



IR Strategy Series

Is Earnings Guidance Disappearing in 2006?

Of all the issues facing senior management, few provoke as much consternation and debate as that of earnings guidance. Each quarter, media and analyst coverage of corporate financial performance fixates on a single issue – Did the company make, miss or beat The Number?

CEOs and CFOs recognize that missing the “consensus” earnings per share target can have devastating impacts on their share price. Some companies feel that wild fluctuations in firm value caused by a single quarterly data point confirm that the market is short-sighted, if not irrational. And many commentators have opined that the pressure to make inflated earnings estimates led companies down the slippery slope from earnings management to aggressive accounting practices and outright fraud.¹

Recently a small but highly visible number of blue-chip companies have declared that they will no longer provide EPS guidance so as to “focus on the long term.”

- In 2003, Coca-Cola announced that beyond the March 31, 2003 first quarter they would stop providing earnings per share estimates because of “the unpredictability of the telecommunications industry these days.”
- The day before, McDonald’s Corporation reported that “the company is focused on delivering improved results over the long term. Therefore, the company will not be providing earnings per share targets by quarter or for the year.”

Other notable companies announcing similar decisions recently include Progressive Insurance, The Washington Post, and Gillette. These developments raise several important questions for CEOs, CFOs and the directors of public companies:

- Is the reduction or elimination of earnings guidance the beginning of a growing trend?
- Will small-cap companies follow the lead of those large-cap examples?
- If guidance is reduced, will this reporting approach contribute to increased share price volatility?
- How will the new regulations being promulgated by the SEC, Nasdaq and the Exchanges change the climate of guidance?
- And, what other variations to quarterly earnings guidance are available to companies that don’t provide EPS guidance?

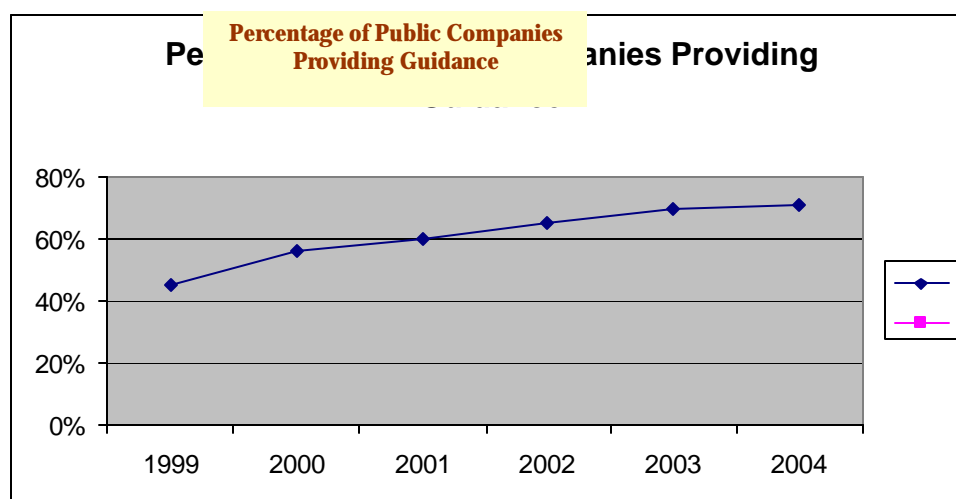
In this paper, we review the current literature and some alternative approaches that are being taken to providing guidance so as to identify the range of options and best practices in the important subject of “managing earnings expectations.”

It is an undisputed principle of American corporate governance that management’s primary responsibility is to achieve the highest *sustainable* value for the company’s shareholders. Sustainable is

italicized to emphasize its importance. Overstating earnings or inflating a company's business prospects may drive up stock value in the short-term, but these actions inevitably result in the destruction of shareholder value once unmasked. This distinction was missed by commentators who suggested that efforts to maximize shareholder value led to the excesses that produced Enron and WorldCom.

