

THE LONG CLOCK · CHAPTER EIGHT

The Quarterly Question

Chapter Eight of The Long Clock

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Chapter Eight of The Long Clock. The whole book, with every chapter, is at business.hautelumiere.life/library/the-long-clock (DOI https://doi.org/10.5281/zenodo.23989072).

A NOTE BEFORE YOU READ

This work is offered for education and leadership development. It is not legal, financial, accounting, investment, medical or psychological advice; take the advice of a qualified professional who knows your circumstances. Companies and events are described from the public record as the author understands it; characterisations are the author's analysis. Examples are illustrative, and no particular outcome is promised to any reader.

ABSTRACT

On 5 February 2009, in the depth of the financial crisis, Unilever published its results for the previous year. Its new chief executive, Paul Polman, had been in the post a few weeks. The statement carried a sentence that, in the language of results statements, was unusually blunt: "Given the current economic uncertainty I believe it would be inappropriate at this stage to provide an outlook specifically for 2009 or to reaffirm the 2010 targets." He added that he was confident in the underlying strength of the business and expected, "over the longer term," to deliver "very competitive levels of growth and margin improvement." The sentence has since been retold as the moment one of the largest consumer-goods companies in the world stopped playing the quarterly game. In the retellings, Polman abolished earnings guidance and quarterly reporting on his first day and told short-term investors to take their money elsewhere. Some of that may be so; the retellings come from interviews and features, not from the company's filings, and the house has not found the primary record of each claim.

CHAPTER EIGHT

The Quarterly Question

A sentence in a results statement

On 5 February 2009, in the depth of the financial crisis, Unilever published its results for the previous year. Its new chief executive, Paul Polman, had been in the post a few weeks. The statement carried a sentence that, in the language of results statements, was unusually blunt: "Given the current economic uncertainty I believe it would be inappropriate at this stage to provide an outlook specifically for 2009 or to reaffirm the 2010 targets."[59] He added that he was confident in the underlying strength of the business and expected, "over the longer term," to deliver "very competitive levels of growth and margin improvement."[59]

The sentence has since been retold as the moment one of the largest consumer-goods companies in the world stopped playing the quarterly game. In the retellings, Polman abolished earnings guidance and quarterly reporting on his first day and told short-term investors to take their money elsewhere. Some of that may be so; the retellings come from interviews and features, not from the company's filings, and the house has not found the primary record of each claim.[60] What the primary record shows is narrower and, for a reader, more useful. A company under pressure declined, in writing, to set itself a short clock it could not honestly keep, and said instead that it would be judged over a longer one.

This chapter reads that decision, and the evidence on what happens when companies make it, through the two clocks of chapter 4. Its claim is deliberately modest: the quarterly forecast is a clock a listed company sets for itself, the evidence does not show that stopping it lengthens a company's horizon on its own, and the decision helps only when it is part of a deliberate change in who the company speaks to and what it measures. That claim is less exciting than the legend. It is more use on a Monday.

The clock a company sets for itself

Most of the clocks in this book are set by other people: an owner who might sell, a lender with a covenant, a remuneration committee. Earnings guidance is different. It is a forecast a company publishes of its own future results, often quarter by quarter, and once it is published the company is judged against it. The clock is voluntary. It is also very hard to stop once started, because markets read silence as news.

Ammanuel Santa Anna's manuscript on regenerative governance describes the mechanisms that shorten a listed company's horizon as a set that work together: "quarterly earnings disclosure requirements, analyst coverage calibrated to quarterly cycles, executive compensation tied to share price over periods of three to five years, and the liquidity premium that markets award to firms whose performance is predictable over short intervals." He draws the consequence in the next sentence: "These mechanisms interact to produce a systematic bias toward decisions that generate near-term financial results at the expense of long-horizon productive capacity."[61]

Guidance sits at the centre of that set, because it ties the others together. Analysts calibrate to it. Share-based pay responds to the share price, which responds to whether guidance is met. And chapter 3 described the survey in which financial executives told researchers they would give up economic value, and delay worthwhile projects, to avoid missing an earnings target.[62] A target the company has set for itself is the most visible one there is.

So the case for stopping is easy to state. If the company does not publish the target, it cannot be tempted to cut a long-clock line to meet it. Santa Anna's manuscript puts the logic in a sentence: "by declining to commit to short-horizon financial targets, management preserves the authority to make long-horizon investments."[61] That sentence is the hope. The research asks whether it comes true.

What the research found

Two studies published within a year of each other examined American companies that announced they would stop giving quarterly earnings guidance. Both are careful, both are limited, and both reach findings that the legend leaves out.

