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Earnings Guidance – Part of the Future or the Past?

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Abstract



This report sheds light on the long-standing debate around the impact of regular Earnings Guidance. We start by investigating the forces behind Earnings Guidance and we follow its evolution over the years. We review the current landscape analyzing the number of companies providing Earnings Guidance around the world and relate Earnings Guidance activity to ownership structures. Following an extensive literature review, where we discuss the (perceived) benefits and (actual) costs of the practice, we conclude that despite the benefits being intuitive, there is little evidence supporting regular issuance of guidance. On the other hand, the costs are real and can have a significant and negative impact on the firm's long-term competitiveness. We propose an action plan for CEOs that want to abandon Earnings Guidance while minimizing any short-term stock price effects. Moreover, we recommend a new framework of corporate communication (Integrated Reporting and Integrated Guidance) that is likely to improve the firm's information environment and the communication channels with its stakeholders, supporting the execution of a sustainable strategy.

Table of Contents

1. Executive Summary	5
2. History of Earnings Guidance.....	7
2.1. Regulatory environment and EG	7
2.2. The rationale for Earnings Guidance: The Beginning	8
3. The Present	10
3.1. Current landscape of EG.....	10
3.2. The perceived benefits and costs of Earnings Guidance.....	12
3.3. Empirical findings on Earnings Guidance and Short Termism	19
3.4. Case Studies – Companies that abandoned EG.....	20
4. The Future	24
4.1. Long term thinking – Sustainability as the new status quo.....	24
4.2. The next generation of corporate communication.....	25
4.3. Reshaping the landscape	29
5. Appendix	32
5.1. Exhibit I	32
5.2. References.....	33

1. Executive Summary

The need to manage corporations for the long-term is more apparent than ever. Short-termism in corporate management has repeatedly affected the long-term competitiveness of corporations that have been held hostage to short-term pressures and incentives.

Short-termism is at the core of a fundamental problem in the capitalist system: the conflict between the interests of business and society. Although in the long-term externalities from corporate activities can affect the company's operating efficiency, brand and reputation, ability to attract talent, license to operate, and consequently its financial performance, in the short-term such externalities are less likely to affect the financial performance of companies.¹ As a result, we are more likely to move towards Sustainable Capitalism, which "seeks to maximize long-term economic value creation by reforming markets to address real needs while considering all costs and integrating ESG metrics into the decision-making process", if companies become more long-term oriented.

In 2012, the Generation Foundation issued a report making five recommendations that could help businesses and the capital markets move towards Sustainable Capitalism. One of them was to end the default practice of quarterly Earnings Guidance. Quarterly Earnings Guidance can create incentives for executives to manage for the short-term and encourage some investors to overemphasize the significance of quarterly earnings at the expense of the longer-term, more meaningful measure of sustainable value creation. Ending this default practice in favor of only issuing guidance as deemed appropriate by the company (if at all) would encourage a long-term view of the business rather than the current focus on quarterly results.

Section one of this report examines in depth the managerial practice of Earnings Guidance. By Earnings Guidance, we mean the *regular* disclosure of *point* or *tight range* earnings forecasts for *future quarters* or the *next fiscal year*. As a result, forecasts of earnings of qualitative nature, nonregular earnings forecasts, or forecasts with multiyear horizon are not included in our definition. Indeed, we see no reason why a company would not want to issue an earnings forecast when market conditions, changes in the business model of the company, or future corporate events justify such issuance. For example, in cases where market expectations are diverging to a great extent from company fundamentals, or in cases of future mergers and acquisitions, issuing earnings forecast might be appropriate. However, issuance of earnings forecasts in those infrequent events does not justify regular Earnings Guidance where management is pre-committing to an earnings number.

The second section of this paper provides a review of the evolution of Earnings Guidance identifying the key regulatory milestones that allowed the practice to evolve and discusses the rationale at its initiation. Prior to 1973 Earnings Guidance was very rare in the US, as managerial projections were considered misleading and risky from a litigation perspective. The practice became mainstream after 1996 following the extension of the Safe Harbor Law that protected companies from being easily sued for inaccurate forecasts. Through the use of Earnings Guidance, companies aimed to increase their transparency and provide the market with additional information while exploring new communication channels that would attract the market's attention.

1. Although the impact on individual companies from such externalities can be severe even in the short-term, the impact on a diversified portfolio of companies is less likely to be significant in the short-term.

In section three we provide a summary of academic findings along with a comprehensive literature overview discussing the perceived benefits (e.g. i. information asymmetry reduction, ii. increased analyst visibility, iii. reduced stock price volatility, iv. lower litigation risk) and actual costs (e.g. i. earnings management, ii. short-term investor base, iii. analyst herding, iv. insider trading) of the practice. The literature review suggests that there is little evidence supporting the claimed benefits of the practice. On the other hand, various studies attribute real costs to Earnings Guidance that significantly affect companies' competitiveness and, as a result, long-term financial performance. Since the mid-2000s, a number of managers feeling hostage to short-term targets (introduced by the adoption of EG) started abandoning the practice citing a refocus to a more sustainable strategy aligned with the firm's long-term horizon. We provide various case studies of leading firms that abandoned (or never initiated) the practice and the steps they followed to successfully do so.

