

FAILURE OF BUSINESS ETHICS PART III

The market discipline that is not so tight

A trading scandal that hit GE highlights the dilemmas executives face in presenting results, write **John Plender** and **Avinash Persaud**

In the Anglo-American model of capitalism the stock market imposes a ferocious discipline on managers of quoted companies.

For a start, the movement of the share price offers a minute-by-minute critical commentary on corporate performance and prospects. Quarterly results are closely examined by stock market analysts, fund managers and journalists, and there is an ever-present threat of hostile takeover. The credibility of top executives in this system depends on their generating consistent increases in earnings. They also have to develop the art of carefully guiding analysts' expectations and subsequently "hitting the numbers".

Putting chief executives into a financial pressure cooker in this way has disadvantages, not least the pressure to lose their moral compass and cook the books. The underlying assumption is that companies are capable of delivering consistently rising, above-average earnings. Yet not all companies can be above average.

Equally absurd is the assumption that accountability is an objective science capable of producing a single exact number that is worth hitting. As for the discipline, it is peculiar, in that top executives set the benchmarks against which they themselves are measured.

stood out so clearly in my mind."

For Jack Welch the ethical issue here boils down to the contrast between the greedy, footloose individualism embedded in the culture of Wall Street and the healthy team spirit exemplified by managers in GE's mainstream businesses. He seems blind to the possibility that others might be shocked that the GE culture was one in which playing fast and loose with the quarterly numbers was regarded as good teamwork.

Some might argue that on the Richter scale of ethical lapses this does not rate high. Mr Welch could no doubt claim that such smoothing of the numbers is an antidote to stock market short-termism and thus in the interests of all shareholders.

Yet while massaging the numbers may be a rational response to the somewhat arbitrary discipline of the expectations game, there is a question about whether shareholders should have been told on what basis this was being done at GE, not least because such opaque reporting can put manage-

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ees now own stock in the company where they work, the categorical imperative of hitting the numbers may be felt throughout the organisation. Inevitably there is a temptation, in this ritualised expectations game, to massage results to keep the stock price up. Where performance criteria for bonuses and stock incentive schemes are related to the behaviour of the stock, such temptation is acute.

In the wave of corporate scandals from Enron to Royal Dutch Shell, this pressure drove top executives to juggle the numbers in ways that boosted their own compensation packages. Yet it is also open to executives to tailor quite lawfully their spending decisions and choice of accounting policies in order to smooth the quarterly earnings trend.

The nature of these dilemmas emerges in a surprising way in the autobiography of Jack Welch, former chairman and chief executive of General Electric, when he recounts the disaster that struck the conglomerate's investment banking subsidiary, Kidder Peabody, in 1994.

Kidder's bond trading desk was run by Joseph Jett, who made a series of fictitious trades to inflate his own bonus. These artificial trades had inflated Kidder's reported income and the team of GE managers assessing the damage concluded, with GE's first-quarter earnings release due to be published in just two days time, that a \$350m write-off would be needed to deal with the financial black hole left by the rogue trader.

Mr Welch explains how he apologised to 14 of GE's business leaders for what had happened and felt terrible because it would hit the stock and hurt every GE employee. He continues: "The response of our business leaders to the crisis was typical of the GE culture. Even though the books had closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra \$10m, \$20m, and even \$30m from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I had been hearing from the Kidder people.

"Instead of pitching in, they complained about how this disaster was going to affect their incomes. 'This is going to ruin everything,' one said. 'Our bonus is down the toilet. How will we keep anyone?' The two cultures and their differences never

ment on to a slippery slope. The risk in creative accounting is that managers end up fooling themselves about the profitability and viability of the businesses they run.

Deciding whether shareholders are being seriously misled is one of business's countless ethical grey areas. It is nonetheless possible to highlight questions executives should ask in relation to smoothing the numbers.

The most basic query concerns failure to be open with shareholders about earnings manipulation. Is it really in shareholders' interest for the short-term earnings trend to be smoothed or are they being kept in the dark to protect executives' jobs, bonuses and other equity-related awards? Is there a risk that the short-term benefit to the share price of massaging earnings will be outweighed by longer-term adverse consequences? Or, more crudely, are earnings being relentlessly massaged against a background of deteriorating corporate performance in the hope that something will turn up?

Openness in business is usually a good principle, except where it would inflict competitive disadvantage on the company concerned. In the context of earnings manipulation, a very basic principle would be that managers should "tell it like it is" unless openness would demonstrably inflict damage on shareholders and other stakeholders.

That said, the capital market expectations game is a flawed form of accountability. It reduces the relationship between managers and shareholders, and the analysis of corporate performance, to an oversimplified credibility test. The wider question for those involved is whether to play at all. In the US, Coca-Cola has led the way in refusing to offer guidance on quarterly earnings. That is one useful way to reduce the ethical pressure.

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All You Need To Know About Ethics And Finance, by John Plender and Avinash Persaud, will be published in September by Longtail Publishing. www.allyouneedtoknowguides.com

The authors will answer readers' questions on business ethics today at 1-2pm BST. Go to www.ft.com/ethicsqa