Joseph Houston, Baruch Lev and Jennifer Wu Tucker, in *Contemporary Accounting Research* in 2010, asked why companies stop and what follows.[63] Their abstract is direct. They find that "poor operating performance" (decreased earnings, missed analyst forecasts and lower anticipated profitability) "is the major reason firms stop quarterly guidance." After stopping, they "do not find an appreciable increase in long-term investment once managers free themselves from investors' myopia." The alternative forward-looking disclosures that stoppers might have offered instead "are curtailed." And the information environment worsens: analyst forecast errors and dispersion rise, and analyst coverage falls. Their conclusion: "guidance stoppers are primarily troubled firms and stopping guidance does not benefit either the stoppers or their investors."

Shuping Chen, Dawn Matsumoto and Shiva Rajgopal studied the same question in a paper later published in the *Journal of Accounting and Economics* in 2011.[64] The abstract of their working-paper version, which is the version the house could read, describes seventy-five firms that publicly renounced quarterly guidance between October 2000 and October 2004. It reports that the stoppers had poor trailing earnings and stock-return performance; that their shares fell on average 3.8 per cent over the three days around the an-

nouncement; that after stopping, "analyst forecast dispersion increases and forecast accuracy decreases"; and that there was no change in overall stock-return volatility or analyst following.

A third, later study sharpens the picture rather than reversing it. Beatriz García Osma, Encarna Guillamón Saorín and Facundo Mercado, in the *Journal of Business Finance & Accounting*, examined whether guidance pushes managers to manipulate real activity to hit their own numbers.[65] Their abstract reports that quarterly guidance, on their large sample of American firms, "is informative and lowers myopic incentives," while guidance appears problematic in infrequent guiders, in firms issuing good-news guidance, and where earnings pressure is high.

What the research cannot show

Each study is honest about its limits, and the house adds a few of its own.

They study the companies that stopped, and the companies that stopped were mostly in trouble. That is the central finding of the first study, and it is also its central limit. A troubled company that stops guidance to avoid announcing bad numbers is not the same as a healthy company that stops guidance to lengthen its clock. The evidence is mostly about the first kind, because the first kind is most of the sample.

They measure what follows over a few years. The long-clock assets this book cares about renew over longer periods than the studies follow. A firm that stopped guidance and then rebuilt its research pipeline over eight years would not appear in their results as a success.

They are American, and mostly from the early years after a change in American disclosure rules in 2000. Unilever was a European company, in a crisis, under a new chief executive, and its case is not in their samples.

And they test one change at a time. Stopping guidance alone, the research suggests, does little for investment and costs something in market information. It does not test the combination this book recommends: stopping the short clock, publishing measures of the long-clock assets in its place, and speaking first to owners on a longer clock.

The fair reading is therefore not that stopping guidance is good or bad. It is that stopping guidance is a small structural change that does not do the work of a large one, and that a company which uses it as a substitute for the large one should expect the outcomes the research records.

Bushee's finding, again

Chapter 3 introduced Brian Bushee's study of research and development spending, which found that the pressure to cut research to meet earnings came not from institutional investors in general but from a par-

ticular kind: those with high portfolio turnover and momentum-trading strategies.[66] That finding is the key to reading the guidance research usefully.

A company that stops guidance changes the signal it sends. It does not, by that alone, change who receives the signal. If its shares are held mostly by investors on short clocks, those investors will read silence as bad news and act accordingly; the 3.8 per cent fall in the Chen, Matsumoto and Rajgopal sample is what that looks like. If its shares are held mostly by investors on long clocks, the same silence may cost very little, because those investors were not trading on the quarterly number in the first place.

So the quarterly question is really a question about owners. Chapter 4 called it the question of whose clocks are represented in a decision. Santa Anna's book names the underlying problem in its account of distance between capital and consequence. "When investors cannot *feel* the impact of their investments," he writes, "they make decisions that a somatically connected human being would never make."[67] Guidance is one of the few channels a listed company controls through which it can choose what its investors feel: a quarterly number, or a reading of the assets on which the next decade depends.

Reading Unilever's sentence

With the research in hand, the Unilever sentence reads differently from the legend, and better.

It was not a refusal to be accountable. The same statement reported the year's results in full and named the measures on which the company expected to be judged "over the longer term": growth and margin. It declined one specific clock, a forecast for a single year in a crisis, and kept the others.

It was made by a company with an unusual base of owners and a long history, not by a firm in trouble trying to hide a miss. That places it outside the population the research mostly studied.

And it was costly at the time. The share price fell on the day, as the press reported.[60] Any leader who reads the Unilever case as proof that markets reward the abandonment of guidance has read only the end of the story the retellings choose to tell. What the case can be taken to show is that a large company can decline a short clock, accept the immediate cost, and remain a large company. Whether it did better in the long run because of that decision is a counterfactual nobody can test.

The house reads the sentence as an example of a company choosing which clock it would be measured on. That choice is available to every listed company. It has costs, and the research names them. It has a precondition, which is a reason to be believed, and the precondition is the subject of the rest of this chapter.