Section four introduces the idea of sustainability and long-term thinking and answers the question "If not Earnings Guidance, then what?" We discuss the characteristics of alternative communication forms that could be more relevant and value adding not only to investors, but also to other stakeholders. Moving towards Sustainable Capitalism requires companies to practice both integrated management and reporting. Integrated management is a management approach that integrates economic, environmental, social, and governance (ESG) criteria in the resource allocation process. Integrated Reporting refers to the combination of financial and ESG performance in a single document and ideally reveals the relationship between the two. As part of Integrated Reporting we advocate that companies adopt a practice of Integrated Guidance where they provide market participants with information conveying management's view of how the different forms of capital (natural, human, financial, social, intellectual, and physical) are enhanced or depleted. These different forms of capital are the engines of the value creation process, and therefore affect the long-term competitiveness of the company.

We are mindful that the market can perceive eliminating Earnings Guidance as a negative signal in some cases either because it will be perceived as a sign of increased uncertainty about future economic conditions or a sign of opacity and bad governance. We propose a seven-step process that CEOs could follow to successfully stop Earnings Guidance and at the same time minimize any negative perceptions during transition from earnings to Integrated Guidance. Specifically, we propose the following steps:

1. To signal that the decision to stop guidance is not a sign of increased uncertainty or deteriorating economic conditions, a CEO can announce the drop of Earnings Guidance and at the same time confirm guidance numbers for the same quarter but also issue one last guidance number for the next quarter.
2. The CEO should be the one that announces the decision to stop Earnings Guidance. This will be a clear signal that the organization takes this decision seriously and

understands the risk of short-termism.

3. The CEO should clearly articulate why the company is ceasing Earnings Guidance issuance. The explanation should justify why frequent and regular guidance is inconsistent with the long-term sustainable strategy of a company.
4. The CEO should 'get the board on board.' By highlighting that the board of directors agrees with the decision to stop Earnings Guidance it is less likely that market participants will perceive this action as an attempt to hide something. Moreover, it shows that the board of directors is knowledgeable and engaged with the company's long-term vision.
5. The CEO can communicate a five-year strategic plan for the company defining milestones, why these milestones are important to achieve, and the actions that need to be taken in order to be successful. This will enhance confidence in the management of the company and will make clear the strategic priorities of the company.
6. The CEO can announce the adoption of Integrated Reporting. Integrated Reporting not only enhances the information environment of the firm but it also serves as a disciplining mechanism to ensure that the company has a long-term sustainable strategy.
7. As part of adopting Integrated Reporting the CEO can announce the adoption of integrated Guidance. Integrated Guidance does not seek to provide numeric forecasts about specific metrics regularly. Rather, it informs market participants about changes over time in a firm's different forms of capital and their effect on the future competitiveness of the company over the long-term.

In addition, we describe a methodology to identify a group of 'change agents' that could redefine the field of Earnings Guidance. These are large and influential companies that have issued regular Earnings Guidance. While these companies are leaders in their industries, their practice of frequent Earnings Guidance has had the unintended consequence of shaping a relatively short-term investors base. Whether this could affect these companies is not clear. However, it seems intuitive to us that formulation and execution of a sustainable strategy requires the support of an investor base that shares the time horizon that is required for the strategy to generate benefits. We believe that if these companies were to stop issuing Earnings Guidance, more companies would follow, making an important step towards mitigating short-termism across the market ecosystem and moving towards Sustainable Capitalism.

Finally, we offer some recommendations for organizations that are part of the capital market ecosystem. Specifically, we discuss how asset managers, sell-side brokerage houses, stock exchanges, accounting firms, and financial news agencies could promote long-term thinking and adjust to an environment where Earnings Guidance is not present.

2. History of Earnings Guidance

2.1. Regulatory Environment and Earnings Guidance

Until 1973, the SEC did not permit corporations to include financial projections in the various informational reports prescribed by the federal securities laws. The main reason for the prohibition was that corporate projections had traditionally been considered misleading per se. The SEC's reversal of this long standing view was based in large part on the critical reception the view received in the academic community (Anderson, 1974; Mann, 1971; Schneider et al., 1972).

Following the stock market crash of 1929, the United States Congress realized the need for tighter regulation governing the securities market. As a response to fraudulent practices in the 1920s, Congress introduced various securities regulations. The impetus behind those decisions was to protect investors by ensuring "fair and honest" markets. During the ensuing Great Depression the United States Congress enacted the Securities Act of 1933 and the Securities Exchange Act in 1934. Whilst the 1933 Act regulates the original issues of securities, the 1934 Act governs the secondary trading. The 1934 Act also established the Securities and Exchange Commission (SEC), the agency primarily responsible for enforcement of United States federal securities law.

