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Corporate Governance Update: The Forecast On Earnings Guidance

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Over the past few years, an increasing number of U.S. public companies have discontinued or modified the practice of issuing quarterly earnings-per-share (EPS) guidance and, in the current financial crisis, this trend has accelerated. A recent survey of 1,300 chief financial officers concluded that "the struggle to produce accurate forecasts now tops the list of things that keep them awake at night."[1]

In recent months, more companies have joined the movement away from quarterly EPS guidance in favor of annual forecasts or individua1lized programs of disclosure. EPS forecasts throughout the 1990s and early 2000s were a crucial aspect of share analysis and investor communications, but critics long have maintained that quarterly EPS forecasts support an unhealthy emphasis on short-term results rather than long-term value.

In early May, Unilever made headlines with the announcement, during the release of its first-quarter earnings, that it would not issue financial targets for the foreseeable future and may discontinue them permanently.[2] Other noteworthy public companies currently eschewing quarterly EPS guidance include: Ford, Berkshire Hathaway, AT&T, Safeco, and Gillette.[3] Costco and Union Pacific, among others, have decided not to publish annual earnings estimates for 2009.[4]

A number of other public companies are taking the middle-ground approach of offering less specific guidance. One example is Texas Instruments, which in its first quarter

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[1] "Corporate planning: Managing in the fog: The struggle to make meaningful forecasts in a downturn," The Economist, Feb. 28, 2009, at 67 (describing a global survey by Tilburg University (Neth.), Duke University and *CFO Europe*).

[2] Elizabeth Rigby and Jenny Wiggins, "Unilever Chief Executive Rules out Return to Issuing Financial Targets," FT.com, May 7, 2009. *See also* "Corporate planning: Managing in the fog: The struggle to make meaningful forecasts in a downturn," The Economist, Feb. 28, 2009, at 68 ("'We're not just going to provide numbers for the sake of it,' explains James Allison, the company's head of investor relations.").

[3] "Earnings Guidance," Deloitte Centre for Corporate Governance (Canada) (undated).

[4] "Corporate planning: Managing in the fog: The struggle to make meaningful forecasts in a downturn," The Economist, Feb. 28, 2009, at 68.

2009 earnings release, provided earnings and revenue guidance for only one quarter, with the guidance encompassing a wide range of numbers compared to past estimates.[5]

There is a growing sense that, in the current economic environment, it may, in some cases, be impractical or irresponsible to issue earnings guidance. The chief executive of Manpower, which did not provide a first-quarter EPS estimate this year, stated in an analyst call in February: "We believe it would be cavalier of us to use such a limited visibility to guide to an earnings-per-share range."[6]

Similarly, Intel announced in April that it would not issue formal guidance for the second quarter and, instead, stated only that, for internal purposes, the company was planning for revenue to continue at the same level as the first quarter.[7] Intel's first quarter earnings release noted that "[c]urrent uncertainty in global economic conditions makes it particularly difficult to predict product demand and other related matters and makes it more likely that Intel's actual results could differ materially from expectations. Consequently, the company is providing less quantitative guidance than in previous quarters."[8]

Recent research from the Hackett Group, a management consulting firm, indicates that companies are having trouble estimating cash flow due, in part, to difficulties with drawing down credit and predicting customer demand.[9]

The National Investor Relations Institute (NIRI) recently released a member survey that compiles responses from over 500 public companies regarding earnings guidance, broader financial guidance (other than EPS) and non-financial guidance (including "any information about current market or business conditions that may impact company performance and is not typically reflected in corporate financial statements").[10] The data indicate a small but noticeable downward trend in the number or companies that provide earnings guidance: 60 percent in 2009 compared with 64 percent in 2008 and 77 percent in 2007.[11] In the survey, nine percent of respondents answered that they provide earnings guidance annually, holding basically steady from 10 percent in 2008 and representing a sharp increase from a mere two percent in

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[5] "TI Reports Financial Results for 1Q09," Texas Instruments Press Release, Apr. 20, 2009. TI provided a second quarter EPS estimate of $0.01-$0.15 and revenue of $1.95-$2.40 billion; by contrast, one year ago, TI provided a second quarter 2008 EPS estimate of $0.42-$0.48 and revenue of $3.24-$3.50 billion. "TI Reports Financial Results for 1Q08," Texas Instruments Press Release, Apr. 21, 2008.

