Guiding the Misguided: *A Discussion of Earnings Guidance*

To guide or not to guide? Issuers are consistently faced with this question. Oftentimes, they possess valuable and up-to-date information regarding their companies' future earnings forecasts; however, is it wise to disclose this information to the market in the form of guidance forecasts? While sharing guidance with the market has an upside, there are also a number of (negative) implications to consider before releasing this type of information…

In July 2016, 13 of the most prominent U.S. institutional investors and CEOs, including Warren Buffet of Berkshire Hathaway, Jamie Dimon of JP Morgan Chase and Larry Fink of Blackrock[1], met to create the *COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE*. This document discusses important corporate governance principles, such as Shareholder Rights and Board of Director composition, that aim to "drive the best governance practices through companies of all sizes, not just the biggest – where they are more common today"[2]. Specifically, the group's intent focused on offering smaller companies the benefit of their experience from running some of the most prominent institutions in the country today. However, the document also addresses quarterly reporting and earnings guidance, stating the following:

> A company should not feel obligated to provide earnings guidance – and should determine whether providing earnings guidance for the company's shareholders does more harm than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.

That is compelling advice from a group that has created billions in shareholder value. Nevertheless, while there is no right or wrong answer regarding the topic of issuing or abstaining from providing earnings guidance, there is certainly a lot of pressure from the market to do so and arguments from the legal and corporate side *not* to do so. Analysts and investors outright demand some form of guidance in order to build their models and create forecasts. In fact, the

[1] Others included Tim Armour of Capital Group, Mary Barra of General Motors Company, Mary Erdoes of JP Morgan Asset Management, Jef Imelt of GE, Mark Machin of CPP Investment Board, Lowell McAdam of Verizon, Bill McNabb of Vanguard, Ronal O'Hanley of State Street Global Advisors and Brian Rogers of T.Rowe Price.

[2] Glenn H. Booraem, fund treasurer,Vanguard

practice of issuing guidance is believed to mitigate the number of shareholder lawsuits, as guidance can offer the market more information to work with and thus allow issuers to more actively "manage expectations"[3]. Additionally, some investor relations officers argue that "how can you be an effective IRO without providing some sort of guidance". The fact remains that refusal to issue formal guidance, leaves companies to contend with erroneous or inaccurate consensus estimates and analyst reports. This can lead to uncertainty about the future company performance and thus, higher stock volatility.

Guidance is information a company provides as an indication or estimate of its future earnings. It is an "expected result" communicated by a company to shareholders and market watchers as to how it envisions a future period turning out. Such guidance typically includes revenue estimates, along with earnings, margins and capital spending estimates; it is also known as "earnings guidance."

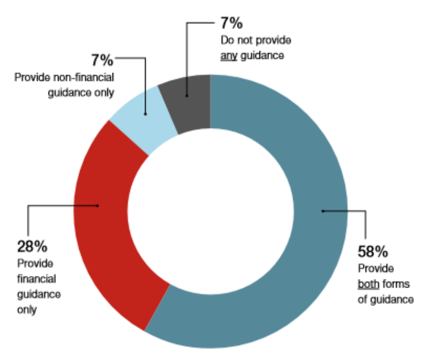
In fact, most U.S. companies issue some type of guidance, whether it is quarterly or annually, hard or soft, financial or non-financial. A study conducted by the National Investor Relations Institute (NIRI) in 2014[4] concluded that providing guidance was actually on the rise, with 94% of the respondents claiming that they provided sort type of guidance (vs. 88% in 2012). Indeed, it has been i-advize's experience that most clients in Latin America (over 30 active clients as of the date of the report) actually do report some sort of forward-looking information aimed at managing expectations and keeping up with their industry peers. Even those who claim that they "do not issue guidance of any form" actually *do* give some sort of outlook that may be construed as forward-looking statements, in their conference call speeches, investor meetings and/or corporate presentations.

