Limitations of Modern International Finance and Accounting Practices through Analysis of Short-Termism

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Abstract. This paper is devoted to analysis of short-termism in its influence on modern international finance and accounting practices. One might say that short-termism is a problem of a particular company and the market should correct this inefficiency in a usual way. However, many analysts and scientists suggest that it is problem of the society as well. Short-termism is not a recent issue in the world of finance and accounting, however, there are not many extensive researches available. The topic became more popular after 2008–2009 when financial crisis hit the financial world and made professionals analyze what went wrong, at what stage and why. The overview of main views on the issue is provided in the article. Main causes of focus on short-term outlook are reasoned in this work. Formal foundation of short-termism and main disadvantages of it is disclosed. In order to mitigate negative impact of short-termism it is recommended to implement three-part model.
Keywords: short-termism; creative accounting; financial results manipulation; internal control.

Выявление недостатков современной международной финансовой и учетной практики посредством проведения анализа явления «шорт-термизм»

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Аннотация. Статья посвящена анализу явления «шорт-термизм» и его влиянию на современную международную финансовую и учетную практику. Можно считать, что шорт-термизм является проблемой конкретной компании, и эта проблема будет скорректирована рынком в стандартном порядке. Однако многие ученые и практики предполагают, что это проблема всего общества. Шорт-термизм не новое явление в мировых финансах и учете, однако сейчас не существует достаточного количества исследований в этой области. Данная проблематика стала более популярной после 2008–2009 гг., когда кризис настиг финансовую сферу и заставил профессионалов начать анализировать, что же пошло не так, когда и почему. В данной статье представлен обзор основных взглядов на проблему, рассмотрены основные причины и недостатки шорт-термизма и рекомендована трехуровневая модель для преодоления негативных последствий данного явления.

Ключевые слова: шорт-термизм; креативный учет; манипуляции финансовыми результатами; внутренний контроль.

INTRODUCTION

It is important to mention several factors that underlie importance of phenomenon of short-termism. Firstly, in the case when institutions including public regulators are subject to short-term thinking, consequences may have an impact on all market participants in different ways, for example causing adverse macroeconomic and social consequences, negatively affecting economic growth, increasing the unemployment rate or deteriorating price dynamics.

Secondly, an excessive focus on short-term objectives of one company may result in other companies behaving similarly and in a simultaneous way. For example, this behavior may take the form of excessive risk-taking in order to maximize short-term profit. As a result, short-termism leads to serious macroeconomic imbalances causing a sudden economic downturn.

Finally, considering the fact that short-termism often leads to the neglect of investment and human activity, it reduces international competitiveness of the company and its capability to meet new market challenges and demands in an effective manner. Short-termism thus results in the reduced potential not only of individual companies, but also of the whole economy.

It is important to stress out that short-termism should not be considered as a problem ‘per se’, mainly negative consequences appear when long-term goals are sacrificed upon due to excessive concentration on short-term benefits obtained and short-term results expected. Short-termism serves as a primary reason for existence of specific finance and accounting limitations that have an impact on both the company’s performance and wider society.

Urgency of this work is denoted by the fact that consequences resulting from excessive short-termism that is considered as a problem of certain individual or a certain company may be destructive for the whole society and the economy. Based on the above, there is little doubt that mitigating the short-termism would contribute to building a better and more transparent business environment. Existing problem of negative impact created by short-termism denotes the necessity of further investigation of this issue.

OVERVIEW OF THE LITERITURE. METHODS

To achieve the primary goal of the research, the following information sources were used: works of Russian and foreign authors, publications in professional periodicals and mass media, tutorials and Code of Ethics for Professional Accountants. Additional modern methods of scientific research applied in the work include synthesis that allowed combining results of the analysis provided in the work with an aim of developing efficient and effective model to be recommended for implementation. Modeling and computations were used in assessing long-term impact that short-termism imposes on financial statements.

One of the first who raised concerns about short-termism issue was Martin Lipton in “Takeover Bids in the Target’s Boardroom” in 1979. More recent studies on this issue include the study by the Business Roundtable in the US and the Discussion Paper released in the UK by the Department of Business, Innovation and Skills. Although concerns over short-termism and its effects are not new, the reasons for these concerns appear to have changed over a period of time.