Several prominent executives have taken the point of view that traditional forecasts of quarterly and annual EPS figures can blind management to the true drivers of long-term shareholder value. Barry Diller, Chairman of USA Interactive, said when announcing the elimination of guidance, "The process [of guidance] has little to do with running a business, and the numbers can become distractingly and dangerously detached from fundamentals."² As a result, these companies have developed alternative modes of providing forward-looking information that hew more closely to the key operating metrics they use to run the business. For example, USA Interactive has moved towards providing investors with a detailed, unfiltered budget for the coming year, so that analysts can see how the company looks from the driver's seat. Quarterly results are then reconciled against management's own internal plan.

Despite the well publicized instances of major companies that have discontinued providing guidance, the broad trend in corporate disclosure is towards more, not less, forward-looking information. A recent survey by the National Investor Relations Institute found that 71% of companies are now providing some form of guidance, up from 45% in 1999.



NIRI Survey of S&P 500 Public Companies, 2004

Providing forecasts of future financial performance entails a number of costs, including the effort to gather and analyze the information, damaged credibility if the forecasts prove inaccurate, and the perceived increased risk of securities litigation. Evidently, the majority of public companies have decided that these costs are outweighed by the benefits of providing guidance.

Finance theory suggests that such information contributes to the efficient functioning of the capital markets: "Reducing investor uncertainty about future corporate performance can contribute to increased shareholder value. Reduced investor uncertainty occurs when information asymmetries, which is when different market participants have different levels of information, is reduced. Therefore, enhanced public disclosure has the effect of reducing the risk premium for securities, which in turn lowers the cost of capital and allows the company to be more competitive in its marketplace."³

Even without the benefit of research studies, common sense suggests that investors will gravitate toward equities when high-quality information is consistently delivered into the marketplace. Because equity prices largely discount future earnings and cash flows, management estimates can play a powerful role in determining investor expectations and stock performance. However, even the best forecasts are inherently uncertain and open the possibility for disappointed expectations.

Recent Trends in Guidance

In analyzing the seemingly conflicting approaches to providing guidance, it would be helpful to review some of the recent trends in corporate disclosure.

During the 25-year period from 1970 to 1995, the process of managing earnings expectations was largely driven by legal considerations and the influence of the sell-side security analyst. As the markets grew in size during this period, they attracted greater numbers of individual shareholders and became inherently more volatile. The plaintiffs' bar capitalized on such volatility with increased levels of class-action lawsuits. The number of class-action lawsuits increased from 150 cases in 1990, with an average settlement of \$6 million, to 350 in 2001, with an average settlement of \$16 million. The combination of large settlements and rising insurance rates had the effect of sharply reducing the practice of public guidance as an "asset protection" and "litigation avoidance" strategy.

In response to the tide of frivolous lawsuits, the Private Securities Litigation Reform Act of 1995 was passed, providing a disclosure safe harbor for companies. As described by the Securities and Exchange Commission, "an important goal of the Act was to encourage companies to disclose forward-looking information to investors while affording considerable protection from shareholder lawsuits."

At the same time, the ranks of sell-side security analysts working for broker-dealers ballooned, supported by a very active IPO market and significant increase in business-oriented programming on radio and television. This created the "celebrity analysts" such as Mary Meeker of Morgan Stanley Dean Witter and Jack Grubman of Salomon Smith Barney, who had the power to move markets for company securities through their research and public announcements.

The combination of fear of litigation and a well-oiled sell-side machine led many corporate managers to provide earnings forecasts primarily through their interaction with analysts, rather than by offering public guidance. This enabled well connected security analysts to disseminate "independent" projections of future performance that were not directly attributable to the company. Management then had the flexibility to agree, disagree or ignore such outside forecasts. This practice also allowed management to bestow favors on institutional investors by shading the quantity and quality of information from one investor to another.

The abuse of this practice of "selective disclosure," which favored certain investment professionals at the expense of broad investing public, led to an important reform of corporate disclosure—Regulation Fair Disclosure (Reg FD). Adopted in 2000, Reg FD mandated approved ways for companies to communicate directly and/or simultaneously with shareholders, instead of using analysts as intermediaries. As a result, the vast majority of companies began to provide public earnings guidance and communicated such guidance directly to the investment community in quarterly releases and conference calls.

