# Giving Good Guidance On Earnings

## by Steven B. Stokdyk, Joel H. Trotter and Nathan Ajiashvili

**Publicly traded companies face strong pressures to give guidance to the markets, analysts and investors on where results are headed. Yet the liability risks and economic consequences of mishandled comments can be significant, and continue to grow. How do corporations safely provide guidance without incurring undue liability under the federal securities laws?**

Every public company must decide whether to give the market guidance about future operating results. Questions from the buy side will begin at the IPO road show and will likely continue on every quarterly earnings call and at investor meetings and conferences between earnings calls. The decision whether to give guidance, and how much to give, is an intensely individual one. The only universal truth is: A public company should have a policy on guidance and the policy should be the subject of careful thought.

Public companies are not required by stock exchange or SEC rules to provide investors with projections of future operating results. However, investors and analysts can be demanding, and many public companies elect to give guidance about their expectations for the future. The decision to give guidance can spring from a desire to share good news with investors in order to help the market get to a higher valuation for the company's stock, or it can spring from a desire to correct analysts' overly optimistic earnings expectations.

Whatever the motivation, the legal landscape should be carefully understood before taking the plunge. It is possible to give guidance in a deliberate and careful way without incurring undue liability. It is also possible to make critical mistakes that have consequences under the federal securities laws and in the financial markets.

A number of provisions in the federal securities laws create liability for forward-looking statements. In the context of a public offering, Section 11 and Section 12 of the Securities Act of 1933 impose liability on issuers, their officers and directors, and underwriters for misstatements or omissions of material facts.

Rule 10b-5 under the Securities Exchange Act of 1934 imposes liability in a similar manner, although the burden of proof on a plaintiff is higher. Rule 10b-5 applies to statements made in the context of securities offerings as well as in periodic reports and day-to-day communications with analysts and investors. Because of the potential for liability, it is prudent for those giving guidance to speak carefully, completely and deliberately.

The Private Securities Litigation Reform Act of 1995 (PSLRA) enacted safe harbor provisions for forward-looking statements that are identified as such and accompanied by "meaningful cautionary statements." The PSLRA safe harbor provisions do not apply in the context of an IPO or to enforcement proceedings brought by the SEC.

**Boilerplate cautionary language may not be enough. Evaluate and tailor your cautionary disclosure for each significant forward-looking statement.**

The federal courts have held that forward-looking statements accompanied by appropriate cautionary language do not trigger a claim for liability under the federal securities laws.

However, boilerplate cautionary language may not be sufficient. Some courts have denied the protections of the PSLRA's safe harbor where risk disclosures did not change over time or did not identify the risks appropriately. Specific, robust and dynamic cautionary language is often the best defense to a review of forward-looking statements that may ultimately prove inaccurate.

As a result, public companies should routinely

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evaluate and tailor cautionary language for each significant forward-looking statement. Well-crafted disclosure can serve as a shield against future challenges if good-faith predictions of future results do not materialize.

**Some courts suggest that you have a duty to update statements if a prior disclosure becomes materially inaccurate.**

Although the PSLRA explicitly states that it does not "impose upon any person a duty to update a forward-looking statement," some courts have suggested that a duty to update may apply if events transpire that cause a company's prior disclosure to become materially inaccurate.

What does this mean for public companies? Among other things, it means a company can answer the question "Are you in merger negotiations with XYZ, Inc.?" with a "no comment" and not be obligated to later update that statement if it enters into merger negotiations. However, if the company answers the question with "This company will never enter into merger negotiations with XYZ, Inc.," then the company may want to consider an updating disclosure if merger negotiations begin in earnest. In other words, once the decision to speak on a particular topic is made, it may be problematic to stop talking about it in the future as the facts change.

Regulation FD's prohibition on selective disclosure of material nonpublic information must also be taken into account in any discussion of guidance. Regulation FD and subsequent SEC enforcement actions have effectively eliminated the practice of privately "walking" analysts' earnings estimates up or down to avoid unpleasant surprises at quarter-end or year-end. Guiding analysts about future earnings is still permissible under Regulation FD, so long as the analysts and the general public learn all material information at the same time.

Updating or confirming prior guidance is treated the same way under Regulation FD: The public needs to receive material information at the same time as the analysts. The question "Are you still comfortable with your guidance for this year?" is right in the center of Regulation FD's bull's eye. An officer who provides direct or indirect guidance to an analyst regarding earnings forecasts "takes on a high degree of risk under Regulation FD."

**Stable, predictable businesses can forecast earnings on a quarter-by-quarter basis. Businesses with lumpy or seasonal revenue streams may not feel quarterly projections are prudent.**

A basic decision is whether to give guidance on a quarter-by-quarter basis or on a year-by-year basis. Some businesses are stable and predictable. For them, predicting earnings on a quarter-by-quarter basis may be an option. Many energy companies, for example, have presold the majority of their output years into the future.