On the flip side, opponents of this practice, mainly comprised of legal counsel and issuers themselves argue that **providing earnings guidance "wastes management's time, encourages short-term thinking, creates significant short-term pressure to achieve earnings targets and creates complex and challenging disclosure issues for companies"[5]**. As a result, and particularly during times of crisis, many companies modify their practice of providing guidance or cease it completely.

Types of Guidance

There are different types of forward-looking statements, or guidance, which are used by issuers to manage expectations. These include non-financial (soft) guidance, which employ alternative metrics for reflecting growth, such as volumes generated, new markets, number of clients, key developments, strategy/outlook, long-terms goals and operating ranges. On the other hand, many companies opt for financial (hard) guidance, which is more concrete, such as earnings per share, EBITDA and net income targets. In the aforementioned NIRI report, (see pie chart) 58% of

FIGURE 1: Type of Guidance Provided



Source: *2014 NIRI Survey Report on Guidance Practices*. N=416. Compiled by NIRI, September, 2014.

[3] Shari Meehan, Investor Relations Officer of American Eagle Outfitters (retailer) as quoted in the February 2015 issue of *IR update Magazine*.
[4] NIRI Survey Report of Guidance Practices 2014
[5] Corporate Finance Alert, Skadden, Arps, Slate, Meagher & Flom LLP – September 2012

the surveyed companies stated that they provide *both* financial and non-financial guidance. Generally speaking, we have seen that this is true in Latin America, as companies use both, hard financial and soft strategic outlook to provide a clearer picture of the future to The Street.

Companies may also opt to provide formal guidance *quarterly* or *annually*. Quarterly forecasts may be appropriate for some industries that are less seasonal and easier to predict such as companies that have an established track record and therefore can predict, short-term performance. This short termism, however, does place a heavy emphasis on guidance and can be an extremely time consuming endeavor for the investor relations department. A 2012 study performed by Francois Brochet, associate professor of accounting at Boston University, George Serafeim, associate professor of Business Administration at Harvard University and Maria Loumioti, assistant professor at MIT Sloan School of Management[6] on short-termism suggests that companies issuing more frequent and regular guidance (in other words, on a quarterly-basis) exhibit a more short-term oriented shareholder base, and acts as a magnet to market participants that pressure for short-term results. This, in turn, can lead to an undesired increase in stock volatility.

More common is the annual guidance practice, which shifts the focus to a longer term perspective and can be less onerous on management's time. It has been our experience that in Latin America, a longer perspective is more realistic and manageable than a shorter term forecast. In fact, short-term forecasts are rarely seen in this region. Globally, the current trend is that more and more companies are discontinuing quarterly guidance and substituting it with thoughtful disclosure about their long-range strategy and business fundamentals. In this manner, companies can uphold their commitment to creating long-term, sustainable shareholder value while aiming to encourage their investors to adopt a similar outlook.

Despite the current preference for annually guidance, however, companies must find out what is the best alternative for them. The type of guidance issued depends on the company's ability to accurately forecast its performance and communicate it effectively to the market.

Regulators' Position on Guidance

The Securities and Exchange Commission (SEC) has no official regulation that obligates public companies to provide any form of guidance. However, its objective has always been to encourage wider, clearer and more accessible disclosure practices that protect the rights of all investors and promote a fair and honest market. As such, in the past 15 years, the SEC has taken several measures aimed at improving the way issuers disclose material information in order to make information more widely available to the market.

For instance, on June 4, 2010, the SEC published a rule under Question 101.1[7] of the Compliance and Disclosure Interpretations (C&DIs) further explaining how issuers can talk about earnings guidance without triggering Regulation FD's public reporting requirements. The rule narrows the window for permissibly confirming or updating prior public earnings guidance on a selective basis; making emphasis that any material information regarding guidance must be provided to the public at the same time as the analysts.

