, keep pushing for regulatory reform, support our coalition on business due process, highlight the problems of the auditing profession, educate the public about the value that strong capital markets bring to their every day lives, and—most likely—file a lot more lawsuits.

If we do these things and do them right, we will secure the future of our capital markets, our business competitiveness, our capacity for innovation, and our economic leadership in the world.

Thank you very much.