University of Virginia
Darden School of Business

Institute for Business in Society

Views from the C-Suite:

CFOs Discuss Earnings Expectations and Building Trust in Management

BY

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Professor of Business Administration

JANUARY 2015

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The University of Virginia Darden School of Business Institute for Business in Society (IBiS) held its Strategic CFO Roundtable on 8 January 2015 in Arlington, Virginia. The first half of the session was spent discussing members' views of the U.S. economy and the performance of their own businesses. The second half of the Roundtable is reserved for a Top of Mind Topic that serves as an in-depth discussion for the CFOs. For this Roundtable, we continued the exploration of how CFOs balance economic performance with specific resource decisions related to the operations of their company, expanding this discussion to include the CFOs' views of the importance of reported performance.

The Department of Labor released the unemployment rate as 5.6 percent for December 2014, which represented a decline for the year of 1.1 percent (1.7 million people). The biggest news for the economy, however, continued to be the story of the price of oil and the price of gasoline. With oil selling at around $50 a barrel and gasoline selling for under $2 a gallon, the stocks of the major oil companies have suffered, but the retail buyer is seeing real benefits at the pump. The stock market (Dow Jones Industrial Average, "DJIA") closed out 2014 at 17,823, up 7.5% for the year. The 10 year Treasury bond yield started the year at 3.00% and ended at 2.17%. With energy costs low, unemployment down, interest rates down and the DJIA just short of 18,000, there was a positive outlook amongst the Roundtable participants who reported solid performances for their companies and continued to carry an optimistic view for both the economy and their own companies.

THE SURVEY

Prior to each Roundtable session, we conduct a survey to provide insights into the business views of the Roundtable Members in the Washington D.C. Metropolitan Area relative to their counterparts nationwide. We compared the survey results of the Roundtable Members to a separate national survey, the Duke University/CFO Magazine Global Business Outlook Survey, which has polled senior finance executives over the past 75 quarters. The survey responses prompted conversation among the Roundtable Members regarding their expectations of domestic and global economic recovery and the financial condition of their own firms.

Economic Outlook

The January 2015 Darden IBiS Strategic CFO Roundtable Survey showed a continued level of optimism regarding the U.S. economy. The graph below depicts how CFOs rated their optimism about the U.S. economy on a scale of 0 – 100%. (Figure 1) Both the national Global Business Outlook and the Darden IBiS Strategic CFO Roundtable Survey reported optimism levels over 60%. The national survey (solid line) rose slightly from 63% for Q3 2014 to 64% for Q4 2014 while the Roundtable Member CFOs (dashed line) exhibited a noticeable increase from 57% for the September survey to 68% for the January 2015 survey.

Figure 1: Optimism for the U.S. Economy
(Scale of 0 – 100%)