To achieve its mandate, the SEC enforced the statutory requirement that public companies implement a policy of disclosure of material information to investors through reports. In addition to financial reports, company executives must provide a narrative account called the "management discussion and analysis" (MD&A) which outlines the previous year's operations and also, usually, touches upon the upcoming year, describing future goals and approaches to new projects. By ensuring equal access and wide dissemination of information, these requirements seek to promote informed investment decisions. In addition to the goal of protecting unsophisticated investors, the full disclosure scheme also promotes more efficient markets. The argument is that securities markets operate efficiently because they rapidly and accurately incorporate all relevant information into the market price of any given security. Corporate disclosure thus improves informational efficiency because investors and the general market have more relevant information to incorporate into security prices, which in turn increases allocational efficiency.

However, with several decisions since 1970s, the SEC has reversed its long standing position and expressed its willingness to allow, and even encourage, voluntary disclosure of management forecasts and other types of "soft information"² that are generally not objectively verifiable. The new rules were accompanied by a set of restrictive guidelines intended to ensure the accuracy of any projections made public. The SEC realized that analysts consider management projections vital only because they may be used to evaluate why the company expects to achieve its goals, not because they are necessarily accurate predictors of future performance (Advisory Committee Report, supra note 3, at 56). Key regulatory events that shaped this development in reporting practices included:

- i) In 1973, the SEC lifted its prohibition against forward looking information
- ii) In 1979 the SEC provided safe harbor to firms issuing forecasts to shield them from frivolous litigation related to forward looking disclosures made in good faith.
- iii) In 1996 the Private Securities Litigation Reform Act (PSLRA) extended the safe harbor so firms could not be sued easily for forecasts that do not materialize.
- iv) In 2000, the SEC introduced the Regulation Fair Disclosure ("Reg FD") to halt the private dialogue between managers and security analysts.

After Congress passed the Safe Harbor law that protected companies from legal liability in performance forecasts, Earnings Guidance popularity increased rapidly. Studies find that the number of firms providing public Earnings Guidance also increased from between approximately 10 and 15 percent in the mid-1990s to approximately 50 percent in 2004 (Anilowski et al. 2007).

2. "Soft information" is defined as forward looking statements about the future such as projections, plans and expectations.

However, concerns were raised that some market participants were recipients of more information, thus the practice was creating an uneven playing field that damaged investor confidence (Levitt, 1998). Specifically, prior to Reg FD, many companies worked closely with analysts in the development of their earnings estimates. Analysts often forwarded their detailed analysis to members of the firm's investor relations group, who reviewed the earnings model and either provided detailed comments or simply indicated whether management was comfortable with the analyst's forecasts. Presumably both sides benefited; analysts produced more accurate forecasts informed by management's nonpublic company information, and firms experienced fewer negative earnings surprises. Reg FD put an end to this practice since it explicitly prohibits disclosure of material nonpublic information to selected market participants.

In Europe, whilst the rules governing trading and markets across the European Union may be the same, there is no European equivalent to the SEC. The regulatory bodies that ensure the implementation and enforcement of securities laws are at the national level. However, in 2004, the Brussels-based European Commission (the policy arm of the European Union) created a single market for financial services across Europe through the Markets in Financial Instruments Directive (MiFID). MiFID applies to the 27 E.U. countries and Norway, Iceland and Liechtenstein. MiFID was developed to provide a common regulatory framework for European securities markets and to enable cross-border competition among European exchanges, multilateral trading facilities, and brokers. Further, on 1 January 2011, the European Securities and Markets Authority (ESMA), a European Union financial regulatory institution and European Supervisory Authority located in Paris, replaced the Committee of European Securities Regulators (CESR) in the field of securities legislation and regulation to improve the functioning of financial markets in Europe, strengthening investor protection and cooperation between national competent authorities. However, there is no European regulatory body explicitly covering the topic of Earnings Guidance.

In Japan, the Stock Exchange Act governs disclosure and financial reporting practices for publically listed companies. In addition, the Timely Disclosure Rules enforced by Japanese stock exchanges impose more stringent requirements on reporting practices. These rules strongly encourage managers of listed firms in Japan to provide regular forecasts of annual sales and earnings (Kato, Skinner and Kunimura, 2009). Forecasts must be updated if there are changes in sales estimates of 10 percent or more and/or changes in earnings estimates of 30 percent or more.

In China, stock exchanges adopted a rule in 2000 requiring firms to issue warnings if managers anticipate losses for the year. In 2002, Chinese stock exchanges expanded the scope of mandatory forecasts to include forecasts of earnings increases or decreases of at least 50 percent from the previous year. In 2004, Chinese stock exchanges mandated forecasts for firms that anticipate profits for the year after experiencing losses in the preceding year. Over the years,

Regulatory and institutional changes encouraged firms to issue Earnings Guidance. However, the associated benefits and costs may not have been thoroughly considered

the stock exchanges gradually added semi-annual and third-quarter earnings as forecast items. Firms are required to update a previously issued earnings forecast if the direction of the previous forecast (e.g., incurring losses, transition from losses to profits, earnings increases, earnings decreases) changes or if the new estimate differs by 50 percent or more from the previous estimate (e.g., the previous estimate is an earnings increase of 50 percent and the new estimate is an earnings increase of 100 percent).

