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FINANCE

Earnings Guidance

How Should Companies Interact With the Market?

By Steven Dolvin, Ph.D., CFA

The Private Securities Litigation Act of 1995 afforded firms enhanced protection from lawsuits associated with the release of earnings forecasts and other material information. As expected, following the passage of this Act, the number of companies providing earnings guidance increased dramatically. For example, in 2007 approximately two-thirds of publicly traded firms engaged in such activity.

More recently, however, the trend has reversed. Firms such as Pfizer, Intel, Motorola, AT&T, Coca-Cola, Google and McDonalds have eliminated their earnings guidance. This change has been supported by well-known investors like Warren Buffett, as well as leading industry groups such as the CFA Institute and the U.S. Chamber of Commerce.

Opponents of earnings guidance cite various reasons for their position. Most importantly, the belief is that earnings forecasts entice both firm managers and investors to take a short-term view of the company, which comes at the expense of long-term value creation. For example, with these official targets in mind, executives might be prone to manage earnings and possibly even forego important long-term investments or research and development expenditures for fear of the market response associated with a shortfall to target.

From an investor perspective, earnings targets may indirectly reduce the extent of analysis performed, as investors are tempted to overlook the complexities of the business and focus on a single number. The result is an increase in volatility for the stock as a short-term divergence from earnings guidance is given more weight than the long-term implication of the root cause of the deviation.

Estimate accuracy

Nonetheless, firms are often hesitant to eliminate guidance simply for fear of backlash from the investment community – and stock analysts in particular. Analysts are fond of guidance, as it provides a baseline for their own forecasts, essentially making their jobs easier. Some investors thus worry that analyst estimates would be less accurate without the guidance, thereby inducing greater stock price volatility as investors respond to actual earnings reports that deviate substantially from the imprecise analyst estimates.

So, the question remains: Should firms eliminate earnings guidance? Unfortunately, the debate, as detailed above, typically focuses on only the extreme positions to this question, leaving no middle ground from which both companies and investors could benefit. Yet, it seems that a simple yes or no decision is not the optimal outcome. For example, published studies find that price volatility subsides after companies eliminate earnings guidance, suggesting that opponents of earnings

guidance are correct.

However, these studies also note that this result is particularly significant during periods of relative stability in firm/market performance (and even more so for larger firms). Thus, smaller firms and those experiencing turbulent times may promote price stability by providing earnings guidance. Similarly, the concern that analyst estimates would be inaccurate may be correct; however, studies show that the propensity of firms to pre-announce (outside of typical earnings guidance) is correlated to the accuracy of the published estimates. Thus, eliminating earnings guidance does not suggest abolishing all material information or discussion of general (or even specific) earnings drivers.



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Going the longer route

There is no “one-size-fits-all” solution to this issue. But, there is evidence that points to what the probable outcome may look like. Although analysts like guidance, surveys suggest most may actually prefer longer forecasts, such as one-year EPS (earnings per share) targets. This seems to be consistent with the feelings of leading CFOs. Further, many participants seem to agree that a single earnings number is not necessary if a sufficient discussion of key performance drivers is provided. So, over time, earnings guidance may progress to a more detailed discussion of firm performance and critical value creation drivers, with actual earnings ranges given on a longer-term (yearly) basis.

The particular issues that need addressed are not the same for every company; thus, each company needs to develop a disclosure policy that is relevant for the characteristics of the particular business and industry. In doing so, however, firms need to make sure that internal measures are structured to match accordingly. For example, elimination of earnings guidance would not reduce the incentive to focus on short-term results if executive compensation is directly tied to quarterly earnings. So, crafting a strategy of market interaction requires detailed thought and integration across more departments than simply investor relations.

INFORMATION LINK

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