[6] David Pitt, "Companies Pull Back on Earnings Guidance," BusinessWeek, Apr. 20, 2009 (quoting Manpower CEO Jeffrey A. Joerres). *See also* Jena McGregor, "GE Stops Giving Quarterly Earnings Guidance," BusinessWeek, Dec. 16, 2008.

[7] "Intel Reports First-Quarter Results," Intel News Release, Apr. 14, 2009. Intel's 2008 fourth quarter profit declined by 90 percent.

[8] *Id.*

[9] *See* Pitt, *supra*.

[10] Guidance Practices and Preferences - 2009, NIRI, May 2009 ("2009 NIRI Survey").

[11] *Id.*; Guidance Practices and Preferences Survey - 2008, NIRI, May 2008 ("2008 NIRI Survey"); NIRI 2007 Earnings Guidance Practices Survey Results, July 2007 ("2007 NIRI Survey").

2007.[12] In 2009, 82 percent of respondents reported providing guidance on other financial performance measurements; 55 percent of respondents provided guidance on non-financial performance measurements.[13]

After a year during which 80 percent of S&P 500 companies revised earnings downward,[14] the current trend toward eliminating or broadening guidance may seem merely self-serving. One recent analysis found that companies are less likely to provide quarterly earnings guidance when past forecasts were overly optimistic, resulted in earnings disappointments or had been followed by increased stock price volatility.[15]

A move toward providing broad ranges of guidance could result in communications that are of little use to analysts and investors and have the same effect as discontinuing guidance completely. Supporters of providing quarterly guidance would argue that eliminating quarterly EPS guidance could increase market uncertainty, reduce transparency and create confusion over numbers that are released, although these impacts can be ameliorated through careful explanation of the rationale for abandoning EPS guidance and further enhancing qualitative guidance on an ongoing, consistent basis.

The Forecast

Companies are beginning to be creative in devising ways to provide guidance without relying on pure EPS numbers. For example, some U.S. companies are using for internal planning purposes "rolling forecasts," which forecast three quarters ahead and add projections for one further quarter.[16] If quarterly earnings guidance can be replaced with specific, though perhaps non-quantitative, disclosures regarding results and trends, it may produce higher quality, more useful information than pure EPS forecasts, thereby increasing overall corporate transparency while still serving the interest of shareholders in long-term value creation and growth.

We noted in 2007 that, as companies move in this direction of providing more qualitative disclosure, as an interim step, they may choose to provide annual guidance in lieu of

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[12] 2009 NIRI Survey, 2008 NIRI Survey, 2007 NIRI Survey. In the 2007 and 2008 surveys, this question required respondents to pick a single answer; in the 2009 survey, respondents could select as many answers as applicable.

[13] 2009 NIRI Survey.

[14] Jena McGregor, posted comment to "GE Stops Giving Quarterly Earnings Guidance," BusinessWeek, Dec. 16, 2008 (citing statistic given by GE).

[15] Mi Feng and Adam Koch, "Once Bitten, Twice Shy: The Relation Between Outcomes of Earnings Guidance and Management Guidance Strategy," March 2008 (available at http://ssrn.com/abstract=932839).

[16] *See* "Corporate planning: Managing in the fog: The struggle to make meaningful forecasts in a downturn," The Economist, Feb. 28, 2009, at 67 ("One benefit of rolling forecasts is that they discourage executives from becoming too fixated on the present at the expense of the future."). According to The Economist, many companies in Europe already use such a forecasting system. *Id.*

quarterly forecasts;[17] some companies appear to be taking this route. One recent analysis of the 50 largest public companies indicated that, while only a handful provided quarterly earnings guidance in 2009, many did provide guidance as to specific line items that they could forecast with confidence, such as operating expenses, capital expenditures, and other company-specific charges and developments.[18]

Companies such as TI, Intel and others are beginning to follow the advice of the Commission on the Regulation of U.S. Capital Markets in the 21st Century (Capital Markets Commission), which in 2007 recommended that public companies "stop issuing earnings guidance or, alternatively, move away from quarterly earnings guidance with one earnings per share number to annual guidance with a range of EPS numbers."[19] They are not alone; in the recent analysis mentioned above, approximately 40 percent of the 50 largest companies provided full-year earnings guidance this year (as opposed to less than 10 percent that provided quarterly guidance).[20]

The Capital Markets Commission's recommendations were echoed in a November 2008 report issued by the Aspen Institute, which promoted a set of best practices designed to create long-term value.[21] Focused on combating the problem of "short-termism," defined as "corporate and investment decision making based disproportionately on short-term expectations and metrics," the recommendations concentrated on long-term strategic planning, communications, earnings guidance, and incentive structures. The Aspen Institute report recommended that companies move toward discontinuing quarterly EPS guidance by, as an interim step, issuing annual earnings guidance in a range.