2.2. The Rationale for Earnings Guidance: The Beginning

Following the relaxation of regulatory rules, and especially after the Safe Harbor law, companies became more attracted to the idea of providing guidance. Especially since the early 1990s, and following the 1987 stock market crash, markets entered into an era where analysts and investors were strongly demanding increased transparency from companies. Taking into consideration the limited information channels available at that time, Earnings Guidance was perceived by managers as an effective and efficient way to communicate their private beliefs to the market, differentiate their companies from peers, and allow their investors to make better informed decisions.

Indeed, not many years ago, access to material and quality information was restricted and expensive. Up until the mid-1990s, internet connections were extremely limited, and the information that could be found online was very basic. Further, travelling was time consuming and expensive and low cost conference calls were not supported by the existing technology. The available ways for companies to communicate with market participants were limited to public filings and direct meetings with investors and analysts. Thus, the adoption of a policy of communicating forecasted earnings was welcomed by existing and potential investors as well as analysts covering the company.

On the basis that voluntary disclosure reduces information asymmetry (Healy and Palepu, 2001), managers concentrated on the benefits that Earnings Guidance could provide without being able to foresee the potential costs. Additionally, at that moment in time, when access to foreign investments was more difficult to achieve, managers identified Earnings Guidance as a way to attract the attention of more analysts, thus increasing their visibility and investment to their companies.

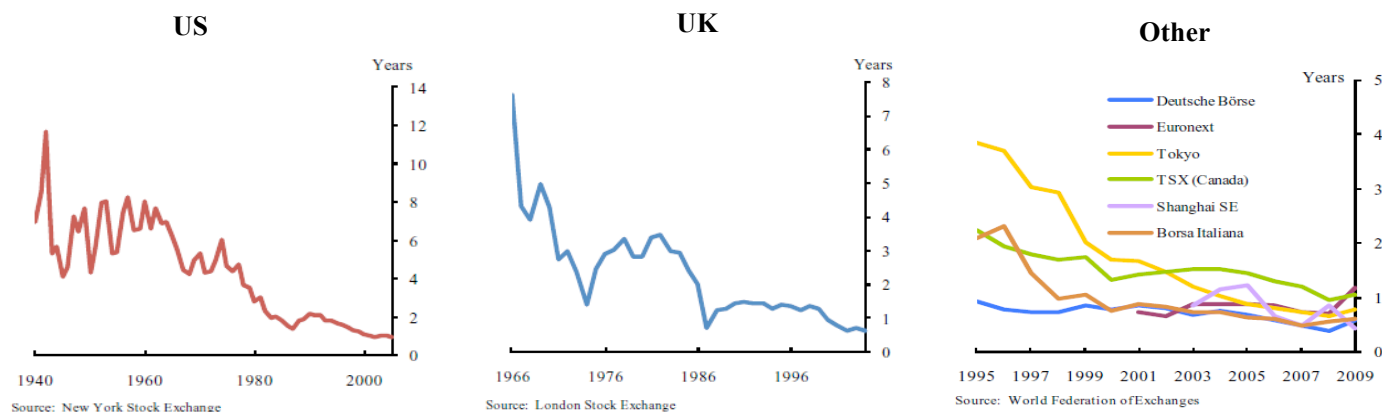
However, it wasn't just the managers concentrating only on the bright side of earnings forecasts and underweighting

potential consequences. The academic world was doing so as well. Specifically, most of the academic literature until the late 1990s that discussed the impacts of Earnings Guidance concentrated on elaborating its benefits and investigating their validity. It wasn't until after the late 1990s that the trend shifted and academics started examining the costs accompanying the practice.

One potential reason why market participants were initially not attributing a significant weight to the drawbacks of Earnings Guidance was because the main cost that the practice is currently accused of was not profound at the time. Opponents of Earnings Guidance blame the practice for shifting investors' attention to short-term performance, underweighting the long-term prospects of the company, and attracting investors who speculate on a short-term basis on the share price. However, when Earnings Guidance started, that phenomenon was not obvious. Based on data from stock exchanges³, and as shown in Figure I below, the mean duration of holding period by US investors was around seven years in 1940. This stayed roughly the same for the next 35 years. By the time of the 1987 crash the average holding period had fallen to 2 years and declined to below one year by the turn of the century. The average holding period was around 7 months by 2007. Similar trends exist in the UK. Specifically, the average holding period has fallen from around 5 years in the mid-1960s to less than 7.5 months in 2007. Figure I below illustrates a similar pattern across all major stock exchanges.