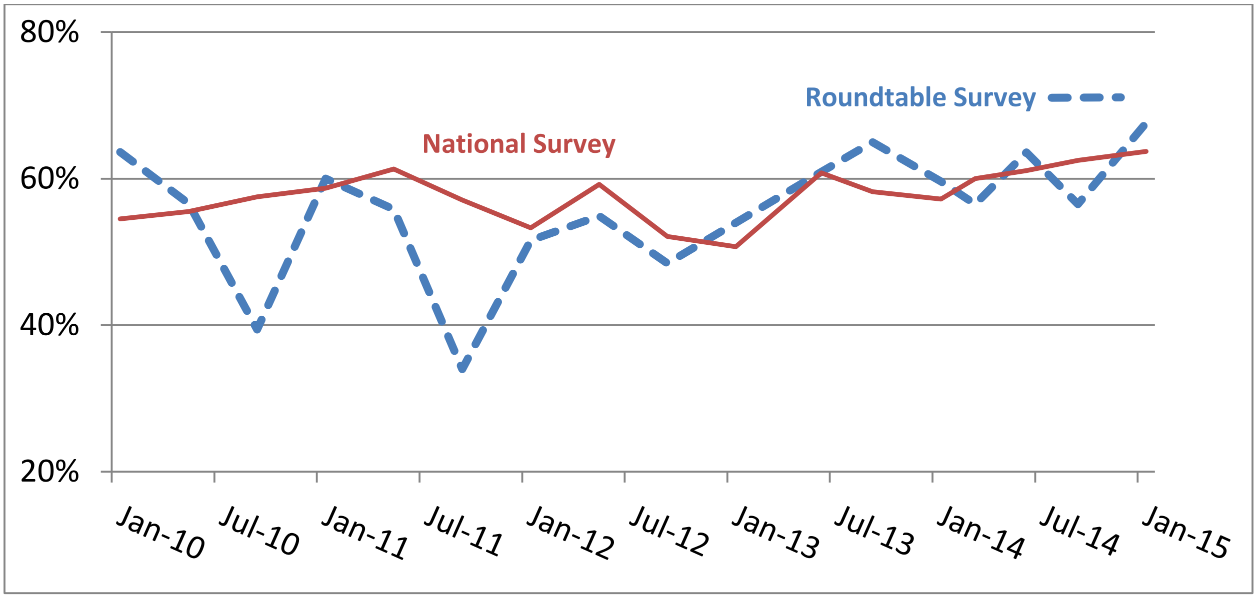
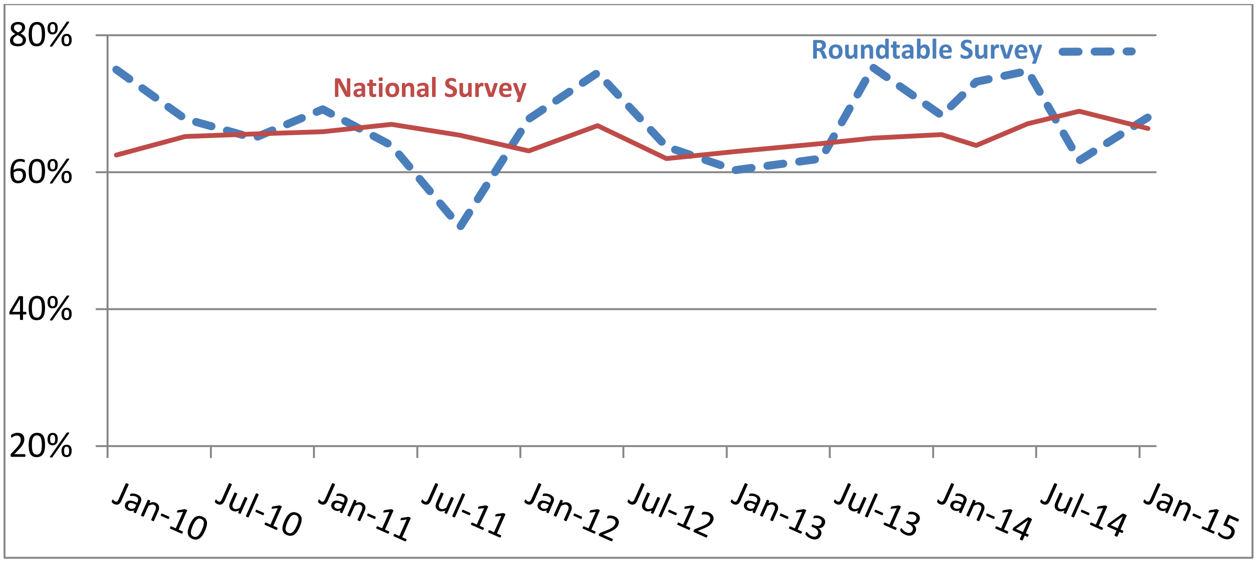


Figure 2 compares the CFO Roundtable group with the national survey regarding optimism about their own companies. Historically both of these surveys have reported higher levels of optimism for their own companies relative to the U.S. economy and the Roundtable optimism for "own company" has frequently been higher than those reported by the national survey. For the January survey, the optimism levels for the Roundtable CFOs (dashed line) are only slightly higher than the national survey (solid line). When we compare Figure 2 and Figure 1 levels, the national survey has higher levels of optimism for the CFOs' own company (66%) relative to the U.S. economy (64%), whereas those levels are virtually the same for the Roundtable survey: 68.0% own company and 67.6% U.S. economy.