Further, the Aspen Institute report advocated for consistent reporting of broader financial and non-financial measures that the company uses to track its own performance and an emphasis, during quarterly earnings reports, on long-term strategic goals and plans.

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[17] *See* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Companies Consider Ending Quarterly Earnings Guidance," NYLJ, July 26, 2007.

[18] *See* Lisa A. Fontenot and Brandon W. Loew, "Earnings Forecasts: To Guide or Not To Guide," Law.com, Apr. 29, 2009 (available at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202430152661). The companies selected were the fifty largest based on trailing 12-month net revenue, as compiled by Bloomberg as of March 31, 2009. *Id.*

[19] Report and Recommendations, Commission on the Regulation of U.S. Capital Markets in the 21st Century, Mar. 2007 ("Capital Markets Commission Report") at 7. The Capital Markets Commission is an independent, bipartisan commission established by the U.S. Chamber of Commerce.

[20] *See* Fontenot and Loew, *supra*.

[21] Operating and Investing for the Long-Term: Best Practices in Communications, Guidance and Incentive Structures To Create Value for the Long-Term, Aspen Institute, Nov. 2008 ("Aspen Institute Best Practices"). Signers and supporters include the Aspen Institute Business and Society Program, the Business Roundtable Institute for Corporate Ethics, the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, the CFA Institute Centre for Financial Market Integrity, and the Committee for Economic Development. In 2007, the Aspen Institute released a precursor set of principles in a report titled Long-Term Value Creation: Guiding Principles for Corporations and Investors, The Aspen Institute, June 2007 ("Aspen Principles"), of which the signers and supporters included the Business Roundtable, the AFL-CIO, the Council of Institutional Investors, the five largest audit firms, and top executives at companies such as Pfizer and Xerox.

The report recommended that any changes to a company's guidance practices be announced a year or more in advance to the investment community along with a clear business justification and a clear communication plan to ensure investors that the company would continue to provide quality information required by investors and analysts. Finally, the Aspen Institute report suggested that analysts and investors, in turn, cooperate by clearly identifying the long-term, forward-looking metrics that they would like to see companies provide.[22]

Two Useful Models

For public companies seeking ideas regarding earnings releases that are informative to investors and help to focus analyst and investor attention on fundamentals, there are at least two useful models available: the CFA Institute and Business Roundtable Institute's Model Earnings Release[23] and NIRI's Earnings Release Content.[24] Both emphasize clarity and consistency and offer suggestions for the effective use of non-GAAP financial measures, when necessary. NIRI notes that depending on the industry, the type of information that is relevant to financial guidance will vary.

Both advocates and critics of the practice of issuing quarterly earnings cite the importance of transparency as a justification for their position. The practice of issuing quarterly earnings began in the early 1990s, driven, in part, by demands from institutional investors and research analysts for increased corporate transparency.[25] As EPS numbers began to dominate quarterly earnings releases and a company's failure to meet estimates often meant a significant blow to its stock price, the practice of providing quarterly EPS guidance seemed to have taken on a life of its own.

Reformers such as the Aspen Institute cite the drain on corporate resources that preparing and delivering EPS numbers can entail, including: unproductive time spent preparing the guidance; neglect of long-term business interests in order to meet short-term expectations; distortion of managerial incentives to meet quarterly numbers by any means necessary; a "quarterly results" financial culture focused on the downside and upside of earnings surprises; and macro-incentives for companies to avoid earnings pressure by moving to the private markets.[26]

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[22] Aspen Institute Best Practices at 5.

[23] Apples to Apples: A Template for Reporting Quarterly Earnings, CFA Institute Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics ("CFA Template"), Mar. 2007.

[24] Standards of Practice -- Earnings Release Content, National Investor Relations Institute Working Group on Earnings Releases and NIRI Board of Directors, Sept. 18, 2008.

[25] *See* Built to Last: Focusing Corporations on Long-Term Performance, A Statement by the Research and Policy Committee of the Committee for Economic Development, 2007, at 24 ("CED Report"). The Private Securities Litigation Reform Act, enacted in 1995, created a safe harbor for companies to make certain forward-looking statements, including earnings guidance. With the Securities and Exchange Commission's adoption of Regulation FD in 2000, public companies could no longer provide non-public guidance privately to analysts but generally were required to publicly disclose any material information furnished to analysts or investors, thus eliminating the practice of "selective disclosure."

