

## What You Should Know About Earnings Guidance

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**Why Provide Earnings Guidance** A very important goal for public companies is to maintain continuing communication with the investment community, regardless of market cap. Earnings guidance has evolved into an important component of a company's investor and analyst communications. Guidance is a window into the company's plan for revenues and expenses, an important data point for analysts.

With only a third of listed companies having an analyst following, providing them 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 what the company anticipates in 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.

### **A Reopening of the Earnings Guidance Issue**

The recent U.S. Chamber of Commerce's independent, bipartisan Commission on the Regulation on U.S. Capital Markets in the 21st Century has placed the issue of earnings guidance once again in the spotlight.

The issue of quarterly earnings projections as a causal factor for short-term management behavior in running their companies was also the focus of the Commission's recommendations on quarterly earnings guidance. Specifically, the recommendation was 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."*

Associated with that report was an op-ed piece in the March 3, 2007 New York Times titled “Reporting for Duty” by Robert Pozen, a member of the Chamber’s commission, former head of Fidelity Asset Management and now a professor at Harvard University. Mr. Pozen concluded his opinion piece saying, “If we want American companies to take a long-term approach, we must help chief executives free themselves from the tyranny of projecting quarterly earnings. Of course, American executives will still feel pressure to meet the Wall Street consensus on quarterly earnings. But that pressure will be much lower if company chiefs are not trying to meet their own public predictions.”

Mr. Pozen cited a National Bureau of Economic Research report of 401 senior financial executives where “80 percent said they were willing to forego spending on research and development to meet their predictions, while 55 percent were willing, for the same reason, to delay projects that promise gains in the long term for their company.”

### **Other Causes of Short-termism**

It is important, in looking at the earnings guidance issue, to step back and ask the question: Is earnings guidance the main factor causing companies to take a short-term view of operations and performance?

The 2006 CFA Institute Center for Financial Market Integrity and the Business Roundtable Center for Corporate Ethics white paper, “Breaking the Short-Term Cycle,” looks not only at the corporate side of the issue, but takes a hard look at the incentives for short-term behavior coming from the analyst/investor side. Most of the incentive compensation programs for asset managers are short-term focused, i.e. quarterly. This point cannot be overly emphasized in examining the causes of the short-term phenomenon, particularly as this puts pressure on companies to guide on a quarterly basis since the investor side is being evaluated quarterly.

This short-termism task force had four recommendations to deal with this:

1. “Align corporate executive compensation with long-term goals and strategies and with long-term shareholder interests. Compensation should be structured to achieve long-term strategic and value-creation goals.
2. “Align asset manager compensation with long-term performance and with long-term client interests.
3. “Improve disclosure of asset managers’ incentive metrics, fee structures, and personal ownership of funds they manage.

4. “Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.”

Now, a relatively new factor has entered the picture that has significant potential to impact short-term vs. long-term corporate behavior. CFO magazine’s editor-in-chief, Julia Homes, opined in the April 2007 issue that various surveys show that the average CFO’s tenure ranges from a mere 17 to 48 months. “Reeling from the Sarbanes-Oxley blues, backdating scandals and intense pressure to perform, CFOs (and their bosses) are vacating their offices at an alarming clip,” Ms. Homes wrote.

Citing the most recent Duke University/CFO Business Outlook Survey, Holmes said that, “...nearly 90 percent of (CFO) respondents admit that business decisions are often based on tenure considerations. That is, people don’t develop strategies for the long term, because they don’t expect to be around to see them reach fruition.” She also noted the migration of public company CFOs to the private equity side with its longer-term horizons and bigger paychecks.

We are seeing the same tenure trends among CEOs. That combined with a growing number of risk-adverse boards of directors that are looking over their shoulders at Sarbanes-Oxley compliance more than they are looking ahead and advising senior management on long-term strategy, is also affecting the short-term issue.

At the same time, we are witnessing a more fluid shareholder base, particularly with the impact of the hedge funds, some of which are very short-term investors while only a few are focused on the longer term.

### **A Walk Through the History of Guidance**

In examining the issue of guidance, it is important to look back to the era of the 1960s and 70s when there was little in the way of earnings guidance and what there was varied widely. Analysts at that time found it more difficult to make their earnings estimates resulting in higher stock-price volatility and greater dispersion of analysts’ estimates. And, research that will be cited later demonstrates these same phenomena with respect to companies that more recently have stopped providing earnings guidance.

