

COMPLIANCE WEEK

The Rationale For Giving Earnings Guidance

By Louis M. Thompson, Jr., *Compliance Week Columnist* — December 19, 2006

It's always a good practice for companies to review their corporate-disclosure policy—preferably a written document—at least annually. For calendar-year end companies in particular, now is a good time for the disclosure committee to review your company's disclosure policy and recommend appropriate changes.

One of the practices that is getting increasing attention in the C-suite and the boardroom is earnings guidance—whether to provide earnings or revenue guidance at all, and if so, how often (annual, quarterly, or both) and whether you should provide a range of estimates or a point estimate.

From a historical perspective, it was just more than 30 years ago that the Securities and Exchange Commission allowed companies to put forward-looking information in their filed documents. As companies were desirous of “managing expectations,” earnings guidance became part of their disclosure regimen. When the market became institutionalized in the late 1980s, the sell-side investment banks played a much more prominent role than they do today, providing research recommendations to their brokers and selling their research to the buy-side banks. Having their finger on the earnings pulse was very important. Knowing whether companies could meet their estimates was also important to the buy-side.

In the early 1990s, one consequence of earnings guidance was the shareholder strike suit filed on behalf of shareholders when a company missed the Street's “consensus” number—particularly on the downside. More than 90 percent of the companies would opt for a settlement rather than encounter the expense of a long court battle. In 1994, of the more than 300 cases filed that year, the average corporate settlement was around \$8 million.

A coalition of associations representing publicly held companies and the major accounting firms sought congressional action to raise the bar so that plaintiff lawyers had to bring some evidence to the table that the company intentionally provided investors with fraudulent information—particularly when it came to earnings guidance. (In full disclosure, I served as media

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Prior to joining NIRI, Thompson was assistant White House press secretary to President Gerald Ford.

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In December 1995, Congress passed the Private Securities Litigation Reform Act, and in a matter of days overrode the President's veto. One vital provision in the act was a safe harbor giving companies the opportunity to provide forward-looking information, so long as investors were warned that there were risks that the prospective information might change.

But companies that provided earnings guidance were not yet out of the woods. In 1998, then-SEC Chairman Arthur Levitt gave a landmark speech in New York during which he chastised companies for engaging in the game of "winks and nods" with the analysts who were seeking selective information, particularly relevant to earnings expectations. Soon after Levitt's speech, the SEC began crafting Regulation Fair Disclosure, which the Commission adopted on Oct. 23, 2000. A major focus of Reg FD was on the practice of discussing earnings guidance in one-on-one meetings with investors. The Reg FD implementing release specifically said that persons covered by the rule were at great risk of violating Reg FD if they discussed their earnings guidance with analysts or investors in one-on-one situations.

So what has happened to earnings guidance over the past six years? By now, most companies know what they can and cannot do under Reg FD; indeed, only seven cases have been brought against companies for FD violations.

Meanwhile, the National Investor Relations Institute has conducted three surveys of earnings guidance practices—in December 2003, March 2005, and March 2006. These surveys show a clear trend toward annualized earnings or revenue guidance, and away from quarterly guidance. In one year, of those companies that provide earnings guidance, those issuing only annualized guidance rose from 28 percent to 42 percent. Those providing only quarterly EPS guidance declined from 28 percent to 13 percent. While a third of the 654 companies surveyed provide no EPS guidance at all, they still provide qualitative statements about trends and factors that impact corporate performance, and in some ways provide a framework for analysts and investors to come to their own conclusions about potential earnings.

While the NIRI surveys and the McKinsey 2006 survey show a trend away from quarterly earnings guidance, both demonstrate that more than half of companies still provide earnings guidance, though most are moving toward annualized guidance.

In July 2006 the Business Roundtable Institute for Corporate Ethics and the CFA Center for Financial Market Integrity issued a report on "Breaking the Short-term Cycle." (I was a participant in the roundtable discussions leading to the report.) One recommendation to curtail the short-term focus on corporate performance was to end the practice of providing quarterly earnings guidance. The report urged companies that see a strategic need to provide such guidance to adopt a consistent format, along with a range of estimates and metrics that reflect long-term goals and strategy.

So, what should companies do in reviewing their disclosure policy with respect to guidance?

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1. Analyze your ability to forecast quarterly and annual EPS estimates based on your internal forecasts. Then examine how well you do with respect to the Street's estimates on a quarterly and annual basis.
2. If you have a relatively good track record at forecasting, you should continue to provide some form of guidance, preferably annualized guidance with a quarterly update of your EPS or revenue range. Providing a range of estimates is far more preferable than a single number or point estimate. The 2006 NIRI survey shows that only 5 percent of companies forecast a point estimate.
3. Do *not* reaffirm your publicly announced guidance in subsequent private meetings. If someone asks if you are still comfortable with what you last said publicly, simply say, "Our policy is that we do not reaffirm previously announced guidance in non-public meetings."
4. If you are presenting at an investor conference, be sure it is webcast so you can answer questions that might elicit a response containing new material information. The Webcast should protect you for the moment from a Reg FD violation, but then promptly issue a news release containing any new material information you discussed.
5. Whether or not you provide EPS or revenue guidance, I invite companies to consider "guidance" in a much broader context—a holistic context of how you run your company. Consider giving non-earnings guidance to assist analysts in arriving at their estimates and recommendations, and to aid investors in making an investment decision. This might include:
 - trends that may impact the business of your company;
 - qualitative statements about market conditions affecting your company;
 - a discussion of your strategy to achieve near- and long-term growth; and
 - qualitative statements about key performance factors that drive shareholder value in your company.

CEOs have long complained about the market's short-term focus and how that inhibits them from taking a longer-term strategic view of running their companies. There is little doubt that quarterly EPS guidance has contributed to that phenomenon. But the fact remains that a strong majority of companies believe that the practice of providing guidance satisfies the needs of analysts and investors and keeps an open channel of communication with the investment community. As a fundamental part of this communication process, companies would be well served—as the market becomes more globalized and investor informational needs more diversified—to adopt a holistic approach to guidance, going well beyond focusing on earnings.

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