Earlier research concerned short-termism as a result of market imperfections due to information asymmetry. On the other hand, recent researchers addressed this issue as a deliberate strategy required of managers by stakeholders.

Consequently, regulators and researchers considered short-termism as being potentially harmful to the credibility of markets in the long run, as well as to the economy, and society in general. Besides, there was a fear that short-termism might have a negative impact on decisions of potential creditors; it may discourage corporate managers from undertaking long-term R&D investments, thus adding to the volatility of capital markets through rapid shifts in investment.

Most existing literature on this issue places its focus on the damage to the economy caused by the short-term outlook of investors with substantial capital (for example, hedge funds and institutional shareholders), as well as on the question if short-termism is the product of investors with substantial capital making managers to act in this way, or whether the investors choose to invest in entities whose managers engage in short-term conduct.

In 2011 Dominic Barton, managing director of McKinsey & Company, appealed to business leaders 'to reform the capitalist system by fighting the tyranny of short-termism' (Denning, 2014). However, the situation is getting worse and worse. In order to understand why it is so difficult to cope with short-termism and financial results manipulation, several studies were used including those conducted by Ernst & Young in 2014, Deutsche Bank in 2011 and 2014, Forbes in 2014, The New Yorker in 2015 and Harvard Business Review in 2015.

The goal of the Ernst & Young report is to contribute to the discussion on short-termism through empirical research conducted for European companies, which have not been the subject of many studies so far. Taking into account the costs that short-termism cause for the whole economy, E&Y strongly recommends considering number of the measures outlined in the report, as well as other instruments that may help to address the excessive focus on short-term goals. If dealt with effectively, it would improve the capacity and competitiveness of national businesses, encourage long-term value creation and contribute to the welfare of society (Kedzior & Rozkrut, 2014a, 2014b).

Even despite the numerous amount of conducted studies, the results are quite controversial and suggest conflicting assessments of causes and consequences of the issue. Depending on the way how short-termism is measured, different opinions are expressed — sometimes even relating to the existence of short-termism in general.

Consequences of short-termism such as creative accounting or human capital neglect are described in articles and studies conducted by foreign analysts. For example, G.D. Chryssides and J.K. Kaler provide comprehensive assessment of ethical issues involved in creative accounting process. Furthermore, their colleagues K. Gowthorp and J. Blake analyze general impact of ethics on accounting and its limitations created due to short-term outlook.

Short-termism as a phenomenon is closely looked at by L. Roger and A. Rappaport is their articles. Moreover, S. Denning and J. Surowiecki consider conditions that have an impact on companies trying to cope with this phenomenon. Corporate short-termism is described in detail by such authors as R. Sappideen and N. Shilon who analyze it in the context of current corporations.

Interlink between remuneration and short-termism is investigated by P. Bolton, N. Scheinkman, C. Andrew and D. Gregg in published articles, where authors suggest that there is direct relationship between compensation and focus on short-term perspective.

In general, as short-termism was not fundamentally studied before XXI century, mainly articles of foreign analysts and studies conducted by large audit companies were used in this research. Additionally, literature on business ethics, financial fraud, remuneration policies and corporate governance was examined in order to investigate preconditions that cause short-termism existence and measures that may be implemented in order to mitigate negative consequences.

MAIN CAUSES AND THE BACKGROUND OF SHORT-TERMISM

In order to understand why the short-termism exists, it is necessary to consider main causes and the background of this phenomenon.

First of all, as mentioned before, expectations and objectives of stakeholders provide for significant impact on the behavior of company's management. Not many stakeholders who have direct power on the company are interested in the long-term prospects — some of them have short-term concerns causing management to act appropriately. While employees require increase in salary, shareholders want to see quarterly profits and good figures in the financial statements. Lenders are interested in the current ability of the company to repay debts, and only general community usually have the most long-term vision among other stakeholders as they are looking at the place of the company in general and are interested in more large-scale issues such as environmental protection.

Attempts to satisfy all expectations at once is rarely possible or effective for business and thus it needs to concentrate on the most significant objectives — implying objectives of the parties who may have the greatest influence on the company.

Usually these appear to be shareholders and other investors.