Looking back at the disclosure environment of that era, those who were on the buy- and sell-side say that while there was some information that might be called guidance coming from a few companies, it varied widely. Many companies did not even meet with analysts and, others who did, provided very little information or “color.”

Some who were then on the sell-side can name on one hand the number of companies that invited analysts in for periodic briefings – companies like Control Data, Hewlett-Packard, IBM, Burroughs and AMP. One cited AMP’s IRO as an example. Bill Oakland, a pioneer in the IR field, was the company’s only contact for analysts. AMP ran one analyst meeting a year in which all of senior management was on display, but Bill was available throughout the year, according to Chuck Hill, former head of Thomson’s First Call. He said Oakland would provide earnings guidance for the year and the quarters in terms of a range. As the reporting period neared, the range was narrowed to a couple of pennies and then a single figure. Hill said there were never any reporting surprises at AMP and no volatility in the stock following a quarterly report.

On the other hand, Hill recalls that Hewlett-Packard provided nothing in terms of revenues or margins – only likely tax rates and other income. The result, he said, was a lot of volatility following each quarterly report. The company ran two analyst meetings a year between Palo Alto and New York but gave no guidance or segment data.

For some sell-side analysts, the game was providing multiple-years of P&L estimates, for which no company guidance was provided, that might not be realized. In this regard, Polaroid comes to mind.

Sam Jones, former chief investment officer for Trillium Asset Management, recalls that with the development of the semi-conductor in the late 1960s, start-up companies begged for a new medium to “evangelize” their growth prospects. The electronics conferences became that means and from those conferences emerged the concept of “breakout sessions.” Jones recalls that it was not until the late 1970s that the broker-sponsored annual conferences sprang up – Hambrecht & Quist, Montgomery Securities and Adams Harkness & Hill, for example. These mass meetings gave way to broker-sponsored tours for the sell-side analysts’ best clients that became recognized as venues for “selective disclosure.”

Once the SEC in 1978 provided companies a safe harbor to make forward-looking statements in filed documents, earnings guidance and managing analysts’ earnings expectations became part of the corporate disclosure regimen. From the sell-side analyst’s perspective, it became very important to have a finger on the earnings pulse in order to advise institutional clients and their retail investors on the likelihood that a company would meet its earnings estimates.

Some of this guidance was provided selectively to certain analysts and was not always made fully public. Company investor relations officers or financial executives guided analysts by reviewing their earnings models and the assumptions that led to their earnings estimates and recommendations. Legal counsel often advised against this practice citing the *Elkind v. Liggett & Myers, Inc.* case whereby engaging in the review process, the company became “entangled” with the analyst’s conclusions and recommendations. Yet, the practice continued in many instances. Congress, in passing Section 501 in the Sarbanes-Oxley Act, sharply curtailed what companies can now do in reviewing analysts’ reports.

In the 1980s, the plaintiff’s bar began using the SEC’s Rule 10b-5 as a basis for suing companies that missed their estimates, alleging the companies’ executives defrauded their investors with rosy projections. The proliferation of these shareholder lawsuits in the early 90s caused many companies to curtail projections to avoid strike suits under 10b-5.

Shareholder strike suits became a “business” for about six major plaintiffs firms around the country. A typical scenario was as follows: A company would miss the Street’s earnings consensus number – normally on the downside resulting in a 20 percent decline in stock price. Within hours, one of these firms would file a strike suit against the company and several of the other plaintiffs’ firms would pile on alleging senior management defrauded its investors. Plaintiffs’ names were plucked from a list of shareholders and there were many instances where the plaintiffs were not even aware they were named.

Over 90 percent of companies, rather than fight these cases in court, settled at an average cost of \$8 million. The plaintiff firms took some 30 percent of the settlement and the shareholders represented in the suit received mere pennies. In the early 90s, over 300 of these strike suits were filed each year.

In 1993 the business community went to work with Congress to create a bi-partisan bill that would raise the evidentiary bar so that plaintiffs’ lawyers would have to provide some evidence that company executives “knowingly” defrauded their investors. With the passage of the 1995 Private Securities Litigation Reform Act, a more comprehensive “safe harbor” was created that provided the opportunity to provide forward-looking information so long as the company listed factors that might cause these statements to change. This additional protection kept the door open to continuation of earnings guidance.