What to put in the silence

If stopping a forecast alone does little, the work is in what replaces it. Four replacements follow from the two clocks, and none depends on the company being large.

Publish the long-clock measures. Replace the quarterly forecast with a short set of measures of the assets on which the purpose depends, reported on the clock they renew on: apprentices qualified, products in development by stage, customer retention, staff turnover, maintenance against depreciation. Chapter 10 sets out how to choose them so they cannot easily be gamed. The research found that stoppers curtailed other forward-looking disclosure. The point here is to do the opposite.

Speak to long holders first. Identify the owners on long clocks and give them the company's reasoning before anyone else. A listed company cannot choose who buys its shares, but it can choose whom it addresses, and it can make its long-clock reporting the thing those holders come for.

Explain the change before making it. Silence that arrives unannounced reads as bad news. A change explained a year in advance, with the replacement measures already published alongside the forecast, gives the market time to learn a new clock.

Change the pay at the same time. If executives are still paid on a one-year earnings number, stopping the forecast removes the public target and leaves the private one in place. Chapter 5 set out the four design questions for pay. Ask them in the same board meeting.

For a private company, a family firm or a household, the quarterly question arrives in another form: the monthly management accounts that the lender asks for, the target the owner set last January, the budget that is checked every four weeks. The same four replacements apply. Decide which of the short clocks you set for yourself, which you can stop, and what you will read instead.

The household's quarterly question

A household rarely publishes a forecast, but it often keeps one, and it often judges itself against it. The monthly budget is a household's earnings guidance. It is useful, because months are real; rent and food are monthly. It is also a clock that can crowd out every longer one.

The same lesson applies, and nothing here is financial advice. Stopping the monthly check would not help; the research suggests that abandoning a short measure without replacing it simply makes things harder to see. What helps is adding the long-clock reading beside it: once a quarter, the household asks the question of chapter 4, which long-clock line paid for this quarter's result, and how long it will take to refill. The budget stays. It stops being the only clock in the house. Chapter 12 builds this into a household's year.

The finer points

Ask why before asking whether. The research found that most companies stop guidance because their results are poor. Before stopping, write down why you are doing it. If the honest answer is that the next number is bad, the research suggests the market will reach the same conclusion.

Replace, do not remove. A forecast removed leaves a gap that the market fills with suspicion. A forecast replaced by better measures of the long-clock assets fills the gap with information.

Read the owners' clocks. Before any change in what you report, list the largest holders and estimate how long each expects to hold. The same change means different things to different owners.

Expect the cost. The research records falls in share price, wider disagreement among analysts and lower coverage. Plan for them. A leader who promises the board that the change is free has made the kind of forecast the change was meant to end.

One clock at a time. As chapter 13 will say again, a system absorbs one lengthened clock at a time. Stopping guidance, changing pay and changing reporting in a single quarter is a reorganisation, and reorganisations shorten everyone's clock while they last.

The house's book on Hirschman's exit and voice, *The Embedded Market*, reads the choice an investor makes between selling and speaking up, which is the choice on the other side of every guidance decision. *Ecstatic Economics* is kept at .

The Tool: The Investor Clock Letter

A one-page letter a company writes to its owners and lenders, once a year, in place of or beside a short-term forecast. A private firm writes it to its family owners and bank; a household can write it to itself.

1 · The clocks we are declining

- The short-term forecast or target we will no longer publish or be judged on: _____
- Why we are declining it, in one honest sentence: _____
- What we expect it to cost in the short run: _____

2 · The clocks we will be measured on

LONG-CLOCK ASSET	MEASURE	REPORTED HOW OFTEN	REGENERATION TIME (YEARS)	LAST YEAR	THIS YEAR

3 · Our owners and their clocks

OWNER OR LENDER	APPROXIMATE SHARE OR AMOUNT	EXPECTED HOLDING PERIOD	WHAT THEY CAN DO IF THE PERIOD RUNS SHORT

4 · What we ask of them

- The period over which we ask to be judged: _____ years

- What we will tell them each year, and when: _____

5 · What we have changed alongside

- Pay: the period and measure on which executives are now judged: _____
- Reporting: the measures added: _____
- The date we explained the change before making it: _____

6 · The honest note

- What the evidence says about changes like this, and what it cannot show about us: _____
- The date we will read this letter again: _____

A forecast not given

The sentence in Unilever's results statement is twenty-seven words long. It declined a forecast and gave a reason, and the sentence after it named the longer clock on which the company expected to be judged. By the press's account it cost the shares something on the morning it was published. It is remembered not because it was brave but because it was rare.

Chapter 9 gathers everything in the book so far into a field manual: twelve weeks, step by step, for a leader who wants to change the clocks in her own organisation.

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The Quarterly Question

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