An incisivemedia website

LAW.COM

Online Feature

April 29, 2009

An incisivemedia publication

IN-HOUSE COUNSEL

FEATURING CORPORATE COUNSEL MAGAZINE

Earnings Forecasts: To Guide or Not to Guide?

LISA A. FONTENOT AND BRANDON W. LOEW

Special to Law.com

April 29, 2009

Boards of directors and management currently face the question of whether, and how, to provide guidance in an unprecedented environment. Recent, rapidly changing market conditions, stock market declines and historically low business confidence levels are causing many public companies to rethink whether they can responsibly provide earnings guidance.

In this environment, directors and management should review the considerations that have traditionally guided public companies in formulating their practices regarding guidance, with an understanding of current market practices. This article summarizes those considerations and recent approaches taken by some of the largest U.S. public companies.

CURRENT PRACTICES

We reviewed recent practices of the fifty largest public companies, measured by trailing 12-month net revenue, as compiled by Bloomberg as of March 31, 2009, as well as an additional group of large technology companies, to discern industry-specific practice.[FOOTNOTE 1] We refer to the first group as the "Bloomberg fifty" and refer to the technology companies, whether included in or additional to the Bloomberg fifty, as the "technology group," respectively. For each company, we reviewed company earnings releases and Web site postings and compared them to the same items published one year prior.[FOOTNOTE 2]

Our review indicated that approximately 40 percent of the companies in the Bloomberg fifty provided full-year earnings guidance for 2009, but less than 10 percent provided quarterly earnings guidance. Among the 22 companies in the technology group, less than 15 percent provided annual earnings guidance, while more than one-third provided quarterly earnings guidance.

A number of the companies reviewed stopped providing either annual or quarterly guidance, or both, between 2008 and 2009. Based on the stated reasons for these changes, they appear to be more a reaction to current economic circumstances, than a response to the long-standing call by many corporate governance proponents to move away from quarterly guidance. Additionally, a meaningful number of companies that provided guidance as an absolute number or range in 2008 either began providing guidance as a range (where previously absolute) or moved to a more expansive range in 2009, reflecting relative uncertainty about future earnings.

LISA FONTENOT

BRANDON LOEW

Of those companies not providing earnings guidance for 2009, less than 10 percent of those in the Bloomberg fifty provided quantitative revenue guidance, while over half of those in the technology group provided revenue guidance. In addition, numerous companies not providing earnings guidance for 2009 nevertheless provided guidance with respect to specific line items that they had confidence in their ability to forecast, such as operating expenses, capital expenditures, retirement costs, research and development, depreciation and amortization, or restructuring charges and potential operating developments specific to the company. Guidance provided for these items varied between precise quantitative guidance, range guidance and qualitative directional guidance. As expected, companies stating reasons for not providing earnings guidance for 2009 generally cite difficulty forecasting future results due to market volatility and uncertainty in global economic conditions.

Our review also indicated, not surprisingly, that guidance practices vary by industry. 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.

In addition, companies in the banking and financial sectors generally provided no earnings guidance, reflecting the rapid, dramatic changes occurring in that industry, as well as the difficulty of predicting the performance of global securities markets, to which many of those companies' operating results are subject. Nor did companies in the energy sector provide earnings guidance, perhaps due to similar forecasting challenges associated with the commodities markets. Most energy companies, however, provided estimates of future capital expenditures, reflecting the materiality of new investments to those companies' future businesses and the relative confidence with which capital expenditures could be accurately predicted.

WHETHER TO GUIDE

Our review reflects that a wide variety of practice exists with respect to the guidance, if any, provided by public companies. However, a perceptible trend towards providing more limited or no guidance with respect to earnings and other items prevailed in early 2009.

What does all of this mean for a public company? The appropriate guidance practices for a particular public company depend on its unique situation. However, all companies evaluating their guidance practices would be wise to factor certain general considerations into their decision-making, including:

- Management's visibility into future earnings and other financial metrics, as well as the factors affecting those metrics;
- Legal liability, including how a change in guidance practices may affect the company's exposure under securities laws requiring updating of public disclosure and prohibiting material misstatements or omissions relating to capital markets offerings, periodic reporting, stock repurchase programs and open-market stock purchases by employees and senior management;
- How a failure to provide earnings guidance may affect management's ability under Regulation FD to communicate with investors and analysts regarding company prospects;
- Analyst and investor community reaction to a change in guidance practices, including whether a lack of guidance will be interpreted as a negative signal about the company's future prospects;
- Whether a lack of earnings guidance will dampen stock price volatility associated with minor misses of publicly disclosed earnings targets or whether an informal consensus "street" estimate is likely to nevertheless result in the same volatility if missed;
- Whether ceasing to provide earnings guidance will cause a decrease in the number of analysts following the company or an increase in the dispersion of analysts' own forecasts of the company's earnings; and
- The effect of a change in guidance practices on management behavior, including whether it will allow management to focus on longer-term value creation and corporate goals over achieving short-term quarterly or annual earnings targets.