Figure I

Average Holding Periods



This significant shift in average holding periods can be largely attributed to the dramatic change of ownership structures as well as decreasing trading costs because of advances in technology. Currently, institutional investors dominate the US market. Over the past 40 years, ownership by institutions has increased from 10 percent in the 1970s to more than 60 percent by 2006 (Aghion, Van Reenen, Zingales, 2013; Gompers and Metrick, 2001). Brancato and Rabimov (2008) report that by the end of 2007, institutional investors accounted for 76.4 percent of the ownership in the largest 1,000 U.S. firms.

While the initial rationale for issuing Earnings Guidance was reduction of information asymmetry and exposure to a larger investor base, the associated drawbacks were largely overlooked at the time primarily because the investors' horizon, even if in a decreasing mode, still allowed companies to make long-term strategic plans. However, especially over the past few years, companies are under increased pressure to meet short-term targets which may come at the expense of the firm's long-term prospects.

3. Source: New York Stock Exchange, London Stock Exchange and World Federation of Exchanges. <http://topforeignstocks.com/2010/09/06/duration-of-stock-holding-period-continues-to-fall-globally/>

3. The Present

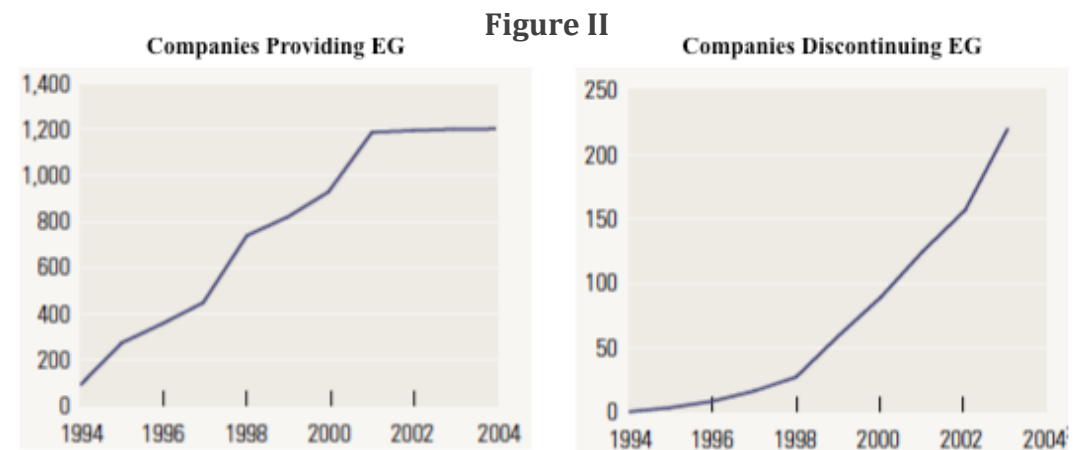
Following the passage of the Safe Harbor Law, which protected companies from legal liabilities for statements about their projected performance, Earnings Guidance became increasingly popular as managers were primarily focusing on the perceived benefits of the practice. Since then, the number of companies issuing guidance, annually or quarterly, has increased.

3.1. Current Landscape of EG

Evolution of EG over the years

However, as managers and investors started realizing the associated costs, the rate with which Earnings Guidance was adopted started falling, eventually reaching a plateau during the mid-2000s, when an increased number of companies started abandoning the practice. Specifically, recent surveys by the National Investors Relations Institute (NIRI) suggest a trend toward firms discontinuing quarterly guidance or moving toward providing annual guidance only (NIRI, 2007; Kelleher, 2007). Specifically, the percentage of firms giving quarterly guidance has declined from 75 percent in 2003, to 61 percent in 2005, to 52 percent in 2006, and to 27 percent in 2007, while the percentage giving annual guidance only has increased from 16 percent in 2003, to 28 percent in 2005, to 43 percent in 2006, and to 58 percent in 2007 (Kelleher, 2007). Recent NIRI surveys found that 76% of 2012 respondents provided financial guidance compared to 81% in 2010 and 85% in 2009 (NIRI, 2012). In sum, we observe companies shifting from quarterly Earnings Guidance to annual guidance as they realize the costs of very short-term targets. However, managers are still held hostages to market pressures allowing some market participants to speculate on the achievement of short-term narrow-sighted targets rather than investing in a sustainable strategy.