Some of the other egregious practices on the part of the plaintiffs’ bar were dealt with in the PSLRA, such as requiring the plaintiffs to certify that they were aware they were named plaintiffs.

Then in 1998, former SEC Chairman Arthur Levitt, in a speech before the Financial Executives Institute, labeled the earnings guidance process a “game of winks and nods” between companies and certain analysts, thereby creating an un-level playing field. The SEC then began crafting draft rules for Regulation Fair Disclosure. While professional associations representing the analyst/institutional investor side, along with securities lawyers, opposed the proposed Regulation FD largely based on the fear that the rule would severely chill information that companies would be willing to share with the investment community.

As President and CEO of the National Investor Relations Institute (NIRI), it became clear to me that the Commission would adopt a rule in some form to deal with selective disclosure. So, I advised the NIRI board of directors that we work with the SEC staff to help them craft a rule that corporations could live with. We were largely successful. The underlying premise of Reg FD was that if you as a company had something material to say, you said it to all – full and fair disclosure. To help ensure this, Reg FD allows the fully accessible Web cast to serve as a means for full disclosure of an earnings conference call or other investor forums.

Given this background, one can see that while quarterly earnings guidance may be a contributing factor to short-term behavior, it is clearly not the only the factor. The quarterly compensation incentives for analysts and investors comprise another causal factor. Once the PSLRA provided companies with a safe harbor for providing forward-looking information, earnings guidance became an important factor in maintaining open communications between companies and the investment community.

Using earnings guidance as a primary means of communicating with investors is particularly important for the 1,200 top-tier NASDAQ companies and 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.

### **What Research on Earnings Guidance Indicates**

Following the SEC’s adoption of Regulation FD, with its emphasis on earnings guidance, the academic community became interested in the trends in earnings guidance as well as the affect that guidance or the lack of guidance was having on stock price volatility, analyst coverage and other related factors. The National Investor Relations Institute also began tracking trends in earnings guidance in 2003.

## **NIRI Surveys**

The first survey on earnings guidance in 2003 established a baseline for future surveys. The organization surveyed 686 respondents, representing a cross-section of market-cap and exchange listings, and found:

- 77 percent provided earnings guidance with only 9 percent providing a single point estimate and 75 percent providing a range of EPS. Seventy percent of the 23 percent that did not provide earnings guidance, maintained their communications with analysts by providing various market and company related trends and other forms of “soft guidance” to aid analysts in arriving at their estimates.
- Of the 77 percent that provided EPS guidance, 53 percent did so quarterly, 16 percent annually and 22 percent provided both. 80 percent said they would update their guidance using a news release during the quarter should there be a material change.
- Nineteen percent said they were considering discontinuing EPS guidance and 27 percent believed if they were to do so, they would lose analyst coverage while 49 percent said that decision would have no impact on their coverage.

### **The March 2005 survey found:**

- There was a slight decline in the number of companies providing EPS guidance, to 71 from 77 percent. We began to see an increasing trend in the percentage providing annual guidance, to 61 from 53 percent.

### **The March 2006 survey found:**

- There was a significant increase in the percentage of companies providing annualized EPS guidance to 82 from 71 percent and a decline in the percentage providing quarterly guidance, to 52 from 61 percent. Those providing only quarterly guidance declined, to 13 from 28 percent, and those providing only annual guidance rose to 43 from 28 percent.
- The percentage that was considering discontinuing EPS guidance was only 14 percent. Forty seven percent attributed this to a change in management philosophy, 27 percent said industry trends and 25 percent said low earnings visibility were reasons to discontinue earnings guidance.

### **The June 2007 survey found:**

- A majority (71%) of survey respondents provide quantifiable financial measurements with 77% of those providing EPS guidance and 71% giving revenue guidance.
- Consistent with the 2006 survey, the trend continues with more companies providing annualized guidance than quarterly estimates.
- With respect to discontinuing earnings guidance, the largest percentage of respondents reported indifference on the part of the buy- and sell-side to the decision, a neutral effect on valuation, no increase in stock price volatility, and no substantial change in the short position.

### **Summary**

Some 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 affect the business, statements about high-level performance measures and key value drivers, along with long-term vision and strategy.

### **McKinsey & Co. Research**

McKinsey & Co. conducted a survey in 2006 showing:

- That three-fourths of participating companies were providing earnings guidance and 48 percent were doing so on a quarterly basis.
- 83 percent said they have no plans to change their guidance policies and two-thirds said they have not changed the frequency of their guidance in the past three years.
- More than three-fourths of the companies providing EPS guidance say that the practice helps to satisfy the demands of analysts and investors and slightly fewer attribute the value of guidance to be a means for maintaining a channel of communication with analysts and investors.