[26] Aspen Institute Best Practices at 3; CFA Template at 3.

Some of these detrimental impacts from providing quarterly EPS guidance are supported by empirical research.[27] There is a concern that the provision of EPS numbers does not increase transparency, but, instead, serves to distort the picture that is being presented. The Aspen Institute and other supporters of abandoning quarterly earnings guidance believe that focusing on long-term metrics and communicating with investors "on a frequent and regular basis about business strategy" [28] would increase transparency well beyond what is conveyed by a single EPS number.

On the other side of the issue, opponents of eliminating quarterly guidance also cite transparency as a rationale for maintaining guidance. Indeed, one concern facing companies wishing to eliminate quarterly guidance or move to an annual guidance model is that analysts will continue to offer predictions, possibly less accurate, to investors eager for numbers.[29]

Certainly, analysts themselves are not eager to see guidance eliminated.[30] If outside analyses deviate significantly from a company's own internal forecasts, financial officers may be compelled by practical considerations to provide revised guidance or specifics in order to correct or clarify investor expectations.

Dangerous Game

In today's challenging environment of market fluctuations and shaky investor confidence, issuing earnings guidance can amount to playing a dangerous game. It may be more sensible, from the perspectives of both short-term stock price stability and long-term enterprise value, for companies to focus on communicating with investors and analysts by providing more detailed information regarding performance, strategy, sustainability, risks, key developments, and other long-term variables and value drivers.

Forecasts as to EPS numbers on a quarterly or annual basis are an element of disclosure that may be appropriate for some companies and not for others. The frequency and

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[27] CED Report at 24 (citing Hsieh, Koller, and Rajan, "The Misguided Practice of Earnings Guidance").

[28] Aspen Principles.

[29] Fifty percent of the NIRI 2009 survey respondents that have discontinued guidance indicated that the spread of analyst estimates had not changed appreciably. 2009 NIRI Survey. *But see* Jon C. Ogg, "The Death of Formal Earnings Guidance" 24/7 Wall Street (Jan. 27, 2009) (available at http://247wallst.com/2009/01/27/the-death-of-fo/) ("Analyst expectations start to fluctuate much more widely. This could create a more common scenario where investors are told that a company is a screaming buy by one firm but a screaming sell by another firm.").

[30] One recent survey of 100 sell-side analysts found only seven percent believed that it was appropriate for companies to suspend guidance in light of the current uncertain economic environment, with 76 percent believing that the stock market would penalize companies suspending earnings guidance in the current environment, 29 percent believing it to be appropriate to provide a wider range of guidance in 2009 and 43 percent of analysts indicating that any range of guidance is helpful, no matter how wide the range. Tony Rossi, "2009 Earnings Guidance Survey - Executive Summary" (An MWW Group White Paper) (available at http://www.mww.com/images/thought_leadership/FRB_2009_Earnings.pdf).

nature of disclosures are best determined on an individual, company-by-company basis and tend to vary widely by industry.[31]

As a matter of corporate governance best practices, management should review quarterly or annual EPS guidance with the audit committee before it is provided publicly. Audit committees should work with management to consider whether to maintain or continue guidance practices.[32] If information is drawn from a company's internal forecasts, it should require fewer resources to prepare, and generating such disclosures should have little to no impact on the company's culture or focus.

As the trend toward eliminating, generalizing and annualizing earnings guidance continues, companies, analysts and investors can be optimistic that they will benefit from higher quality information, arising in a more natural fashion from the operations of the business and communicated in terms that befit the content and focus on the longer-term.

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[31] *See* Fontenot and Loew, *supra* ("For instance, companies in the technology group that provided earnings guidance were generally more likely to provide quarterly versus annual earnings estimates, while the non-technology companies we reviewed were more likely to provide annual than quarterly earnings estimates."). Fontenot and Loew also note that the companies they reviewed in the banking and financial sectors generally provided no earnings guidance while companies in the energy sector often estimated future capital expenditures while avoiding giving earnings guidance. *Id.*

[32] The question as to whether to provide guidance and, if guidance is to be provided, how much guidance to provide, should be reviewed by management and the audit committee on a regular basis or, at a minimum, at least annually. Public companies need to also consider what types of guidance are being provided by members of their peer groups and how important such guidance is to their respective investors.