On average, our Roundtable members have reported a premium level of optimism for their own company of 12% since 2010, compared to a 7% premium reported by the national survey.

Figure 2: Optimism for their Own Company
(Scale of 0 – 100%)



Regarding the optimism measures, one CFO commented:

> It seems like the news flow is improving relative to the U.S. economy in terms of what people are saying and some of the indicators. The general sentiment seems to be that the economic prospects in the U.S. are getting better. That drumbeat has been gradually increasing, I think, throughout the course of last year.

Another CFO added:

> I think there's some relativism in this in that we all realize the Fed isn't doing anything on rates right now in part because the rest of the world is still pretty shaky. And we're stronger than the rest of the world so we can be more optimistic. Now, we may see if the rest of the world gets really sick, we get a cold too. But, right now I think there's some relativism in the optimism in that we know we're doing a little bit better than everyone else and we don't feel some of the same competitive pressures from the rest of the world that were there when it looked like Europe was a little stronger.

TOP of MIND TOPIC

For the Top of Mind Topic, we continued the September discussion of the relationship of long term profits and specific, shorter-term resource decisions. The discussion began with a look at the impact of meeting performance benchmarks and expectations. We asked the CFOs to evaluate several statements related to performance benchmarks and expectations:[1], [2]

1) For each of the earnings benchmarks listed below, evaluate the statement: "This benchmark is *important* to our company when we report a quarterly earnings number."
   a. Same quarter last year EPS
   b. Analyst consensus forecast of EPS for current quarter
   c. Reporting a profit (EPS >0)
   d. Previous quarter EPS

2) For each of the explanations below, evaluate the statement: "Our company tries to meet earnings benchmarks, because it helps…"
   a. us build credibility with the capital market
   b. us maintain or increase our stock price
   c. us maintain or reduce stock price volatility
   d. the external reputation of our management team
   e. us convey our future growth prospects to investors
   f. us assure customers and suppliers that our business is stable
   g. our employees achieve bonuses; us achieve or preserve a desired credit rating

3) For each of the explanations below, evaluate the statement: "Our company prefers a smooth earnings path because it…"
   a. is perceived as less risky by investors
   b. makes it easier for analysts/investors to predict future earnings
   c. assures customers/suppliers that business is stable
   d. reduces the return that investors demand (i.e. smaller risk premium)
   e. promotes a reputation for transparent and accurate reporting
   f. conveys higher future growth prospects
   g. achieves or preserves a desired credit rating
   h. clarifies true economic performance
   i. increases bonus payments

Their responses revealed that all the earnings benchmarks were important (better than neutral), but the top two were "same quarter last year EPS" and "reporting a profit (EPS > 0)", both of which received a median assessment of "agree". For the second question, CFOs also rated all the explanations as higher than neutral with the highest two receiving an "agree" evaluation being "the external reputation of our management team" and "convey our future growth prospects to investors". The third question asked the CFOs to evaluate potential reasons for preferring a smooth earnings path. The CFO's viewed "increases bonus payments" as not being a valid reason ("disagree"), but the top two explanations (assessed as "agree") were "perceived as less risky by investors" and "makes it easier for analysts/investors to predict future earnings".

[1] These same questions were asked of a large sample of CFOs (N = 312) in a 2005 article and are reported as tables 3, 4 and 8 in Graham, J., C. Harvey, and S. Rajgopal, 2005, "The economic implications of corporate financial reporting". *Journal of Accounting and Economics* 40, 3-73.
[2] Statements were evaluated across 5 categories: strongly disagree, disagree, neutral, agree and strongly agree.

Taken together these survey responses suggest that the CFOs are very aware of the importance of meeting quarterly earnings expectations and that the failure to meet expectations is damaging to the reputation of the management team as well as to how investors and analysts are assessing the growth prospects of the company. For public companies that are growing and have a significant portion of their stock price driven by growth expectations, the stock price can be adversely impacted significantly with one quarter of disappointing earnings; i.e., earnings that are off the growth trend line. Smooth earnings are rewarded by investors and analysts because of the perceived lower risk of the company and the ability to predict the continuation of the growth trend, both of which help increase the stock price.