Secondly, management of the company has constant fear of funds withdrawal and lack of investments of company. As company needs to finance its operations and expansions, it is necessary to be able to attract and retain significant amount of funds. Primary objective of investors is to make profit — and in this case the quicker the profit is made the better for investors.

When deciding on where to invest in, market participants examine financial statements and current figures of prospective companies; inspect recent ratios and stock prices. Thus, as management is interested in increasing volume of investments, they want the company and its figures to look attractive. In order for financial statements to look good, management focuses its efforts on achieving good financial figures and ratios in short-term when new financial inflows are needed. Thus, management is able to slightly manipulate financial figures in order for the public information to look attractive. Consequences of such actions are to be discussed later in the study.

Looking further, when the current investor notices deteriorations in the performance of the company he invested into, he becomes worried about future returns and may think about withdrawing his funds before the situation gets even worse. The wave-making effect may appear and cause other investors to withdraw their investments as well — consequently, the company will not only lose potential funds that it uses for day-to-day operations and future development, but also financial statements will be deteriorated as large withdrawal of funds affects figures dramatically causing new potential investors to make a negative decision regarding investment in this company.

In order to avoid withdrawal of funds by investors, the company will do its best in order to hide financial problems applying different accounting methods. Current practices suggest many ways how the company, legally or illegally, may make its problems undetected by its shareholders and potential investors. In the case when company has problems that should be kept back, the focus of the management is to hide unfavorable details in the short-term with an intention to change the situation in the nearest future. However, when the focus is placed on the short-term without thinking about long-term consequences, the situation for the business may even worsen when it appears that the company is not able to manage its problems effectively and quickly.

Remuneration schemes used by many companies also play significant role in determining time horizon for management's attention. Currently lots of large companies implement performance-based pay system, which implies payments to employees based on the performance achieved. There are several reasons why the company chooses this system exactly:

Performance-based pay promotes behavior desired by management and shareholders;

It inspires employees to implement new efficient ways of work;

It assists in retention of high-performing workers and discourages low-performers;

Finally, many employees prefer this system to be used themselves as it works as additional incentive for them.

While this system is commonly used, in many cases it causes short-termism to appear. In order to implement performance-based pay, every employee is assigned with goals, KPIs and is then assessed against these targets. This system may be rather motivating for employees, but a huge difference exists between theoretical aspects and its practical implementation.

The problem is that it is rarely applied effectively enough to deliver strategic outcomes of the business. This system may lead to dysfunctional behavior (Ryan, 2015) —for example, salesmen may get involved in window dressing in order to meet sales target set by applying a 'sale and return basis' in the final month of the year, with the inherent understanding that the goods will be returned in the following month of next financial year. This also leads to short-term thinking and acting, where salesmen never put the customer above the sales target.

For top-management staff, which is not an exclusion from the rule, quarterly profits and short-term figures are often set as KPIs to be achieved — and this is made in order to make shareholders and potential investors satisfied as discussed above. Thus, as management wants to receive high salary and related bonuses, they are self-motivated to achieve quarterly figures. When manager is putting all the efforts on short-term results achievement there is no time left to think about the strategy and long-term outcomes — thus, short-termism prevails.

The next point to consider as background of the short-termism phenomenon is allocation of goals in the company depending on time phasing. It is quite common that every employee is responsible for some short-term goals within his or her area of work, but also for contributing to achievement of long-term goals. Long-term goals may not be always clear or evident for the low grade staff and moreover not all of them have a strategic vision on the company's future — thus, they decide to focus on the short-term goals they have.

Lack of specific strategic goals among employees and absence of relevant reward system together lead to the situation when employees do not align their activities with the global goals of the business and have no ability to guide themselves through strategic directives set by the management. Such disorientation often results in ineffective resource utilization and short-termism.

Moreover, inability to allocate your time and efforts efficiently may cause useless actions and high proportion of waste of time and resources. While this problem may be attributed to low-level staff, it may also be present at higher levels of the company. These skills need to be improved so they would not serve as additional underlying reason for short-term focus. Otherwise sooner or later the situation arises when due to inefficient time allocation employees concentrate all their efforts on short-term targets just before the deadline in order to ensure at least some level of acceptable performance.

