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Corporate Communications and Earnings Guidance: To Lead or Not to Lead?

> *Many interviewed executives feel that the primary role of voluntary disclosure is to correct investors' perceptions about current or future performance, so that the stock is priced off company-provided information rather than misinformation (or "'rumors" as one CFO put it)*
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> -- Graham, Harvey, and Rajgopal (2005, p.54)

Corporations have many ways to communicate information to interested parties. The obvious avenue of communication is the annual financial statement and quarterly reports. However, information can be distributed by a company in ways that go beyond the requirements of financial reporting standards. This essay examines the research on such communications and includes a discussion of the communication channels and types of disclosures that are voluntarily provided by companies, the role of accounting research in shaping corporate behaviors and government intervention, and the part played in the communication process by trade associations.

Current Practices

Managers have several ways to voluntarily provide information to investors. Two traditional channels are (i) earnings announcements and (ii) the management discussion and analysis (MD&A) included in the 10-K and 10-Q filings. Earnings announcements are voluntary except that companies are required under Regulation G to reconcile their GAAP earnings with *pro forma* earnings if the latter are voluntarily disclosed. However, when an expected announcement is expected but overdue, investors are suspicious of bad news and stock prices can be negatively affected implying that such announcements can become *de facto* mandatory. In addition, companies have been required to provide an MD&A since 1980 to help investors make their own predictions about the firm's future

operations. The actual content of the MD&A is largely left to the discretion of management. Finally, managers can communicate through three recently developed channels: company websites, conference calls, and conference presentations organized by financial analysts or industry trade associations.

Some of the topics covered in corporate communications include quantitative or qualitative descriptions of past or projected performance. For example, past performance may include discussion of *pro forma* earnings or monthly sales reports. Forward-looking disclosures may include (i) earnings forecasts (guidance), (ii) earnings-related forecasts (e.g., revenue, cash flows, and specific expense forecasts), and (iii) non-earnings-related disclosures, such as capital expenditure forecasts and strategic plan disclosures. Earnings guidance is by far the most frequent forward-looking voluntary disclosure. Among large firms about 60% provide earnings guidance. Revenue guidance is also common with 37% of the S&P 500 firms providing such guidance. Some firms also give forecasts for specific expense items. For example, about 23% of the S&P 500 firms provide earnings, revenue, and at least a major expense forecast. Cash flow forecasts are less common (about 18%). Non-earnings-related guidance is also prevalent: about 40% of the S&P 500 firms reveal their expected level of capital investments and 50% of the firms discuss initiatives and strategic plans.

Initial Approaches to Earnings Forecasts and Guidance

Although voluntary corporate disclosures such as earnings guidance are now commonplace, the idea of companies voluntarily providing forward-looking information was hotly debated in the 1970s. On the one hand, such information is clearly useful to investors; on the other hand, the information could be misrepresented or abused by

managers. Because of the latter concern, the SEC initially prohibited forward-looking disclosures. Much of the voluntary-disclosure research in the 1960s and 1970s was devoted to the information content and *ex post* accuracy of corporate earnings forecasts. Despite raising doubt about the reliability of forecasts, the research showed that investors responded to earnings forecasts as if they were very useful. In the mid-1970s the SEC changed its position and began to encourage forward-looking disclosures. Moreover, in 1979 the SEC granted a safe harbor to protect companies from legal liability resulting from inaccurate forecasts included in SEC filings as long as the forecasts were made in good faith. These changes led to more corporate earnings forecasts and further research on these disclosures. In general, theoretical research has shown that there are market-related incentives for voluntary corporate disclosure. Applied to the issue of earnings forecasts, this research would imply that calls for mandatory earnings forecasts are unwarranted.

Subsequent research, responding to calls for the government to make earnings forecasts mandatory, examined the credibility of earnings forecasts and found no evidence that they were systematically biased. Research found that investors actually react more strongly to earnings forecasts than to earnings announcements, possibly because of the timeliness of forecasts. Studies find that most often firms provide forecasts privately and forecasts are issued publicly only when managers need to adjust investors' expectations closer to the firm's. Others find that firms with volatile earnings are less likely to publicly issue earnings forecasts for fear of costs associated with unattained projections. Research also finds that even when a firm does not issue earnings forecasts, its stock price is affected by firms that issue earnings forecasts.