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[6] Short-termism: Don't Blame Investors, June 2012, Francois Brochet, George Serafeim and Maria Loumioti

7 Regulation FD, Question 101.01 of the Compliance and Disclosure Interpretations (updated June 4, 2010), available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm ; and article Practice Pointers on Earnings Guidance by Morrison Foerster, June 2015 available at https://www.mofo.com/resources/publications/practice-pointers-on-earnings-guidance.html

Pros and Cons

Every situation is unique, and many factors must be taken into account prior to deciding whether or not to issue earnings guidance to the market. After carefully studying the pros and cons, companies must ensure that the benefits gained by issuing earnings forecasts are tangible enough to outweigh the costs. Following are some pros and cons:

PROS	*CONS*
• Reduces uncertainty as it gives insight on strategic plans and progress. • Aligns management and market expectations. • Can lead to a more fair valuation of the company's stock as the market has a better understanding of outlook. • Released prior to weak earnings can be a mitigating factor in shareholder lawsuits. • Increased transparency and credibility can support the wider sell side analyst coverage and shareholder base.	• It can be time consuming for management and the investor relations department. • Must be updated, otherwise can become "misleading information". • Can lead to an overreaction by investors when management misses its quarterly forecasts. • Encourages short-termism.

Questions to consider if your company is considering issuing guidance:

1. ***Are you able to accurately forecast earnings given your company's business lifecycle?***

If the company is in a fast-growth mode or the business growth is hard to predict because it is undergoing a restructuring process or significantly invested in path-changing R&D (i.e. certain technology companies) you may be unable to accurately forecast performance compared to more established peers. If this is the case, consider your limits and really think about whether or not this practice is a good option. Giving out unreliable guidance will do more harm to your stock than good and furthermore, it can lead to management losing market credibility. Instead, refrain from issuing guidance until the company has reached more stability and has more data to accurately forecast results.

2. ***Are your internal forecasts really accurate?***

Provide guidance when you feel comfortable that your internal forecast closely resembles the *actual* quarterly/annual results. Find out whether your predictions are "nailing it" by comparing your own forecasts to the actual results for a number of periods. In the event that they differ significantly, review the drivers and key elements used in your analysis that caused the discrepancy. If these are external factors that management cannot control, consider abstaining from issuing guidance, for example, until external conditions have stabilized, making it easier to predict future results. Similarly, if analysts' consensus estimates or individual forecasts differ significantly from management's calculations or consistently miss actual results, this may be an indication that the market is missing a critical piece of information.

3. What are the guidance practices in your industry?

Take a look around your industry and analyze if you are the only company providing or not providing guidance. Just because everyone else does doesn't mean you have to; however, the market will expect some level of information from your company. You will have to have valid reasons why you are the only one who does not. Perhaps your company is newer and doesn't have an adequate track record, or maybe your company is unique within its own industry.

If you cannot provide financial forecasts but your peers do, consider providing a breakdown of the primary growth drivers of each business segment of the company. Soft guidance, can offer The Street qualitative information that is not as precise but can still guide the market in analyzing the company's future outlook. This way, management can respond to market expectations to receive a certain level of disclosure from you and the industry.

4. Will the practice of issuing guidance help the issuer avoid Selective Disclosure?

Guiding analysts about the future is permissible under Regulation FD (which is a disclosure rule). However, issuers are at a high risk of violating Reg. FD when they engage in private discussions on forecasts with analysts and investors; and need to be alert to the specific language used. Seemingly benign comments regarding the company's future outlook could be in violation of this law. For instance, the SEC brought enforcement actions to company executives that confirmed previous earnings guidance, corrected analyst projections[8] and disclosed information at investor conferences that differed from previously disclosed earnings guidance.[9]

Useful tips on avoiding Selective Disclosure in connection with earnings guidance

1. Designate a limited number of company personnel to communicate with the market about future plans and prospects.

2. Have prepared remarks reviewed by your legal advisors and stick to the script.

3. Don't be afraid to say "no comment" in response to questions or to deflect uncomfortable questions by restating the company's guidance policy.

