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A Slippery Slope Down Wall Street

By Jim Lucas

When Reg FD leveled the playing field for investors, it also turned earnings guidance into a slippery slope down Wall Street.

Dianne Douglas, senior vice president of external affairs for Mattel, has peered down this slope — even after her company discontinued its earnings guidance. Mattel CEO Robert Eckert, emerging from a successful turnaround, wanted to focus investors on long-term strategies and value creation. In 2002, he used a quarterly earnings webcast to announce the end of guidance:

"We have reiterated our guidance today, and have every expectation of continuing to deliver on it just as we've done so far. But this is the last time we plan to provide this kind of guidance. Please be assured, however, that we will continue to provide you with important information on our strategic initiatives and insights into what we believe to be important trends that may impact our business and drive future performance."

"A Yawner"

It was "a yawner," said Mattel's Douglas, who noticed little reaction to the announcement. But, months later, as results trended below expectations, guidance started to make sense to her all over again: "If you see something coming, you have to figure out how to communicate it."

CEO Eckert resolved the question with a terse warning on a previously scheduled webcast: "We expect a sizable near-term bump in the road." The stock traded down amid analyst downgrades. It then slowly recovered while Douglas patiently waited the three weeks for the quarterly results that detailed the "bump in the road."

"Long-term investors, who focus on whether we're creating value, tell us they're glad we don't provide guidance," said Douglas. The range between her highest and lowest analyst estimate for one recent period is $1.30 to $1.41, which is within a range that's common at other large companies.

Focusing Investors on What Matters

Her job's easier without guidance, Douglas recently said at a NIRI-Los Angeles chapter meeting: "We focus on the longer term and the strategic issues, and don't have to get into guidance details — it's just a slippery slope once you go there."

In contrast, Erik Randerson says guidance makes his job as IRO at Digital Insights *easier*. "We have significant and predictable recurring revenues. Investors appreciate the visibility," he said of his Southern California technology company, adding, "One size does not fit all."

Analysts tend to be vocal advocates of earnings guidance. "We love guidance," said Brian Riley of B. Riley & Co., who heads a Los Angeles brokerage firm that emphasizes independent research.

"It's a way to hold the company and its management accountable," said Riley. He added that the need to provide guidance may be greater at companies that are smaller and less established than one the size of Mattel.

Despite all the debate, most companies issue earnings guidance, and many offer additional significant detail. Both times NIRI has surveyed its members on guidance practices, more than three-quarters of the respondents said their companies were providing earnings guidance. In the last survey, conducted in late 2003, 98 percent said they believe most analysts want earnings guidance.

NIRI noted one change between the surveys, which to date have offered the most complete perspective on guidance practices: in February 2003, 28 percent of the

respondents indicated they were considering discontinuing earnings guidance — a number that dropped to 19 percent in the December 2003 survey.

Despite the growing acceptance of earnings guidance, however, it's still apparent just how slippery this slope can become.

Managing Earnings

Earnings guidance increases the chances of "earnings management," according to seven out of 10 portfolio managers and analysts surveyed by the Association for Investment Management and Research, which published its member survey in October 2003. Of those surveyed, 51 percent believed earnings guidance increased stock price volatility. Those professionals said they'd rather see "general trend and performance information."

Managing earnings also emerged as an issue for 400 CFOs surveyed for a March 2004 working paper, *The Economic Implications of Corporate Financial Reporting*. Seventy-eight percent of the respondents said they would give up "economic value in exchange for smooth earnings."

This survey found that "CFOs believe that investors demand a smaller risk premium for a smooth earnings path." One CFO said, "Businesses are much more volatile than what their earnings numbers would suggest," reported the researchers, Duke's John R. Graham and Campbell R. Harvey and Shiva Rajgopal of the University of Washington.

But I Can't Stop!

Even if IROs wanted to break the habit of earnings guidance, they would be right to worry about the signal they'd be sending. According to a 2003 Ernst & Young study of financial service firms' guidance between 2002 and 2003, "companies that discontinued offering specific earnings guidance during the previous year have, on average, projected an EPS growth rate that is five percentage points lower than the growth rate of companies that continue to offer specific guidance."

Guidance has become accepted as a standard of practice in IR, said Christopher Kaufman, an attorney with Latham & Watkins. He has a senior attorney's aversion to forward-looking guidance, but he practices in the Silicon Valley where bellwether Intel has set a new standard by publishing guidance twice every quarter. Intel's recent news releases update future revenues and key expenses — but not earnings.

"Analysts and investors should 'own' their decisions," said James MacGregor of Abernathy MacGregor Group in New York, an investor relations consulting firm. He cited the advantages of letting analysts make their own estimates: "The most desirable investors know your company, understand its story and endorse its strategy. They'll arrive at their own conclusions and make better decisions if they add their own insights and calculations."

MacGregor's seen a subtle evolution, even among those who give guidance. Some IROs are searching for ways to bring guidance into line with their own visibility. Others are simply broadening their ranges, a half step that's helping some avoid an agonizing fall when forecasts are wrong. "General guidance, with broader ranges, may focus investors on the right areas and keep them from serious error, but spoon-feeding them the bottom line will build very little real understanding."

Future practices may also be influenced by SOX and related rules. Section 409 of SOX requires "rapid and current" disclosure of certain material changes as the SEC determines to be appropriate. The SEC has responded to this mandate with rules calling for more and faster 8-K filings. While these rules, which become

effective in August, will affect many aspects of an IRO's life, their effect on guidance practices may be limited.

According to Bruce Bennett of the law firm of Covington & Burling in New York, these new SEC rules provide useful boundaries to the broad language of SOX. "In the context of earnings guidance, these new rules leave unchanged the existing view that, as a general matter, real-time updates are not required unless an issuer has previously undertaken to do so," said Bennett.

But he added that the new 8-K requirements significantly expand the range of items that will trigger disclosure, and that some of these events could affect earnings guidance. Under these new rules, a simple "no comment" response may not be appropriate. The rules may require disclosure of both the event triggering the 8-K filing, said Bennett, and the impact of that event on outstanding guidance. This could contribute to making the slope even more slippery.

A Best Practice: Keep Communicating

In the years since Reg FD altered the investor relations landscape and prompted many companies to publish their expectations, one thing has remained constant: An IR best practice is to always help investors understand the barometers of a business's future.

Jim Lucas

"We try to provide enough information so investors can understand our long-term objectives and challenges," said Mattel's Douglas. "We talk about costs — for example, trends in labor, raw materials and, recently, ocean shipping. I think this provides investors with a much broader context in which to measure the company."

Louis M. Thompson, CEO and president of NIRI, summed up this tenet of IR's best practices: Whether or not IROs issue guidance, they "should not stop communicating with Wall Street."

And, as Douglas said, "It's important that the management team has credibility. You are asking investors to buy into the management team and the business model." IRU

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