Another underlying reason is relationship between the length of Chief Executive Officer (CEO) tenure and the short-term way of thinking. While some studies suggest longer CEO tenure leading to better performance, other assume that longer tenure and higher pay lead to CEO being more inclined towards taking risks. After investigating different studies available, it can be assumed that it is more often that longer CEO tenure leads to weakened relationships with customers and worsened performance which may cause financial results manipulation in order to maintain the CEO position. On the other hand, when tenure is short, CEO aims at having high and convincing short-term results thus showing that even during such short employment he or she is able to achieve high results and improve company's performance.

Reasons mentioned in this section are not the only ones that serve as a background for short-term outlook of employees and management of the company — the list is extensive and not limited only by these causes. Studies conducted by various companies and researchers emphasize that short-termism may appear in any company and cause consequences affecting the business suddenly.

FORMAL FOUNDATION AND MAIN DISADVANTAGES OF SHORT-TERMISM

Discussion of reasons behind short-term thinking may be convincing regarding necessity of taking this issue into account and placing efforts in mitigation of its potential effects. In order to estimate how bad this phenomenon is, it would be useful to estimate its advantages and disadvantages.

It is rather difficult to claim that short-termism provides for some benefits — thus, it should be stressed out that this section does not compare benefits and drawbacks of the issue under consideration, but assists in deciding whether some formal foundations may be found as soft justification for existing disadvantages.

Justification of short-termism is based on its causes and looking behind them — here it is necessary to take into account personal motives and reasoning of employees. While formal foundation may not be convincing enough for acceptance of this phenomenon existence, it stills helps us to understand why it happens this or another way. It is also necessary to point out that justification of short-term outlook is based on the causes mentioned in the previous section, but this time they are considered from more person-specific side of company's management and employees.

Looking back at consideration of remuneration schemes, while it creates conditions for existence of short-termism, it still provides incentives for outperformance. A paper in *The Journal of Finance* found that firms that give CEOs high equity incentives outperform those with low equity incentives by 4–10% per year (Lilienfeld-Toal & Ruenzi, 2014). It is assumed that executives are intrinsically motivated, and that extrinsic motivators like performance-based pay system only crowds out these intrinsic motivators.

The evidence suggests that those executives who are not provided with incentives may simply choose to work in a quiet and slow manner and allow the status quo to persist, avoiding difficult tasks such as major reorganizations, engaging with difficult partners and negotiations, or unpopular decisions. Thus, while short-termism may be present due to application of performance-based pay, it still provides the management of the company with additional incentives that are to improve its performance and increase profitability and effectiveness.

Furthermore, considering the issue of attracting new investment, the situation is almost the same. While short-termism exists due to necessity of showing good figures to potential investors in the short-run, it still allows the company to obtain additional funds for further development. There are two different options for where this situation might evolve to. On the one hand, the company may concentrate on the short-term, assure nice figures and ratios to be shown to potential investors, attract new investors and make good use of these funds. The outcome here is positive as new investments are used so effectively that the company will be able to retain new investors and succeed from this decision in the long-run.

On the other hand, let us consider another outcome of the same situation. The company concentrates its efforts on short-term figures, new investors decide to invest but after that the company is not able to make a good use of additional resources. Thus, the ratios and figures will deteriorate even more seriously and may cause unfavorable consequences resulting in loss of investors and worsened performance. However, as the company needs investments in order to develop, short-termism in this case may still be justified — taking into account possible consequences of management actions.

Another possible justification for short-termism concerns expectations of shareholders. In many situations this group of stakeholders is considered to be the most significant one as they have power and control over the company and may influence crucial decisions. Thus, actions of management aimed at achievement of short-term profits and return for the shareholders may be understood. However, it is vitally important to ensure that these actions will not have large negative effect in the future — otherwise loyal shareholders may lose confidence in the company and trustworthiness will get worsened causing funds withdrawal and loss of key investors.

As mentioned before, these reasons are not to justify myopia of executives in full, but to provide some examples for better understanding of short-termism. While short-termism is generally considered as a negative phenomenon, under certain circumstances it may ensure rather acceptable outcomes.

Some of disadvantages might be clearly seen, while some are to be revealed only in the long-term outlook of the company's operations. The list of drawbacks is not limited only by those mentioned below and may be extended depending on the specific situation in reality.