The sole act of issuing guidance doesn't make companies immune to committing Selective Disclosure. In fact, companies will have further rules to comply with. Question 101.1[10] of the C&DIs states that, following the release of earnings guidance, management must assess if selectively confirming forecasts prior a new public release will provide some level of material information. Its materiality will depend on the amount of time that has lapsed between the original forecast and the confirmation, and on any intervening event that would call into question the earnings guidance.

Therefore, avoid using comments such as "not changed", "still comfortable with" or even reference to a prior forecast during one-on-one meetings, as these statements are no different than confirming earnings guidance.[11]

Duty to Update

It is crucial that management teams understand that once they've provided guidance to the market, they have a responsibility to adjust that guidance the moment it is no longer accurate. While this is not a formal securities law *per se*, "when a statement remains alive in the minds of investors, there may be an implicit representation that the company will update the statement if

[8] SEC v. Raytheon Company, SEC Release No. 34-46897 (Nov. 25, 2002), available at: http://www.sec.gov/litigation/admin/34-46897.htm. See also SEC v. Schering-Plough Corporation and Richard J, Kogan, SEC Release No. 34-48461 (Sept. 9, 2003), available at: http://www.sec.gov/litigation/admin/34-48461.htm; SEC v. Flowserve Corporation, C. Scott Greer, and Michael Conley, SEC Release No. 34-51427 (Mar. 24, 2005), available at: http://www.sec.gov/litigation/admin/34-51427.pdf; SEC v. Christopher A. Black, SEC Release No. 60715 (Sept. 24, 2009), available at: http://www.sec.gov/litigation/admin/2009/34-60715.pdf; SEC v. Presstek, Inc. and Edward J. Marino, SEC Release No. 21443 (Mar. 9, 2010), available at: http://www.sec.gov/litigation/litreleases/2010/lr21443.htm; and Motorola, Inc., SEC Release No. 46898 (Nov. 25, 2002), available at: http://www.sec.gov/litigation/investreport/34-46898.htm, also refer to footnote 7

9 SEC vs. Siebel Systems, Inc. SEC Release No. 34-46896 (Nov. 25,2002), available at: http://www.sec.gov/litigation/admin/34-46896.htm ; also refer to footnote 7.

10 Regulation FD, Question 101.01 of the Compliance and Disclosure Interpretations (updated June 4, 2010), available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm

11 idem

there is a material change in the underlying facts”[12]. Therefore, it is common practice that companies update any guidance quickly to avoid any misrepresentations or erroneous information.

Changes in guidance can result from economic downturns (or upturns), mergers or acquisitions, natural disasters, management changes, among various other factors. The Duty to Update practice is important not only for its benefits regarding maintaining credibility but also for its ability to minimize potential information leaks, the number of shareholder lawsuits brought on by “misleading information” and /or inadvertent selective disclosure during meetings.

In the NIRI survey cited previously, 94% of the surveyed companies stated that they currently update their financial earnings guidance in the event of both positive and negative material changes. We consider that adherence to the Duty to Update principle is crucial to maintaining market credibility and garnering long-term market loyalty.

Some Tips on Issuing Earnings Guidance

1. Guidance is material information; communicate in the form of a press release or in the quarterly conference call.
2. Don’t let the excitement of good news cause you to “hype” the stock. Rather, guide on key value drivers that you can continue updating.
3. If guidance is leaked in a one-on-one meeting or in another selective disclosure situation, remediate the information by issuing a press release immediately.
4. Guidance doesn’t have to be financial; you also may use soft guidance to manage market expectations.
5. Be prepared to update guidance as needed (duty to update).
6. Be consistent: Don't guide in good times and abstain in bad.
7. Don't try to “game” guidance. You'll lose credibility if you release conservative guidance just so you can beat your own earnings estimates later on.
8. When possible, issue guidance ranges.
9. Clearly explain your reasoning behind the forecasts.
10. Aim for annual versus quarterly guidance to minimize stock price fluctuations and encourage a long-term perspective.

[12] Corporate Finance Alert, Skadden, Arps, Slate, Meagher & Flom LLP – September 2012