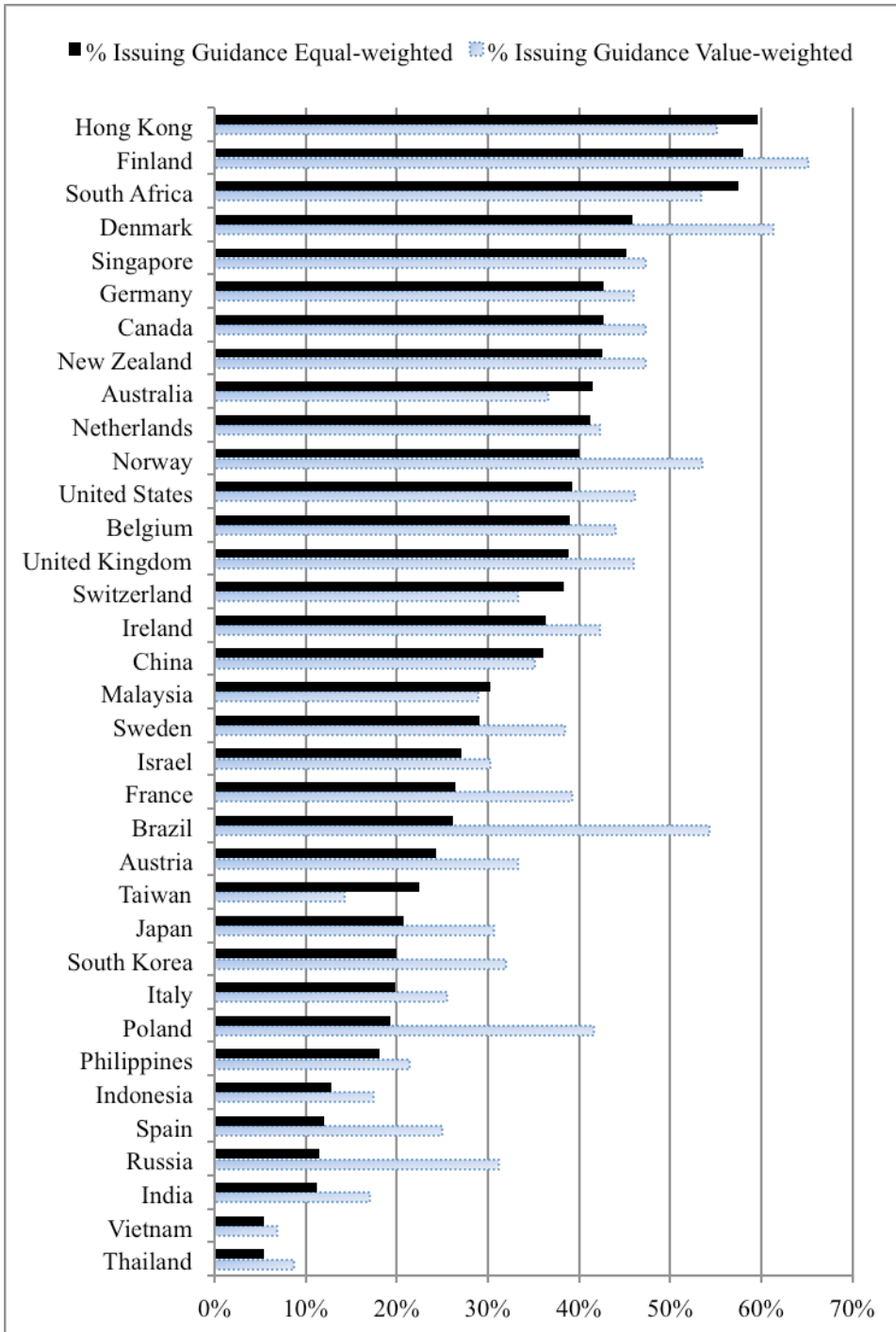
On a similar note, a study conducted by Hsieh, Koller and Rajan in 2006, reviewing 4,000 companies with revenues greater than \$500 million, found that about 1,600 had provided Earnings Guidance (quarterly or annual) at least once in the years from 1994 to 2004. The number of companies that did so increased from only 92 in 1994 to about 1,200 by 2001, when the rate of growth leveled off. The number of companies in their sample that discontinued guidance has also increased steadily, growing to about 220 in 2004. We present their findings in Figure II below:



Guidance around the world

We collected data from Bloomberg and used web crawlers to identify the number of companies around the world that in 2012 issued guidance. Because quarterly financial numbers do not exist in all countries we allowed for the possibility that firms provide guidance for quarterly, semi-annual, nine-month or yearly numbers. While it is hard to provide an accurate picture of how many companies provide guidance around the world, we were able to approximate, from a set of about 35,000 companies listed around the world, the number of companies providing guidance. Figure III presents the percentage of firms issuing guidance in each country. To understand whether the largest firms in each economy are more or less likely to provide guidance we also tabulate a value-weighted percentage where each firm is weighted by its market capitalization. Therefore, larger companies are assigned a larger weight.

Figure III



In most countries, about 40 percent of the companies provided guidance.

Guidance is very frequent in Hong Kong, Finland, South Africa, and Denmark. Lack of guidance in some countries, however, should be interpreted with caution. Most countries have not adopted regulations similar to Reg FD that prohibits companies from privately communicating Earnings Guidance to analysts. As a result, many companies might be providing guidance through private communication channels and they would not be classified as guiders in the Figure below. In many countries, such as Denmark, Norway, France, Brazil, Poland and Russia, large firms are much more likely to provide guidance. This is manifested by the value-weighted metric being significantly higher than the equal-weighted.

