

: Earnings Guidance

INTRODUCTION

The Aspen Principles on Long-Term Value Creation were released by The Aspen Institute's Corporate Values Strategy Group in June 2007 to drive debate about short-termism and identify practical changes to rebalance short and long-term focus in capital markets. A key component of these Principles is the call for an end to quarterly earnings guidance.

This *In Focus* briefing paper explores the research on earnings guidance and identifies key questions for ongoing discussion. This is the first in a series of closer looks at business and investment practices related to short-termism. Future white papers will examine best practices of companies that have abandoned the provision of guidance or use alternative methods of conveying progress to investors, including the use of metrics that move beyond EPS estimates, and other topics relevant to corporate practice.

RESEARCH

The Corporate Values Strategy Group conducted a review of the existing literature on earnings guidance. This literature sheds light on how the practice of issuing quarterly earnings guidance affects the behavior of managers, analysts and firms. The Corporate Values Strategy Group believes that the widespread practice of earnings guidance creates negative effects in corporate practice and capital markets. Although there are certainly articles that argue the opposite (see the Resources section, below), we find the following articles particularly useful in explaining how and why earnings guidance is problematic.

Effects on managerial behavior

- In "Value Destruction and Financial Reporting Decisions," John Graham, Campbell Harvey and Shiva Rajgopal report on the results of their survey of 401 executives. The majority of those surveyed state that they would intentionally sacrifice company value to smooth quarterly earnings.¹

Effects on analyst behavior

- In "Relationship Incentives and Optimistic/Pessimistic Pattern in Analyst Forecasts," Robert Libby, James Hunton, Hun-Tong Tan and Nicholas Seybert use survey findings to show that analysts' desire to maintain congenial relationships with company managers, and the greater access to information that entails, leads them to issue positive beginning-of-period forecasts, and less optimistic (hence, beatable) end-of-period forecasts.

Effects on firm behavior

- In their article "Earnings Guidance and Managerial Myopia," Mei Cheng, K.R. Subramanyan and Yuan Zhang follow a sample of firms that issue frequent earnings guidance, comparing their performance with that of firms that issue only occasional guidance. They find that frequent guiders engage in more myopic behavior, are less likely to engage in R&D, and show lower long-term growth.

¹ Full citations for articles cited are listed at the end of this paper.

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- In “The Misguided Practice of Earnings Guidance,” Peggy Hsieh, Timothy Koller, and S.R. Rajan conduct a survey of 4,000 companies with revenues over \$500 million that have provided guidance at least once between 1994 and 2004. They find that issuing guidance does not affect valuation multiples, improve shareholder returns or reduce share price volatility. They also find that earnings guidance places demands on the time of senior management who must prepare reports and causes firms to focus on short term performance.

ONGOING QUESTIONS

It has been nearly five years since Coca-Cola stopped issuing earnings guidance and a growing number of prominent individuals and institutions have come out against the practice. Critics argue that earnings guidance destroys long-term value and creates an echo chamber in companies’ information environment.

However, despite the likely long-term benefits of ending guidance, the performance of a company that stops issuing earnings guidance today can only be observed in the context of the current capital markets, in which issuing guidance is standard practice. A system for processing other forms of company information is not yet well-established.

The literature on earnings guidance demonstrates that the practice encompasses many different actors and incentives, at the market, firm and individual levels. In light of this, how will broad, system-level change in the ways that company performance is measured and communicated come about? The Corporate Values Strategy Group suggests the following questions as productive areas for further exploration, dialogue, and new pilot practices at firms:

- How can the market be equipped to process and respond to information issued by companies that choose to stop issuing guidance? What firm-level innovations in both the corporate and financial sectors can contribute to this process?
- What metrics, in addition to quarterly EPS, can companies use to demonstrate their projected future success?
- In light of the research on manager and analyst motivations, what changes to incentive structures will increase the use of long-term, forward-looking metrics in market communications?

RESOURCES

Articles Cited

- **Cheng, Mei, K.R. Subramanyan and Yuan Zhang**, "Earnings Guidance and Managerial Myopia," working paper available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=851545
- **Graham, John, Campbell Harvey and Shiva Rajgopal**, "Value Destruction and Financial Reporting Decisions," working paper available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871215
- **Hsieh, Peggy, Timothy Koller and S.R. Rajan**, "The Misguided Practice of Earnings Guidance," *McKinsey on Finance* 19 (Spring 2006)
- **Libby, Robert, James Hunton, Hun-Tong Tan and Nicholas Seybert**, "Relationship Incentives and the Optimistic/Pessimistic Pattern in Analyst Forecasts," working paper available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=963611

Other resources

- **Carolyn Kay Brancato**, "Institutions Want to End Earnings Guidance," *Compliance Week*, May 1, 2007
- Statement of **Candace Browning**, SVP, Head of Global Securities Research & Economics, Merrill Lynch & Co., Inc. Submitted to the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives. Hearing entitled "Fostering Accuracy and Transparency in Financial Reporting," March 29, 2006. Available for download at <http://financialservices.house.gov/media/pdf/032906cb.pdf>
- **Chen, Shuping, Dawn Matsumoto and Shiva Rajgopal**, "Is Silence Golden?: An Empirical Analysis of Firms That Stop Giving Guidance in the Post-Regulation FD Period," working paper available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=820644
- "Earnings Guidance: The Sound of Silence," *The Economist*, April 29, 2006
- **Fuller, Joseph and Michael Jensen**, "Just Say No to Wall Street," *Journal of Applied Corporate Finance*, Vol. 14, No. 4 (Winter 2002) 41-46
- **Houston, Joel, Baruch Lev and Jennifer Tucker**, "To Guide or Not To Guide," working paper available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=875184
- **Robert C. Pozen**, "Reporting for Duty," *New York Times* Op-Ed, March 3, 2007
- **Delaware Chancery Court Chancellor Leo Strine**, "Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance." Speech delivered at the University of Iowa, available for download at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=989624



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