Businesses with lumpy revenue streams, or that experience seasonality or weather issues, may not feel they can make quarterly projections prudently. A September 2012 survey performed by the National Investor Relations Institute (NIRI) found that guidance-giving companies most often communicate annual estimates only. The most common frequency for communicating this is quarterly. Even the most stable businesses typically elect not to provide earnings guidance beyond the year in progress, although some businesses will provide long-term estimates or goals for longer periods.

Directly related to the decision of how far forward to look when guiding investors is the decision of what to say about the periods in question. Guidance takes many forms, not just earnings per share for the year. Some companies will guide investor expectations by giving a range of anticipated earnings per share, or simply by saying that they are "comfortable with the Wall Street analysts' consensus" regarding earnings per share for the year.

However, explicitly blessing a specific analyst's estimate can be viewed under the case law as "adopting" it. This has the same liability considerations as issuing guidance directly. This casual approach to guidance usually does not offer an opportunity to

## Ten Rules For Good Guidance

### Sending The Right Messages

☐ *Designate a limited number* of company personnel to communicate with analysts and investors about future plans and prospects.

☐ *Adopt an appropriate guidance policy early,* and follow it.

☐ *Do not rely on boilerplate.* Explain the assumptions underlying each forward-looking statement and disclose the risks that may cause anticipated results not to be realized. Cautionary statements should be tailored to fit the guidance.

☐ *Have prepared remarks reviewed* by counsel and stick to the script.

☐ *Remember Regulation FD:* Disclose guidance and other material information only in an FD-compliant manner.

☐ *Do not be afraid to say "no comment"* in response to questions or to deflect uncomfortable questions.

☐ *Do not comment on or redistribute analysts' reports,* and only review advance copies of analysts' reports for factual errors.

☐ *Remember Regulation G:* Include appropriate disclosure for non-GAAP financial measures where required.

☐ *Continually evaluate* whether changed circumstances argue in favor of an update of prior disclosures.

☐ *If there is an intervening event* between quarterly earnings releases and calls, such as an offering of securities, share repurchase program or acquisition, or when insiders are buying or selling, be particularly sensitive to the above rules.

include appropriate cautionary disclosure and should generally be avoided.

**More precise information will please analysts in the short run, but can create sharper liability issues in the long run. Only give guidance on metrics you can accurately predict.**

Each company's decision of what to say and how far to go should be made in light of the nature of its industry and the circumstances of its business. Careful thought should be given to the tradeoff that going further down the income statement presents. Much more agility is needed to predict earnings per share successfully than to predict revenue, adjusted net income, adjusted EBITDA or another "normalized" measure of performance. We recommend that companies only give guidance on a metric that they feel comfortable they can accurately predict.

All good guidance should be accompanied by dynamic, carefully tailored cautionary statements. These disclaimers should temper the predictions of a rosy future with a balanced discussion of what could go wrong. Risk factor disclosure should also be appropriately updated with each publication.

It is also helpful if some of the material assumptions on which the guidance is based are disclosed and if the company's risk factors tie to the achievement of those assumptions. The point of cautionary language is to explain what goes into the sausage so investors can make their own intelligent decisions.

It is best if guidance and cautionary disclosures are given in a controlled environment. The most popular forums are the year-end or quarter-end press release and the related quarterly earnings calls. The press release and the script for an earnings call usually receive greater oversight than any casual encounter, and earnings calls are always Regulation FD-driven events.

Many companies prefer to give guidance orally on their earnings calls and do not produce a written version of their statements. For a CFO who is comfortable sticking tightly to a prepared script, this is a perfectly acceptable choice. For others, putting it down in writing in the earnings release may be a wise precaution.

The earnings release or call should include carefully tailored disclaimer language, and the actual guidance statements should be carefully vetted and scripted. Oral forward-looking statements should be accompanied by an oral statement that cautionary disclosures are contained in a readily available written document. Similarly, statements regarding non-GAAP financial measures should identify where the required reconciliations can be found.

There are at least three good reasons to anticipate the questions about guidance that analysts are likely to ask on an earnings call.

☐ First, there are some questions the company will want to answer. If the answer has not been scripted, it may not come out with all of the nuance that is appropriate.

☐ Second, there are some questions the company will not want to answer. It helps to have worked these out in advance.

☐ Finally, Regulation FD frowns on answering follow-up questions privately where the public does not have access, so what is said on the earnings call will set the boundaries of what can be discussed in private meetings between earnings calls.

When management begins to doubt whether the company's actual results will be in line with prior guidance, the decision whether to make a public statement to that effect is entirely dependent on context—all facts and circumstances must be considered. Did the company say that it would (or would not) confirm annual guidance every quarter? Is it obvious from the facts that the prior guidance is no longer reliable (due to an important acquisition, disposition or industry development)?

If a company expects to exceed its prior guidance by a modest amount, it is probably safe to keep that information confidential and pleasantly surprise the investment community. On the other hand, if a company is reasonably sure that it will miss the mark by a material amount, intervening events or market pressures may force an out-of-sequence guidance update. Context is everything. Managing expectations to maintain credibility, provide transparency and avoid unpleasant surprises is always the goal. ■

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