3.2. The Real Costs and Perceived Benefits of Earnings Guidance

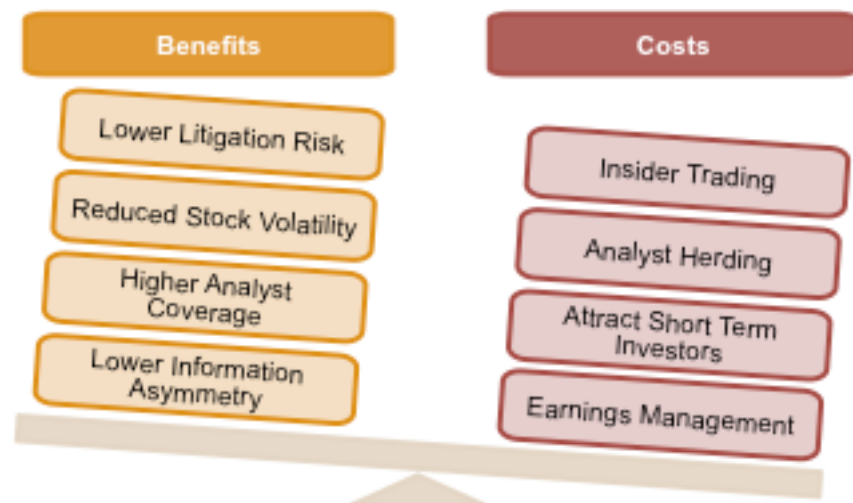
In this section we investigate the perceived costs and benefits associated with Earnings Guidance whilst discussing the merits of arguments used by managers who wish to abandon the practice but still have yet to do so

The disclosure of Earnings Guidance is a decision voluntarily taken by the top management of a firm. One of the key questions that arises is if this is a well-informed decision; specifically, has the company considered and allocated the appropriate weight to the (potential) benefits and costs associated with such a decision accounting for everyone affected in the ecosystem (i.e.: the firm itself, the firm's stakeholders including investors)? Furthermore, the key objectives of issuing Earnings Guidance need to be understood; they frame the characteristics of the guidance provided (such as timing, horizon, type of guidance) and should be the decisive factor of whether to issue guidance or not.

Post 1973, the SEC has taken several steps encouraging the disclosure of forward-looking estimates with the objective to protect unsophisticated investors and promote fair and honest markets. The Safe Harbor law in late 1990's (which protected companies from legal liabilities linked to inaccurate performance forecasts) accompanied by a significant growth in the number of sell-side analysts covering companies⁴ (whose expectations companies wanted to keep within range) resulted in a sharp increase of firms issuing Earnings Guidance. The decision taken at that time by many companies to issue guidance might not have been thoroughly considered, and most of them adopted Earnings Guidance to reduce the information asymmetry between companies and investors/analysts, primarily to attract market attention and to follow what was expected to become common practice within their industry.

However, it didn't take long for corporations to realize that such a decision was accompanied with a number of trade-offs and associated with real costs to the firm's long term vision and financial health. By the beginning of early 2000 a number of blue-chip companies (such as Coca Cola, Gillette, and Unilever), started abandoning the practice citing a re-focus on their long-term strategy as the principal motive of their decision.

In this section we investigate the costs and benefits associated with Earnings Guidance whilst discussing the merits of arguments used by managers who wish to abandon the practice but still have yet to do so. Further, the potential costs and benefits as described below are not from a manager or investor's standalone perspective but refer to the market ecosystem as a whole.⁵



4. Analyst coverage of companies has increased over time. Barber et al. (2001, 2003) report that the number of firms followed by analysts rose from 1,841 in 1986 to 5,786 in 2001.

5. Most, but not all (e.g., China and Japan), of the empirical evidence are drawn from US or European data. Therefore, we are not certain how these results generalize to other jurisdictions with different institutions. For example, one could argue that in more opaque jurisdictions, Earnings Guidance might be more useful as a way to monitor and discipline managers. However, in those settings one could argue that the costs of Earnings Guidance are higher since accounting numbers are easier to manipulate, insider trading might be easier to execute etc.

Costs of Earnings Guidance

An increasing number of high profile investors (Warren Buffett), associations (CFA Institute, US Chamber of Commerce), and analysts (Candace Browning) have argued that the costs associated with providing Earnings Guidance exceed the potential benefits claimed by supporters of the practice. More importantly they argue that such short-sighted information is targeting a different type of investor, interested in short-term returns and not accounting for the long-term growth prospects of the company. As a result they foresee a number of challenges the company will have to face in order to both manage short-term expectations and set the appropriate strategy for long-term success.

Various concerns have been raised regarding the immediate impact that decisions to meet forecasts can have, in addition to the indirect implications for long-term growth prospects. Specifically, these concerns include managers engaging in earnings management through accounting techniques or decision changes in order to meet earnings forecasts. Many commentators are worried that managers are likely to sacrifice long-term earnings growth to meet short-term targets. Furthermore, concerns exist around the time that top management is devoting to update market participants, thereby not allocating sufficient time to the company's strategic targets and operations and managing the company to short-term goals. Additionally, the tight linkage of executives' compensation to share performance enhances fears around insider trading. Finally, providing Earnings Guidance is likely to attract short-term investors who could further reinforce a short-term attitude in business decision making.