The specificity of such guidance reflected the company's own predictive capability, volatility in earnings and the depth of sell-side coverage. Companies that provided no guidance whatsoever soon found that the range of high and low analyst estimates for future periods began to drift further and further apart – with a corresponding increase in share price volatility. The further the spread between high and

low estimates, the less meaningful the “consensus,” or mean estimate, reported by First Call becomes to investors. And small-cap companies with little or no analyst coverage found they had no other practical way to issue corporate disclosure except to provide direct guidance.

However this pattern of communication, while reducing selective disclosure, created an abuse all its own, in which guidance announcements were used as a mechanism for stock promotion. A recent study by the Federal Reserve suggested that aggressive guidance practices during this period resulted in “ill-advised actions aimed at fulfilling these unrealistic expectation(s)—notably value-destroying acquisitions and investments. When the fiction finally became obvious, the result was massive adjustments in earnings and growth projections and consequently in equity valuations.”⁴

This reversal of the excesses developed in the late 1990’s, combined with the poor business climate that followed and the character-building process following the passage of the Sarbanes-Oxley Act in 2002, often put management in the embarrassing position of backtracking on or changing guidance within the quarter and/or within the year. This embarrassing inability to communicate credible future trends in markets and earnings has led to the current debate as to whether guidance creates more problems than value.

“Companies that refuse to provide guidance will be at a permanent disadvantage in the competition for investor attention and be forced to operate with a higher cost of equity capital and reduced opportunities for growth. Thus the question facing small and mid-cap companies is not whether to provide guidance, but at what level to provide guidance.”

However, it is far too early to report that corporate guidance has died. Rather, guidance practices are simply evolving.

A careful analysis of the “no guidance” announcements suggests that McDonald’s Corp., Coca-Cola, AT&T and others are really targeting two goals. First, they are replacing specific (often missed) quarterly earnings-per-share guidance targets with more detailed Outlook or Goals sections in their earnings releases. These disclosures identify market drivers, operating margin and cash flow targets, and capital expenditure plans, thus allowing investors to extrapolate specific revenue and earnings-per-share numbers for future results that the company is unwilling to disclose. Second, they have made the decision to favor longer-term or “value” investors as their core shareholder constituency, as opposed to growth or momentum investors who might afford a higher valuation in return for more aggressive guidance policy.

Earnings Guidance Still Valuable

Despite the media attention accorded to the select number of blue-chip stocks that have opted out of the “guidance game,” the practice of providing meaningful forward-looking information to analysts and investors is not going away any time soon.

In setting guidance policy, companies have two important decisions to make: ***how specific*** to

be in providing forward-looking information and ***how frequently*** to issue and update it.

As one of the most critical aspects of a company’s disclosure practices, guidance policy should be precisely tailored to fit with the overall business strategy, market conditions, operational realities and management’s communication style. As a general rule, companies should provide whatever level of information they consider to be useful to

investors, to provide a reasonable indicator of future performance, and to be useful in understanding or supporting the company's business strategy.

In making this determination, senior management and the board should look carefully at the following issues:

- **Revenue stability** – How much of the company's revenues are recurring or long-term in nature? What is the size, duration and quality of backlog? What component of forecasted growth depends on new customer wins? How much visibility does the company have into customer budgeting decisions?
- **Expense predictability** – What proportion of expenses is variable versus fixed? Is the company subject to major swings in materials costs, labor or overhead expense? How quickly can the expense structure be adjusted?
- **Operational controls** – What has been the historical variance of actual revenues from internal plan? How mature are the lines of business? Has the company recently completed an acquisition or changed management?
- **Sensitivity analysis** – Does the company operate in a cyclical industry? How sensitive are revenues and margins to growth in GDP, changes in interest rates or capital spending?
- **Risk factors** – What are the major risks or contingencies that could cause actual results to vary from forecasts? What material events must occur for guidance to be realized? Can these risks be identified, communicated, managed for and/or hedged?

By carefully working through these questions, companies can determine where they belong on the continuum from short-term, qualitative guidance to longer-term, more detailed, highly specific forecasts of future results.