- There was much less of a consensus on other benefits such as intensifying management's focus on achieving financial targets, moderating the volatility of the company's share price, achieving higher valuations, building a wider shareholder base and increasing liquidity.
- When looking at the costs of providing guidance, 53 percent cited management time and 42 percent cited focus on short-term earnings.
- As to consequences of reducing the frequency of EPS guidance, 46 percent cited a decrease in company visibility as analysts reduce coverage and 41 percent said their share price would become more volatile. If EPS guidance were eliminated, 56 percent said the company's visibility would be negatively affected and 46 percent cited increased share price volatility.

Subsequent to the above survey, The McKinsey Quarterly published a paper, "The Misguided Practice of Earnings Guidance," by Peggy Hsieh, Timothy Koller and S. R. Rajan in McKinsey's New York office. Their analysis of 1,600 companies with market caps of \$500 million across all industry sectors found NO support for benefits executives attributed to providing EPS guidance such as higher valuations, lower share price volatility and improved liquidity.

Their analysis of 126 companies that stopped providing EPS guidance found:

- That they were nearly as likely to see higher as lower Total Return to Shareholders (TRS) compared with the market. 68 had a lower TRS compared with the market but these companies also experienced a lower Return On Invested Capital (ROIC).
- Of the 47 companies that stopped providing guidance when ROIC was increasing, only 18 experienced a TRS lower than the market.

In answering the question: 'To guide or not to guide?', the authors said, "With scant evidence of any shareholder benefits to be gained from providing frequent earnings guidance but clear evidence of increased costs, managers should consider whether there is a better way to communicate with analysts and investors.

The authors added, "We believe there is. Instead of providing frequent earnings guidance, companies can help the market to understand their business, the underlying value drivers, the expected business climate and their strategy – in short, to understand their long-term health as well as their short-term performance. Analysts and investors would then be better equipped to forecast the financial performance of these companies and to reach conclusions about their value."

## **Summary**

While the McKinsey research closely mirrors the NIRI research on the percentage of companies providing earnings guidance and the relatively low percentage that are considering dropping earnings guidance, their study focuses on the costs of providing guidance, citing management time and focus on the short term. About half of the survey respondents say that if earnings guidance were eliminated, the company's visibility would be negatively impacted and their share price volatility would increase.

## **University of Washington Business School Study**

An October 2006 study by University of Washington business school professors Shuping Chen, Dawn A. Matsumoto and Chiva Rajgopal, "Is Silent Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance" investigated 96 companies that publicly renounced quarterly EPS guidance between October 20 (post passage of Regulation FD) and January 2006. They found:

- That stoppers had poor trailing stock return performance and lower institutional ownership and poor prospects for future performance.
- After eliminating guidance, stock prices led earnings with less frequency but there was no change in overall stock return volatility or analyst following.
- Analyst forecast dispersion increased and forecast accuracy decreased following firms' decision to stop guiding, despite increased disclosures made in earnings press releases.
- That 24 of the 96 companies that announced they were stopping quarterly EPS guidance switched to annualized guidance.

The researchers said, "It is interesting to note that only a small number of firms have chosen to stop guiding the market despite calls from prominent regulators and academics encouraging firms to do so. The relatively small number of firms that have stopped providing guidance points to the high perceived costs of bucking the general trend of providing guidance."

## **Summary**

Of the small percentage of companies that stopped earnings guidance, most were poor performers. Once they stopped, they found an increase in stock price volatility and a greater dispersion of earnings estimates resulted from that decision. Contrary to expectations, they found no significant loss of analyst coverage. Lastly, a fourth of the companies that stopped quarterly EPS guidance switched to annualized guidance.

### **Baruch Lev Research**

Noted accounting professor, Baruch Lev, at the Stern School at New York University, along with his finance and accounting colleagues from the University of Florida, Joel F. Houston and Jenny Tucker, similarly found that firms that stop providing guidance have a poor record before they eliminate guidance, and when this record improves, guidance tends to be resumed. Their January 2006 study is titled, “To Guide or Not to Guide? Causes and Consequences of Stopping and Subsequently Resuming Earnings Guidance.”