Several comments during the discussion were consistent with the survey responses:

> In my experience a lot of what investors are trying to do is figure out whether they can trust you and agree that when you're putting out guidance or context around what's happening, you're actually following through and delivering on that. I think it helps to build up the trust and confidence they have in the management team and that has a positive impact on how they view the company and whether or not they want to be an investor in the company.

> What you're trying to do is to create long-term shareholder value, right? Part of it is delivering value {by producing} good numbers, but also making sure that you're doing it in a way that you're getting credit for it from investors who then trust you and want to invest with you and believe in your growth prospects. And when you communicate that the capital market points at you as having flexibility to invest in your business … to go raise equity or debt if you need additional flexibility. So you need to deliver {your results} in a way that creates credibility, shows consistent performance so that when you put out your next forward looking statement, people believe it.

Toward the end of the roundtable, we returned to the September discussion about the balance between investors and other stakeholders. To set up this discussion we added a hypothetical question to the survey:

4) Shortly after the start of a new year it becomes apparent that your company will come in below the desired earnings target. Although you expect the following year to rebound, this year's earnings are likely to be well below target without corrective action. For each potential action listed below, please evaluate the statement: "Within GAAP, our company would *seriously consider* taking this action."

    a. reduce discretionary spending such as R&D, advertising, or maintenance.
    b. reduce optional employee benefits; i.e., benefits well above the industry norm.
    c. reduce community outreach projects and charitable donations
    d. delay starting a new project even if it entails a small sacrifice in value

e. provide incentives for customers to buy more product this year
f. sell investments or assets to recognize gains this quarter
g. negotiate with suppliers to reduce prices
h. repurchase common shares to boost EPS

Most of the actions were assessed as "neutral" by the CFOs, but two received "agree" assessments: "reduce discretionary spending such as R&D, advertising, or maintenance" and "negotiate with suppliers to reduce prices". One action, "delay starting a new project even if it entails a small sacrifice in value", was assessed as a "disagree" by the roundtable members. These responses suggest that CFOs place a high priority on preserving the underlying value drivers of their companies; i.e., the new projects that are likely the source of growth for the company. If forced to take corrective action to offset anticipated poor earnings, the CFOs identified the two areas they felt were the easiest to execute with the lowest long run cost: discretionary spending and negotiating with suppliers.

CFO comments added insights into their responses:

> If it's a bad year because something totally out of the blue random happened, you might just live with the bad year. If we had a bad year because a lot of our growth investments weren't hitting the models they expected to, then we would need to figure out if something was going on with those programs such as the way that we're forecasting and delivering and watching programs is not working. If that was the reason, then we'd probably pull on that lever more aggressively but if it's some other external factor, such as recession or market demand but we still felt like those programs would have good long-term return, we would just take it for that year

The Darden IBiS Strategic CFO Roundtable will re-convene Thursday, 16 April, 2015.

About the Author

Kenneth M. Eades, Professor of Business Administration, is the Chairman of the Darden Finance Department and serves as Interim Academic Director for Darden's Richard A. Mayo Center for Asset Management, as well as Associated Faculty with the Darden Institute for Business in Society. The author of numerous academic articles, more than 50 Darden cases and three books, Eades has received both research and teaching awards.

About the Darden IBiS Strategic CFO Roundtable

The Strategic CFO Roundtable is a quarterly, invitation-only convening of leading chief financial officers in the Washington D.C. Metropolitan Area to discuss, debate and share best practices on enhancing the strategic role of the CFO. With over 300 years of strategic financial and leadership experience, the Roundtable participants share their views on the challenges and opportunities facing their companies. They discuss the lessons learned from triumphs and trials that led to their becoming recognized as strategic CFOs. The Strategic CFO Roundtable is organized by the Institute for Business in Society at the Darden School of Business of the University of Virginia.

About the Darden Institute for Business in Society

The Institute for Business in Society (IBiS), established at the Darden School in 2011, prepares leaders to positively impact society through business. IBiS advances thought leadership and innovative practices through research, teaching and programs.

