

Companies Should Continue to Provide Guidance



Eugene Donati

Guidance on Two Views

BY EUGENE DONATI

THE PRACTICE OF EARNINGS GUIDANCE IS UNDER SUSTAINED SCRUTINY. High-profile calls to end the practice have come from consulting giant McKinsey & Co. and the U.S. Chamber of Commerce as well as a handful of academicians, corporate officers and representatives of several sell-side firms.

But I believe that ending guidance is the wrong action for most companies to take, given how the earnings game is now structured. It would cede control of the conversation away from companies and into the hands of disparate third parties without providing the benefits envisioned by proponents.

Much of the current discussion comes from a McKinsey study debunking earnings guidance as ineffective on valuation, a waste of management's time and a source of excessively short-term focus. McKinsey recommends corporations stop providing it. But this and other studies sharing similar methodology are flawed.

The McKinsey study ignores a key element of financial communication: Regardless whether a corporation issues its own quarterly guidance, analysts will continue to issue theirs. Management will remain obliged to deal with these quarterly proprietary estimates and the “consensus” estimate drawn from them, with the cost to management time and risk of excessive short-term focus unchanged.

The reason McKinsey finds no meaningful benefit on valuation for a guidance-versus-no-guidance regimen is because companies in its study were obliged to deal with a quarterly number of someone's provenance throughout. Thus McKinsey failed to control the most critical factor in its analysis. By always having the element of a quarterly number present, McKinsey has not tested for what would happen in its absence, although it reaches a conclusion that supposes it has. Other studies calling for the end of guidance make the same mistake.

The question, then, is not the quarterly

number but who gets to wield its power. This is where those who want to end guidance get it exactly backward and where corporations have the greatest risk of harming themselves. Who better knows a company's prospects than the company itself, which by law must say so accurately and honestly, if it chooses to say anything at all? If a company does miss its own estimate, or cannot or will not issue guidance, that tells investors something important and different from if it misses some analyst's number.

Analysts will react to what the company says — not vice versa, which would happen under McKinsey's recommendation. If guidance ends, quarterly target numbers will not go away. Corporate executives will still continue to spend resources in responding to various Street estimates. The overall quality of company information will shrink, and CEOs, CFOs and IROs will have surrendered control over the dialogue with third parties, putting themselves

continued on page 16

n Guidance: wpoints



Candace
Browning

Companies Should Drop Quarterly Earnings Guidance

BY CANDACE BROWNING

FOR MUCH OF THE 18 YEARS THAT I WAS A U.S. AIRLINES ANALYST, THERE WAS NO SUCH THING AS QUARTERLY EARNINGS GUIDANCE. The role of the analyst was then, and remains today, to provide investors with insight into companies and industries that results in sensible and profitable long-term allocations of capital.

Whether evaluating the merits of a new business model in an initial public offering or identifying excess capital that should be reaped for shareholders' benefit, the analyst's role in the capital formation process remains critical to transparent capital markets. Projecting a company's future earnings and tracking shorter-term quarterly performance are important, but in recent years the focus on quarterly earnings has overshadowed the rest of the job.

Quarterly earnings can be tweaked by cutting expenses such as advertising and technology investments or accelerating the recognition of revenue. Managing to this short-term orientation presents

obvious drawbacks, as highlighted by the U.S. Chamber of Commerce and a recent McKinsey & Co. study. Both argue that quarterly earnings guidance fails to reduce short-term volatility and can inappropriately create an illusion of stability. But the ancillary effects and unintended consequences of such guidance are arguably more damaging and unrecognized.

By providing specific earnings guidance, a company dictates both the measurement stick and the expected outcome. The measurement stick is typically a certain level of earnings — which may or may not be appropriate. And guidance is typically given without regard to important non-operating items such as write-offs or restructuring charges, which should be included because they reflect management's prior decisions regarding allocation of capital. The company's goal is to encourage the market's acceptance of its self-defined measurement stick and then beat the resulting consensus, thus proving that it is earning higher-than-expected

returns and so worthy of further allocation of investor capital.

This process creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company's operations and performance into a single number — dictated by the company itself.

At Merrill Lynch, analysts are advised to not only discount heavily and question earnings guidance, but also analyze what the guidance — and the way it is constructed — says about management. For example, analysts who follow companies with high operating leverage and little visibility into actual earnings per share know that the reason they give guidance is to ensure they are able to beat that guidance.

At a recent investor conference, a spokesman stated proudly that his company either "met" or "beat" its guidance in 56 of the last 59 quarters. That this metric is carefully tracked shows that beating the guidance is what is important, and

continued on page 17

SHOULD CONTINUE GUIDANCE

continued from page 14

and their companies in the weakened position of being able only to react.

In the game as it is now, it is hard to identify hands-down winners. Guidance critics are correct to point out that the exercise sometimes takes an exorbitant amount of senior officers' time. For this reason, annual or semiannual guidance may make sense in some cases.