First of all, short-termism causes unfaithful representation of company's performance. In order to make shareholders and investors satisfied, management manipulates accounting figures so that financial ratios look good for some short period of time. Actions aimed at intended overstatement of company's achievements undermine the principle of faithful representation and deteriorates assurance of users in company's financial statements and reports.

Consequently, unfaithful representation leads to misleading results that may cause investors, shareholders, lenders and any other interested party to make decisions they would not make under usual circumstances. Misleading results might be even considered as a violation as they cause irrational behavior and may lead to further losses by market participants.

Another drawback associated with misleading results is loss of confidence of intended users. It is of crucial importance for the company to be trusted by stakeholders in order to be able to attract necessary funds and realize its goods and services efficiently. If the fact of unfaithful representation is revealed, the further relationship between the company and interested parties might be seriously challenged.

Taking it even further, such actions may finally result in undermining market's credibility as a whole due to the fact that companies tend to copy each other's behavior. In order to stay competitive, short-term outlook spread among the industry eventually resulting in the total erosion of credibility.

The next drawback to be mentioned is negative effect on the long-term performance and strategic outcomes. Short-termism is the phenomenon that usually exists at an expense of the company's long-term objectives as it causes insufficient attention to be paid to long-term value creation and the strategy of the company. As long-term objectives are crucial to the company's survival and further operations, it is highly important not to neglect long-term focus.

Besides discouraging long-term value creation, short-termism may also negatively influence long-term investments. Many companies postpone large long-term investments in pursuit of short-term figures and do not replace obsolete or damaged equipment. Consequently, this also leads to deteriorations in the production process, as well as reduced efficiency and quality.

Finally, looking at the problem from the global prospective, some researchers assume that global economic downturn points to short-termism of financial organizations and lenders as a fundamental cause. Probably, this may be explained by the snowball effect — when one company engages in short-term behavior, other companies follow the same pattern causing the whole industry's credibility to be undermined. Furthermore, if short-termism is present on a global level, it does not take long time for serious consequences to appear.

RECOMMENDATIONS

In order to mitigate negative impact of short-termism, we recommended implementing three-part model. The model was developed on the basis of analysis provided and mainly refers to internal processes and conditions.

First part of the model includes promotion of long-term value creation that enables executives and employees to fully understand importance and process of wealth creation and benefits that long-term horizon focus enables for company's performance and strategic success. Establishment of appropriate balance between internal and external perspectives, short-term goals and long-term strategic objectives assists in enhancing sustainable development of the company in the long-term. This balance consequently improves company's value for money consisting of economy, efficiency and effectiveness. Focus on long-term strategy and incentives enables the management to find optimal ways of organizing operational activities and also to achieve stated objectives in the most efficient way. Methods of promotion include deep understanding of business environment; improvements in communication processes; forward-looking strategic measures; de-emphasis on short-term financial performance; changes in the reporting framework towards more strategic one; application of integrated reporting; and proper corporate governance.

Second part of the model includes remuneration system based on balanced scorecard. Remuneration system that supports long-term focus and mitigates short-termism impact should promote sustainable growth of the company rather than exclusively short-term accounting benefits, and thus it requires a reasonable proportion of compensation to be in an equity-based form. Remuneration system should be initially developed in accordance with four perspectives: financial, customer, internal process, and learning and growth. System should encompass strategic objectives, measures, targets and strategic actions corresponding to each perspective. It is necessary to rationally set strategic objectives in individual areas within the framework of strategic balanced scorecard system. In order for short-termism to be mitigated by the balanced scorecard application, it is necessary to ensure that targets and consequent performance rewards sufficiently represent and guarantee fulfillment of strategic outcomes. Moreover, it helps employees and executives to understand important interrelationships and connections.

Third part of the model includes establishment of internal controls and forensic accounting function. This function should ensure foreseeing, preventing and eliminating accounting and finance limitations created by excessive short-term outlook in a timely and effective manner. Internal control system and forensic accounting element should be introduced so that they are able to detect and prevent fraudulent activities imposed by short-termism. Supervision of internal control effectiveness should be regularly made for estimation if controls still operate and whether new risks require amendments in internal control procedures. This part of the model may be practically implemented only if control processes are regularly performed and ethical principles are being followed.

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