Their sample of 222 firms that had routinely provided earnings guidance but stopped:

- Had poor earnings, both past and anticipated.
- Had a spotty record of meeting/beating analysts forecasts, experienced managerial change, low frequency of guidance in the firm’s industry, and past and anticipated difficulty in predicting earnings were the major reasons for stopping earnings guidance.

As a consequence of stopping guidance, they found, contrary to the University of Washington study, that analyst following decreased yet it found similarly to the same study that analyst forecast dispersion and forecast error increased.

Importantly, Lev, Houston and Tucker reported that, “contrary to frequent claims by managers and commentators, we found that guidance stoppers, allegedly free of the market myopia shackles to focus on the long-term, do not increase capital investments and R&D after stopping guidance. Our findings do not support the frequent claims that guidance stoppers increase alternative forms of forward-looking disclosure.”

“Finally, 31% of sample stoppers resume guidance, particularly those most negatively affected by the stopping decision. All in all, our findings are not consistent with the widely claimed benefits from guidance cessations.”

### **Summary**

The 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.

This study found that analyst following decreased once EPS guidance stopped, but found similar results to that in the University of Washington study pertaining to an increase in analyst forecast dispersion and forecast error.

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.

## **Determining An Earnings Guidance Policy**

Companies, from time to time, review their earnings guidance policy. Lately, some corporate boards have also asked for such a review. These reviews have resulted in a number of companies going to annualized guidance from quarterly. A few have discontinued providing earnings guidance but continue to provide other forms of guidance.

Unfortunately, recommendations from the U.S. Chamber of Commerce “Commission on U.S. Capital Markets in the 21st Century” paint the issue of earnings guidance with a broad brush when it recommends that companies eschew quarterly EPS guidance, suggesting there is a one-size, fits-all solution to short-termism.

The CFA Centre for Financial Market Integrity and the Business Roundtable for Corporate Ethics paper “Breaking the Short-Term Cycle” urges corporate leaders, asset managers, investors and analysts to reconsider the benefits and consequences of providing and relying on focused, quarterly earnings guidance and each group’s involvement in the “earnings guidance game.” (I served as a member of this task force.)

*Yet, the task force recognized that companies go through a life cycle, “... where an early-stage, small-capitalization company with a shorter-term product/service cycle is likely to be covered by few analysts and may need to raise capital from the financial markets over a regular time frame (e.g., every two to three years). In today’s capital markets, such a company may not have the strategic option of providing less than quarterly guidance.*

“As the company grows and/or diversifies its products, services and markets, however, it can tolerate potential fluctuations in volatility and investor sentiment that may occur with less frequent earnings guidance. Still later in the corporate life cycle, the company may have matured to the point of focusing on managing the business for the long term and have little need to provide earnings guidance to outside sources.”

The bottom line is that the company decision to provide earnings guidance – quarterly or annualized – is NOT a one-size fits-all solution to the short-termism issue nor does it fit all public companies’ interests or needs. What does fit all companies’ needs is *to maintain open communications with the investment community through guidance of some form.*

When you look at the large body of smaller cap public companies that have no sell-side coverage, their needs to provide guidance for those who are reading their earnings releases and listening to the company can be paramount.

Starting with the Gillette Corporation that stopped quarterly earnings guidance six years ago and sent the first shock wave through the corporate and investment community, the subsequent well-publicized decision in December 2002 by the Coca Cola Company was the one that raised the issue of whether to provide earnings guidance to a new level. While Coca Cola temporarily reversed that decision during a quarter when the market expectations were substantially different from the company's, it has basically stuck to its guns on the issue. Yet, Coca Cola contends that the company is providing even more information than before through substantial non-earnings guidance that includes information about:

- Qualitative statements about market conditions
- Trends that affect the business
- Industry specific information
- Quantitative information on relevant business measures
- Statements about high-level performance measures
- Key value drivers but not all factors that might be in the internal financial forecasts
- Long-term vision and strategy

This is the kind of information that allows highly skilled analysts to differentiate themselves and the value they provide their clients.

A significant number of large-cap companies no longer provide earnings guidance but contend they look at guidance more holistically as in the above kinds of non-financial information. Warren Buffett has clearly had an impact on this trend as CEO of Berkshire Hathaway and a board member of Gillette, Coca Cola, and The Washington Post Company, all of which focus on long-term strategy and no longer provide earnings guidance. Others that have followed suit are Intel, Dell, USA Interactive, McDonalds, Motorola and Pfizer. Today, more than 50 large-cap companies no longer provide earnings guidance. Progressive Insurance has never done so but issues a great deal of financial information, including a full P&L monthly and essentially says to analysts – here it is, make your estimates.