The guidance critics are also correct that certain CEOs are tempted to engineer numbers to meet projections. Will these CEOs react any differently in the face of a consensus number rather than guidance? And isn't it the responsibility of the board of directors, not outsiders, to set disclosure policy on when, for instance, income smoothing is permissible? Interestingly, several recent academic studies posit that some forms of

income smoothing may actually enhance the quality of information and improve valuations. While this is hard for many to swallow, it is worth noting that the case against income smoothing is not watertight.

Guidance critics also believe that, in the absence of guidance, there will be greater dispersion of estimates generated by analysts and that they will do better research. Flip that coin over and see that the more

“ENDING GUIDANCE ... WOULD CEDE CONTROL OF THE CONVERSATION AWAY FROM COMPANIES AND INTO THE HANDS OF DISPARATE THIRD PARTIES.”

dispersion increases, the more accuracy of estimates decreases. More analysts will be generating more information that, in the end, does not reflect reality. Do we really want to adopt a practice where the amount of bad information in the marketplace actually increases?

There are only two clear winners under the current regime: the few companies

that assemble, calculate and sell the information that comes to be known as the consensus estimate, and the media who report that data. These benefactors provide the issue's source and its drama.

IROs need to give senior management the realpolitik of financial communication. The consensus number (or whatever it is called this week) will still be out there. Missing consensus is just as costly as

missing guidance. Indeed, university researchers have observed that companies offering guidance see a reduced bid-ask spread and have greater institutional ownership. We had better be careful what we throw away.

In the end, a company's guidance policy will be determined by a trade-off between costs and benefits. Perhaps the best proposal comes from Harvard's Michael C. Jensen, who calls for an end to earnings guidance, which may seem as a contradiction to my thesis. But he does not propose

INVESTOR RELATIONS ROADSHOWS
We know how to get you there.

COMMONWEALTH WORLDWIDE for your next IR Roadshow:

- Staff skilled in working with IR personnel
- Unmatched industry experience
- Professional career chauffeurs
- Service in 550 cities worldwide
- 24-hour reservations and support
- FAA flight tracking system
- Outstanding safety record
- Exceptional Service
- Immaculate vehicles



Attending the NIRI Annual Conference in San Diego? Please visit us at Booth # 713 for a chance to Win a \$500.00 American Express Gift Card. We look forward to seeing you there.

800.558.5466 or 617.787.5575 • commonwealthlimo.com



SHOULD DROP GUIDANCE

continued from page 15

that the guidance is clearly not accurate and should be heavily discounted. Where cyclical companies with high operating leverage provide guidance, an analyst should question not only the figures, but also management's wisdom in providing guidance at all.

But breaking free from company guidance is a tall order. An earnings forecast that contradicts management is provocative. Analysts who disagree with companies are sometimes subject to retaliation, such as being excluded from asking questions. Even Thomson First Call presumes that company guidance is correct and asks analysts to confirm their estimates if they fall outside it. For all these reasons, forecasts that contradict management guidance do not happen as often as they should.

Merrill Lynch believes it would be in the best interests of investors if companies dropped quarterly earnings guidance. Market participants need to see it for what it is: a rough assessment of one indicator of a company's well-being. Earnings guidance dictates an outcome and discourages debate. Worst of all, this one number cannot possibly convey the subtle forces that shape a wise capital allocation decision, and ultimately investors are let down.

None of this means a company should stop providing the marketplace with the financial data needed to make a determination regarding its future

expected performance, particularly if it is aware of an adverse development that will dramatically affect its results. Information on long-term goals or targets such as reducing costs, increasing market share, growing capacity and improving return

“THIS PROCESS CREATES AN ECHO CHAMBER THAT DROWNS OUT INVESTOR DEBATE AND DISTILLS ... A COMPLEX MESSAGE ABOUT A COMPANY'S OPERATIONS AND PERFORMANCE INTO A SINGLE NUMBER.”

on equity are all examples of healthy objectives that should be communicated to investors. Running a company is a complex task; the dialogue between analysts and companies should reflect that. IRU

Candace Browning is senior vice president, Global Securities Research and Economics Group at Merrill Lynch.

a stand-alone burden falling only on management, while everyone else goes on unchanged. Instead he calls for a comprehensive restart of the conversation that must begin with the recognition that the earnings game, as Dr. Jensen puts it, has had a bias toward collusion and “lying” all along.

The key precondition for this new conversation is the abolition of consensus numbers. We need to have a clear-eyed recognition where this dysfunction truly originates. If data providers do not calculate consensus numbers, or analysts and their firms jointly refuse to participate in them, they will cease to exist. Then perhaps the conversations can begin anew among companies, analysts and investors. But until then, guidance remains a most effective and powerful way to ensure company control of its conversation. IRU

Eugene Donati is a financial communication consultant in New York. He can be reached at gene.donati@utoronto.ca.

annual reports
corporate literature
interactive
financial branding
corporate identity

creativitystrategy

Curran & Connors

where **creativity** and strategy meet

631.435.0400
www.curran-connors.com