Summary

The question of guidance has become more complex and more important than ever before. Clearly, small-cap companies without broad analyst coverage will enhance management credibility and shareholder value by providing guidance. The degree of guidance is based on a number of company-specific factors, including: the confidence management has in its short- and long-term internal forecasts; industry conditions: the degree of recurring versus non-recurring business; and the maturity of business forecasting processes and internal controls.

The following best practices will aid in effectively managing guidance expectations so as to achieve the highest sustainable shareholder value.

1. **Disclose assumptions along with earnings forecasts.** If a forecast is provided, use a range rather than a specific number. Further, provide the underlying assumptions – such as industry growth rates, pricing trends and materials costs – that will allow management the flexibility to adjust if conditions change.
2. **Identify key indicators that support guidance provided.** By disclosing reliable forward-looking indicators such as book-to-bill ratio, backlog, design wins, customer inventory levels, and qualified pipeline, companies can enhance the credibility of their forecasts and provide investors with components to reach accurate independent assessments.
3. **With non-specific guidance, provide sufficient detail for investors to reach credible conclusions.** This information should include data on business units, product lines and global geographies. Additional information should be provided on capital expenditures, share buybacks, and assumptions regarding the deterioration or recovery of market conditions.

4. ***Integrate guidance with formal disclosure practices.*** Under provisions of Sarbanes-Oxley, public companies are now required to evaluate and certify the adequacy of the “disclosure controls and procedures” they use to gather, analyze and disseminate material information. For most companies this has meant moving from an informal process to one that can be described, documented and tested for reliability. The corporate guidance policy should be formally documented and formulation of guidance should be administered by the Disclosure Committee in consultation with the Audit Committee and the board.
5. ***Survey analysts and investors as to their informational needs.*** In deciding what type of forward-looking information to disclose, it is a good idea to survey the end users of that information as to their needs. For example, an increasing number of analysts may expect management to provide forecasts of cash generation, capital expenditure, share repurchases, option issuance and other non-earnings metrics that drive shareholder value.
6. ***Update guidance as market conditions or corporate events dictate.*** In addition to providing greater detail in the guidance they provide, many companies are updating this guidance more frequently in order to communicate material changes in the company’s outlook or to create an atmosphere for meaningful discussions with securities analysts without violating Reg FD. If the proposed expansion of 8-K disclosure items becomes law, this can be expected to accelerate the trend towards “real-time” disclosure.
7. ***In volatile market conditions, provide guidance for elements that are within management’s control.*** As demand for many segments of technology sector collapsed in 2001, many companies responded by withdrawing guidance altogether. A more constructive approach is

to identify which elements of the business are currently too volatile to forecast accurately and then provide targets for those aspects, such as overhead expense, capital spending and research and development, which are clearly within management’s ability to plan and influence.

8. ***Monitor earnings estimates of analysts and peers.*** Estimate providers such as First Call, Zack’s and Nelson’s offer the basis to determine the range of estimates and therefore the range of uncertainty regarding future performance. Management should monitor such estimates in the context of the accuracy of estimates and/or the dispersion or range of estimates. It is also helpful to be aware of the estimates of competitor or peer companies.
9. ***If guidance is not provided, make sure that the company’s strategy to build value and minimize risk is clearly delineated in the annual report, investor website and conference calls.*** Increasingly, information reinforcing the key elements of the company’s business model, investments in technology and training, and operational targets are being reviewed in quarterly and annual earnings releases and discussed in conference calls.

In the absence of any form of guidance, be prepared for the market volatility that is likely to accompany the release of quarterly results in the context of uninformed investors.



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¹ Dr. Min Wu, "Earnings Restatements: A Capital Market Perspective," CFO.com, February 2003

² Joseph Fuller, Michael Jensen, "Just Say No to Wall Street: Putting a Stop to the Earnings Game," *Journal of Applied Corporate Finance*, Vol. 14, No. 4, Winter 2002

³ Christine Botosan, "Evidence That Greater Disclosure Lowers the Cost of Equity Capital," *Journal of Applied Corporate Finance*, Vol. 12, No. 4, Winter 2000

⁴ Gene D'Avolio, Efi Gildor and Andrei Shleifer, "Technology, Information Production, and Market Efficiency," Federal Reserve Bank of Kansas City Symposium, 2001