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Darden IBiS Strategic CFO Roundtable Survey Results

January 2015

	N = 7 CFO RT Jan 2015		N = 6 CFO RT Sept 2014		N = 6 CFO RT June 2014		N = 6 CFO RT Mar 2014		N= 513 Duke Q4_14		N= 379 Duke Q3_14		N= 400 Duke Q2_14	
	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median
1. Compared to last quarter, are you more or less optimistic regarding:-**U.S. economy** (Less =1, More = 3)	**2.3**	**2.0**	**1.8**	**2.0**	**1.8**	**2.0**	**2.0**	**2.0**	2.3	2.0	2.2	2.0	2.2	2.0
1. Compared to last quarter, are you more or less optimistic regarding:-Financial prospects for **your own company** (Less =1, More = 3)	**2.0**	**2.0**	**2.0**	**2.0**	**2.2**	**2.0**	**2.5**	**2.5**	2.2	2.0	2.3	2.0	2.3	2.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)- **U.S. economy**	**67.6**	**70.0**	**56.5**	**57.5**	**63.6**	**66.0**	**56.5**	**60.0**	63.7	65.0	62.5	65.0	61.1	60.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)-Financial prospects for **your own company**	**68.0**	**68.0**	**61.7**	**62.5**	**74.8**	**75.5**	**73.2**	**70.0**	66.4	70.0	68.9	75.0	67.1	65.0
4. Regarding domestic employment, when do you anticipate a return to pre-crisis (year end 2007) levels for the **U.S. economy**-Months	**23.1**	**24.0**	**31.2**	**36.0**	**27.0**	**24.0**	**28.5**	**33.0**						
4. Regarding domestic employment, when do you anticipate a return to pre-crisis (year end 2007) levels **for your firm**-Months	**7.2**	**0.0**	**4.8**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**						
5. How would you rate...-Your **employees' morale level**? (Poor =1, Satisfactory =3, Excellent = 5)	**3.7**	**4.0**	**3.7**	**4.0**	**3.8**	**4.0**	**4.2**	**4.0**						

Darden IBiS Strategic CFO Roundtable Survey Results

January 2015 (Continued)

	N = 7		N = 6		N = 6		N = 6	
	CFO RT Jan 2015		CFO RT Sept 2014		CFO RT June 2014		CFO RT Mar 2014	
(Weaker =1, No change = 2 Stronger = 3)	Average	Median	Average	Median	Average	Median	Average	Median
6. Recent quarter's financial results **vs. previous quarter: -Income Statement**	2.3	2.0	2.2	2.0	2.3	2.5	2.5	2.5
6. Recent quarter's financial results vs. previous quarter: - **Balance Sheet**	2.3	2.0	1.8	2.0	2.2	2.0	2.7	3.0
6. Recent quarter's financial results vs. previous quarter: - **Cash Balance**	2.0	2.0	1.7	1.5	2.2	2.0	2.4	3.0
8. **Expected change** over the next 4 quarters vs. last 4 quarters: **-Income Statement**	2.7	3.0	1.9	2.0	2.3	2.5	2.7	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Balance Sheet**	2.0	2.0	1.9	2.0	2.3	2.5	2.7	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Cash**	2.1	2.0	1.9	2.0	1.7	1.5	2.4	3.0
(Reduced =1, No change = 2, Higher = 3)								
9. **Expected change** over the next 4 quarters vs. last 4 quarters: - **Headcount**	2.3	2.0	2.3	3.0	2.2	2.5	2.3	2.5
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Capital Spending**	2.1	2.0	2.0	2.0	1.7	2.0	2.2	2.5
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Compensation**	2.3	2.0	2.0	2.0	2.2	2.0	2.2	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Pro develop/training**	2.1	2.0	2.0	2.0	2.0	2.0	2.2	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (new mkt/product)**	2.0	2.0	1.8	2.0	2.3	2.0	2.2	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (Acquisition)**	1.7	2.0	1.7	2.0	2.2	2.0	2.0	2.0