

The Bottom Line on Earnings Guidance

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A very important goal for public companies is to maintain continuing communication with the investment community regardless of market cap. Earnings guidance is one form of periodic communication. Providing analysts and investors with a sense of what the company anticipates in terms of earnings is important, but even more essential for those without an analyst following is to provide investors with a range of anticipated earnings.

Earnings guidance should not be viewed in isolation. Instead, companies should view guidance holistically to include financial and non-financial trends, industry specific information, key factors that drive value for the company, quantitative information on relevant business measures and long-term vision and strategy.

Why Companies Are Reviewing Their Earnings Guidance

Companies periodically review their earnings guidance policy. Some boards of directors are also requesting such a review. Recently the issue of earnings guidance has been placed in the spotlight because of a recommendation by U.S. Chamber of Commerce's independent, bipartisan "Commission on the Regulation of U.S. Capital Markets in the 21st Century to:

"Convince public companies to stop issuing earnings guidance or alternatively, move away from quarterly earnings guidance with one earnings per share (EPS) number to annual guidance with a range of EPS estimates."

See the companion piece, The Genesis Perspective – "What You Should Know About Earnings Guidance" for more detailed information about causes of short-termism, details of earnings guidance research, a discussion of whether to guide or not to guide, and specific lessons from Regulation FD cases.

Unfortunately, the independent commission's recommendation paints the issue of earnings guidance with a broad brush, suggesting there is a one-size, fits-all approach. A company's decision to provide earnings guidance – quarterly or annualized – is NOT a one-size, fits-all policy nor does it fit all public companies' interests or needs. What does fit is to maintain open communication with the investment community through guidance of some form.

Using earnings guidance as a primary means of communicating with investors is particularly important for the 35 percent of listed companies that have no analyst coverage. Moreover, the SEC says that 83 percent of companies with a market cap less than \$125 million have no research coverage. For these companies, guidance is needed to attract and retain investors. And, as the sell-side continues to shrink, coverage for the smaller cap companies is going to become an even more acute issue as they look for effective ways to attract investors.

Earnings Guidance Research

Following implementation of Regulation FD in October 2000, with its focus on earnings guidance, the academic community began to explore the relationship of guidance to stock price volatility, analyst coverage and related issues. The National Investor Relations Institute in 2003 began surveys to determine trends in guidance. This research has found:

- About 70 percent of companies are providing earnings guidance with a clear trend toward annualized guidance with quarterly updates. Conversely, there has been a commensurate decline in the percentage of companies providing only quarterly guidance.
- Relatively few companies are considering dropping earnings guidance with about half of those concerned that if they were to do so, they would lose analyst coverage.
- Most companies that no longer provide earnings guidance are providing considerable information in the form of industry specific information, trends that impact the business, statements about high-level performance measures and key value drivers along with long-term vision and strategy.
- Firms that stopped earnings guidance had experienced poor performance and anticipated the same going forward. They also had a spotty record of meeting or beating analysts' forecasts, experienced managerial changes and anticipated difficulty in predicting earnings.

- Once firms had stopped earnings guidance and were free to concentrate on the long-term, they did NOT increase capital investments and R&D. Nor, did they increase disclosure using alternative forms of guidance.

Legal and Regulatory Implications

Securities Law

Securities law affecting how companies provide guidance is based in the '33 Securities Act, the '34 Securities Exchange Act and the '95 Private Securities Litigation Reform Act and evolving case law.

The Securities Act of 1933, Sections 11 and 12 impose liability on issuers, their officers, directors and underwriters for making misstatements of material fact or if they should omit material facts necessary to avoid a misleading statement.

Under the Securities Exchange Act of 1934, Rule 10b-5 provides a similar liability but from a plaintiff's standpoint, the burden of proof is higher. This rule applies to statements made in securities offerings, periodic reports and more frequent communications between issuers and the investment community.

When companies "bespeak" caution, they are more likely to lower risk of a negative judicial outcome by creating a safe harbor in which the risk factors are relevant to the forward-looking statement as opposed to "boilerplate" language.

Duty to Update

A duty to update guidance stems from case law as opposed to securities law. Case law obligates a company to update using public disclosure means should there be a material change that renders the statement to be materially inaccurate (even if the original statement was accurate at the time). There is no specific time limit for updating material changes once the company receives them on a real-time basis.

Companies will sometimes state in their earnings releases that they undertake no obligation to update their guidance. However, it is a best practice, once the company determines there has been a material change and has enough information to explain it, to issue a news release noting the changes.

Reaffirming Earnings Guidance

When the SEC brought a case against Flowserve Corporation's CEO for allegedly reaffirming earlier guidance in a meeting with a small number of analysts, this caused many companies to reconsider their policies with respect to reaffirming guidance in non-public settings or situations. Some have chosen not to reaffirm guidance at all in these situations. Others will not do so much more than a week following published guidance.

The best practice is to state your guidance in the earnings release, discuss it in the Web cast earnings conference call but do not reaffirm it in subsequent private meetings or conversations.

Regulation FD Lessons

Since October 2000 when the SEC passed Reg FD, the Commission has brought six cases, two of which involved the same company, Siebel Systems, the second of which was dismissed by the 2nd federal circuit court judge. Meanwhile, there have been tens of thousands of conversations and meetings between companies and their analysts/investors in which issuers are helping investors understand the company better by communicating the company's strategy and discussing many other factors that fund managers use in making their investment decisions. The SEC understands this give and take between companies and their analysts/investors and only the more egregious cases are pursued.

Overall, companies have adopted best practices and procedures to comply with Reg FD. (See the full white paper for lessons learned from these cases). Among these are:

- Any material guidance must be issued in a news release, not provided one-on-one to analysts.
- Companies should ensure that their presentations at analyst and investor conferences are Web cast since the SEC considers a fully accessible Web cast as a means for full disclosure
- If material information is inadvertently disclosed in a closed meeting with analyst and/or investors, promptly issue a news release containing that information within 24 hours or sooner.

- The IRO should maintain proper disclosure controls by developing a written disclosure policy in conjunction with the general counsel that reflects corporate behavior – not a wish list of ideals. An educational program should be implemented to ensure that all persons covered by Reg FD are intimately familiar with the policy and follow it.

Conclusion

As companies become increasingly mature in their life cycle and gain an analyst following, they should consider moving to annualized guidance with quarterly updates. In either case, holistic guidance, including earnings, should be viewed as an essential element of a company's communications with the investment community

About Genesis

Genesis is a business consultancy that helps clients discover their unique points of difference and leverage them to achieve measurable business results. Genesis also provides strategic investor relations and integrated communication services. Our 360-degree view of the communication disciplines is based on our belief that communication is a strategic function when it supports corporate business goals, is integrated to combine cumulative impact with the most efficient use of resources and its effectiveness can be measured.