The relative significance of these factors to a company will, of course, depend on its circumstances. For example, whether ceasing to provide earnings guidance is likely to lead management to focus on longer-term corporate goals also depends on other factors. For instance, a board of directors or committee thereof would need to evaluate how short- and long-term earnings targets are used internally, specifically with respect to performance-based compensation and other programs designed to foster specific management behavior.

Likewise, a change in guidance practices may have little effect on the stock price of one company, while having a large effect on the stock price of another company, depending on what the change signals about each company's future prospects, at least for the short-term. The likelihood of investors interpreting a decision to stop providing guidance as a negative signal about a company's prospects will depend, among other things, on the company's track record of results, whether the change accompanies positive or negative results, industry outlook, management team, disclosure of other qualitative indicators of potential success, and stated reasons for the change.

ALTERNATIVES TO EARNINGS GUIDANCE

Finally, our review of recent guidance practices demonstrates that defining a guidance policy is more complicated than a simple, binary decision. Indeed, there are many alternatives to providing quantitative earnings guidance beyond a simple "yes" or "no" decision. Companies evaluating their earnings guidance practices are well advised to consider these alternatives, which include: providing directional earnings guidance instead of quantitative guidance; providing a qualitative discussion of underlying trends and fundamental value drivers in the company's business and industry; and providing guidance for line items (other than earnings) that the company can confidently forecast.

Companies should approach this review as a formulation of policy based upon corporate philosophy, culture and needs, rather than a reaction to specific, temporary events. A well-informed internal and external finance and legal team may be able to craft additional alternatives tailored to the particular company. Indeed, a company's outside counsel and financial advisers are well-positioned to discuss a company's options, as well as to offer a perspective on the legal and investor-relations implications of each alternative.

WHAT DOES THE FUTURE HOLD?

Predicting the depth and length of the recession has proven a challenging exercise at best, and it is similarly difficult to predict whether recent changes in guidance practices will affect market practice over the longer term. The recently stated reasons for the suspension of guidance suggest that many companies are likely to resume providing guidance when the economy recovers from the current recession. At least one company indicated its suspension of guidance for the remainder of the year, suggesting a return to providing guidance next year. However, other companies are careful to create no specific expectations with respect to future practice. Recent market declines and changing practices may also lead to more fundamental long-term change in the market generally.

Ultimately, a company's future guidance practices are likely to depend upon industry and peer company practices and whether recent changes prove over time to be acceptable to investors and analysts as the focus shifts away from the uncertainty of the short term. We expect that the forecast here too will be one of more visibility over time.

Lisa A. Fontenot is a partner, and Brandon W. Loew is a senior associate, in Gibson, Dunn & Crutcher LLP's Palo Alto, Calif., office. The authors thank Christopher Bors, an associate at Gibson, Dunn & Crutcher LLP, for his contribution to this article. The views expressed in this article are the authors' and do not represent the views of the firm as a whole.

:::::FOOTNOTES:::::

FN1 Twelve-month trailing net revenue was defined as net revenue, as calculated by Bloomberg, for the four most recent quarters for which a company reported financial results. The technology companies not in the Bloomberg fifty were chosen, unscientifically, from the technology sector based on our sense of which companies other sector members may look to when comparing their own disclosure practices with others. Of the twenty-two companies, four were included in the Bloomberg fifty, and an additional eighteen were included solely in the technology group. These additional eighteen companies were in either the NASDAQ-100 Index or, if not Nasdaq-listed, the Fortune 1000.

FN2 Items reviewed included earnings releases or, where earnings guidance was not included in such releases, transcripts (but not audio playbacks) of earnings conference calls, analyst presentations posted on the company's Web site and, in a few cases, company annual reports. Each item reviewed was dated between Dec. 15, 2008 and March 31, 2009, or between Dec. 15, 2007 and March 31, 2008.