*In making a determination of whether to provide earnings guidance, you should analyze your ability to forecast quarterly and annual EPS estimates based on your internal forecasts. If you are making a decision to continue earnings guidance, compare how well you have done historically with respect to the Street's estimates on a quarterly and annual basis.*

*If you have a relatively good track record at forecasting, you should continue to provide some form of guidance, preferably annualized with a quarterly update of your EPS or revenue range. Providing a range of estimates is preferable to a single number or point estimate.*

## **Legal and Regulatory Implications for Guidance**

### **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 as well as 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. As mentioned in the section on historical perspective, plaintiffs' lawyers used this rule to sue companies when there was a shortfall in projected results. That was until the Private Securities Litigation Reform Act of 1995 that created the Safe Harbor for forward-looking statements so long as those statements were accompanied by appropriate cautionary language giving reasons that could change the projections.

In *Racheedi v. Cree Research*, the judge held that, even though the factor that caused the company's quarterly results to decline was not mentioned in the safe harbor, the company made clear that there were risks involved in making the investment and that constituted a sufficient warning to investors.

*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 sees a material change and has enough information to explain it, to issue a news release noting the change. Otherwise, the company's credibility with analysts/ investors could be damaged if it waits until the next periodic release to do so. In the short term, Wall Street tends to punish companies for negative surprises and in the long term, it punishes companies for poor performance and a lack of credibility.*

### **Regulatory Implications of Reaffirming Earnings Guidance**

For a period of time after implementation of Regulation FD, some companies felt comfortable reaffirming their published guidance in one-on-one meetings with analysts/ investors, so long as they believed the published guidance was still relevant.

That changed 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. The CEO was cited for making the reaffirming statement, and the IRO, who was present at the meeting, was also cited for not stopping the CEO from making the statement.

The company had published annualized guidance in January 2003, lowered its guidance in July 2003, again in September and October. In the November meeting with analysts, which was a month after the published adjustment in October and six weeks prior to the end of the fourth quarter, the reaffirmation of no change from the October statement was viewed as good news, given the downward trend, and resulted in a 75 percent increase in the small firm's trading volume.

This case 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, if necessary, in the Web cast earnings conference call but do not reaffirm it in subsequent private meetings or conversations. If you are asked in non-public situation, "Are you still comfortable with your previously stated guidance?", simply say, "What we said in our earnings release was effective at that time." If there is a material change in the guidance, issue a news release noting that and, if possible, explain why.*

### **Other Regulation FD Lessons**

Since October 2000, when the SEC passed Regulation 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. Overall, companies have adopted best practices and procedures to comply with Reg FD. So, what are the lessons?

- Once you issue earnings guidance publicly and after a few weeks see that the analysts' consensus is different from where you believe it should be, you must not go to them individually and provide them material nonpublic information to help them bring their estimates in line with the company's estimates. (Raytheon Company and Franklyn A. Caine, November 25, 2002. *A company should provide that information in a news release and furnish that release in an 8-K.*)
- A CEO or any other spokesperson addressing a broker-sponsored conference that is NOT Web cast for public access cannot make a material statement about prospects that differs from what had been publicly disclosed. If the statement was inadvertent, the rule provides an opportunity to promptly disclose the new information in a news release (normally within 24 hours) to remedy an inadvertent disclosure. This does not help if the disclosure is intentional. (SEC v. Siebel Systems, Inc., November 25, 2002) *Companies should ensure that their presentations at analyst and investor conferences are Web cast which allows the spokesperson to go into new material information, if necessary or in response to a question, since the SEC considers a fully accessible Web cast as a means for full disclosure.*
- A CEO or other corporate official meeting individually with major investors cannot disclose material non-public information without promptly issuing a news release, particularly if that information results in major trading of the company's shares by investors attending the meeting. Even if the spokesperson believes that the information

disclosed was already being talked about in the marketplace, the major trading activity within hours of the meeting should be a strong signal that there was a material disclosure thus requiring issuance of a news release. (SEC v. Schering-Plough Corporation, September 9, 2003) *If material information is inadvertently disclosed in a closed meeting with analysts and/or investors, the company must promptly provide that information in a news release within 24 hours, preferably much sooner.*