Despite the supportive regulatory and legal environment, by the mid-1990s only 20% of firms provide earnings forecasts or alerted investors to large changes in the yet-to-be-reported earnings. Some researchers argued that the 1979 safe-harbor protection was inadequate and that frivolous securities class action lawsuits were excessive. As a result, Congress passed the Private Securities Litigation Reform Act of 1995. Subsequently, there was a noticeable upswing in high-tech firms offering earnings and sales forecasts.

The Advent of Conference Calls

Advances in technology have allowed companies to use conference calls as a new communication channel. Research indicates that in 1995 about 35% of the firms of reasonable size were using conference calls at the time of earnings announcements and that most of the calls were limited to a selected group, such as privileged financial analysts and institutional investors. Material information was released during conference calls and large investors traded on such information in real time. This evidence was cited by the SEC in its development of Regulation Fair Disclosure (FD) to restrict selective disclosures. After FD, a series of studies noted that (i) firms increased public disclosures of forward-looking information, (ii) financial analysts invested more time to search for information on their own and their reports made less of a price impact (in the absence of privileged access to management), and (iii) individual investors' trading increased. Now, almost all firms of reasonable size provide an open conference call a few hours after the earnings announcement press release.

Role of Trade Associations

Trade associations play at least two roles in corporate voluntary disclosures. One is to aggregate information collected from individual firms when such information is too sensitive for individual firms to disclose (e.g., it would help competitors). For example, The Semiconductor Industry Association releases industry Flash Reports each month containing aggregate industry data on new orders and shipments. Research suggests that the information helps analysts to assess the persistence of firms' sales and investors to predict future cash flows. The other role is to advise member firms on voluntary disclosure practices. Currently, most firms have an investor relations arm dealing with the strategy and means of information flow to investors. Research shows that such tasks in a small or new firm typically take 20-25% of the CEO's time and 50% of the CFO's time. The National Investor Relations Institute (NIRI), the world largest association for corporate officers and investor relations consultants, has been a key voice in shaping the discussions and practices of corporate voluntary disclosures in the past decade.

In December 2002, Coca-Cola created a ripple effect by publicly announcing that it would stop providing earnings guidance. Those cheering the move blamed earnings guidance for managers' short-termism; those disconcerted by the move cited reduced transparency. (Quarterly) earnings guidance became one of the three most debated issues in 2006/2007. Trade associations, such as the Chartered Financial Analysts' Institute and the U.S. Chamber of Commerce, either convened meetings or conducted studies to examine the issue and publicize their positions.

While refusing to take a position and provide a "best practices" model, NIRI's contribution to the debate was to conduct annual surveys on corporate guidance practices and inform its members and the public of the changes and trends in guidance practices.

According to the surveys, the percentage of firms that provide earnings guidance dropped from 78% in February 2003 to 68% in March 2006 and then to 51% in spring 2007. The number, however, bounced back to 64% in March 2008. This bounce may be due to a public outcry for lack of transparency in the midst of the financial crisis. Alternatively, the increase could be credited to accounting scholars that have documented that some poorly performing firms ceased guidance under the cloak of repositioning for the long term, and that neither firms nor investors actually benefited from this policy change.

Summary

How companies communicate with investors beyond mandatory disclosures is a key issue. The channels and the content of voluntary disclosures have evolved greatly in the past four decades. Accounting research has played an important role in documenting, analyzing, and evaluating disclosure practices, as well as in impacting the decisions of the SEC and trade associations. We can expect continued dialogue about voluntary disclosures. For example, should transparency be achieved by market forces or government regulation? How much information can companies disseminate to investors – and how frequently - without causing excessive market volatility and attracting transient traders? Do managers use their discretion in voluntary disclosures for personal gains? The answers to these questions are not simple and will certainly become the topics of future discussions and scholarship.

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