- The Investor Relations Officer must “...maintain disclosure controls and procedures designed to ensure proper handling of information that is required to be disclosed in reports filed or submitted under the Exchange Act, and to ensure that management has the information it needs to make timely disclosure decisions.” (SEC v. Siebel Systems, Inc., June 29, 2004) NOTE: Based on an appeal, the 2nd federal circuit court judge overturned the second case against Siebel Systems saying that the SEC was parsing the words of the CFO who allegedly made more optimistic statements to a small group of investors than had been made publicly. The judge, however, did not take issue with the SEC’s contention that the IRO is responsible for maintaining proper disclosure controls. *The IRO should maintain proper disclosure controls by developing a written disclosure policy in conjunction with the general counsel and making sure that all people covered by Regulation FD are intimately familiar with the policy and follow it.*

The SEC warned in the implementing release to Regulation FD, that discussing earnings with analysts/investors was where companies would be most vulnerable in violating the new rule. For the most part, companies have adapted to Regulation FD and have learned how to handle discussions of earnings through the quarterly earnings releases and Web cast conference calls.

So, it is important to remember that every day, there are literally thousands of conversations and meetings between companies and analysts/investors in which issuers are helping investors understand the company better, communicating the company’s strategy and the means they will use to accomplish that and discussing many other factors that fund managers use in making their investment decisions. The SEC and self-regulatory organizations understand this give and take between companies and their analysts/investors and only in the more egregious cases as cited above are companies sanctioned.

### **Additional Best Practices**

Have a written disclosure policy that reflects corporate behavior – not a wish list of ideals that may not be followed.

Most companies have a written disclosure policy that incorporates guidance policy – how often you provide guidance and whether and how you will update that guidance should there be a material change. If you choose not to update during an earnings cycle, be it quarterly or annually, you should explain your policy that you will not comment on guidance during the quarter or the year depending on how frequently you issue earnings guidance. However, it is a good policy to update your guidance publicly when there is a material change. The market does not like negative surprises and to wait until the end of a reporting period to spring a change in guidance can negatively affect a company's credibility.

Establish a Disclosure Committee and ensure that the chief investor relations officer is a member of that committee given that most IROs are heavily involved in disclosure decisions.

Limit the number of corporate spokespersons for consistency and credibility it is best to limit the number of corporate spokespersons.

Protect CEOs and CFOs from disclosing material, non-public information by having the IRO, or someone else who is familiar with the company's disclosure policy, be present when the CEO and CFO (or other spokespersons covered by Regulation FD) are speaking with analysts or investors.

This is to ensure that there is no intentional disclosure of material nonpublic information and, if there is an inadvertent disclosure, the information is promptly issued in a news release or, as a minimum, in a Form 8-K filing. (SEC v. Flowserve Corporation and C. Scott Greer – Chairman & CEO, March 24, 2005)

Script and rehearse the spokespersons who present during quarterly conference calls, investor conferences and other analyst/investor events and script and rehearse anticipated questions and answers.

Make sure the above forums are Web cast.

Institute a “no comment” policy with respect to questions about market rumors and stick to it. The best way to say “no comment” is to say, “It is company policy not to comment on market rumors.”

Do not distribute analyst reports to investors or the media as this can imply an endorsement of the report.

## **Conclusion**

Maintaining continuing communication with analysts and investors is the bedrock of a successful investor relations program. A major component of that process is guidance. With the continuing decline of the sell-side, an increasing number of companies will lose sell-side coverage. This void can be at least partially filled by providing realistic earnings and holistic guidance directly to the buy-side.

The real challenge facing CEOs and CFOs is to avoid the temptation to manage their earnings to meet quarterly market expectations. There is little doubt that this short-term behavior can erode a company's long-term strategy for growth and share value creation. Couple this with the more frequent turnover of CEOs and CFOs in today's Sarbanes-Oxley environment, a vicious cycle is created where their replacements are also looking at a relatively brief tenure to create long-term value.

## **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.

I wish to acknowledge the invaluable input from my Genesis partner Debbie Kelly, particularly an historical perspective from her years as an analyst during the 1970s (an era for the most part void of guidance) before moving to the corporate side as the senior investor relations and corporate communications executive in several Fortune 500 corporations. She leads the Genesis investor relations team and serves on the board of directors for Purdue Farms.