All the aforementioned concerns have both financial and reputational impact and could materially change a firm's long-term prospects. In the following pages we examine each one of them in detail and investigate their validity.

Earnings Management

Managers define market expectations by committing to earnings targets. Consequently they self-impose constraints to match those forecasts at the expense of reduced flexibility in their business strategy and increased market pressure to meet the forecasted targets. As a result the investment community and other members of the ecosystem have raised concerns around the behaviors and practices managers may adopt in order to achieve those targets.

The literature has identified various incentives behind managers' choice to overweight short-term performance and specifically current market valuation over future market value. Most documented reasons include:

- i) Short-term compensation schemes (Hall and Murphy, 2003; Rappaport, 2005): a significant portion of managers' overall compensation is linked to share price performance whilst institutional and regulatory changes during the 1990s increased incentives of managers to pay extra attention on short-term performance (Richardson, Teoh, Wysocki, 2004).
- ii) Potential takeover threats (Stein, 1988): managers fear that the market is pricing only short-term poor financial performance, failing to capture long-term prospects of

Costs of Earnings Guidance

1. Earnings Management
2. Attracting short-term investors
3. Analyst herding
4. Insider trading

the company leading to a lower equity valuation.

- iii) Risk of higher cost of capital (Bhojaraj and Libby, 2005): Companies in need to raise capital usually do so shortly after earnings announcements.
- iv) Employment concerns (Fudenberg and Tirole, 1995; Graham et al., 2005): maximize present value of bonus compensation for employees and keep their morale and motivation at high levels to manage potential career concerns.
- v) Management's credibility (Graham et al., 2005): managers could increase their credibility by providing forecasted numbers aligned with reported earnings.
- vi) Market reaction asymmetry (Hutton et al., 2003): Market's reaction to missed analyst consensus is stronger than when consensus is beaten by an equivalent magnitude.

Therefore, managers have incentives to engage into questionable practices or suboptimal behavior to meet earnings targets (Fuller and Jensen, 2002). Specifically, research suggests that managers could use both accrual and real earnings management to meet, or to exceed, forecasted numbers.

In particular, by accrual earnings management we mean accounting decisions (such as the use of positive discretionary accruals) made by managers to revise earnings (Kasznik, 1999). Essentially, managers try to make opportunistic use of the flexibility allowed by accounting standards to change reporting earnings without changing underlying cash flows in the same fiscal year. Further, over the past years, firms have taken advantage of derivatives accounting and extensively used financial instruments to manage earnings. Evidently, fraudulent financial reporting over the past 10 years has almost always been about managing earnings targets (Michael R. Young, Partner, Willkie Farr & Gallagher). Specifically, the SEC has alleged that firms such as Cardinal Health, Nortel Networks, and VeriFone committed fraud to meet their own guidance (Bansal and Dabrowski, 2007; SEC, 2009a; SEC, 2009b) which suggests that managers are often willing to take the extra step to achieve their goals.

Additionally, managers may also enter into real earnings management, defined as the opportunistic timing and structuring of operating, investment, and financing transactions to affect reported earnings, resulting in suboptimal long-term business consequences. Research supports this argument and finds evidence that managers providing Earnings Guidance may engage in short sighted

business actions. For instance, firms that are frequent issuers of guidance invest significantly less in R&D and their long-term earnings growth rates are significantly lower than less regular forecasters (Cheng et al., 2007). Further, managers may forego projects and opportunities that could be financially beneficial for the company if engaging them means that earnings targets will be missed (Wang and Tan, 2013).

Based on the above evidence, Earnings Guidance is highly correlated with practices that are suboptimal for the firm's reputation and long-term growth prospects. Thus, it represents a real and significant cost to the long-term investor and the firm's stakeholders.

Attracting short-term investors

By providing frequent Earnings Guidance, firms implicitly highlight their near term performance, shift management's attention to forecasted targets, and distract the market's attention from the firm's long-term prospects. Consequently, attracting investors with shorter-term horizons.

Indeed, literature provides us with evidence supporting this argument. Guidance does indeed act as a magnet to market participants that pressure for short-term results and who speculate on how far or close the earnings announcement will be from the forecasted number (Bushee, 1998). On a similar note, Chen, Matsumoto, and Rajgopal (2011) find that firms give up guidance when they have lost long-term institutional investors. This finding suggests managers stop providing guidance in an attempt to re-focus on the long-term strategy.

Arguments suggesting that increased disclosure is associated with increased investment in the firm and higher institutional ownership (Diamond and Verrecchia, 1991; Kim and Verrecchia 1994; Healy et al., 1999) do not provide the full picture. Bushee and Noe in 2000 find that dedicated investors' stock ownership is not related to expanded disclosures whereas transient investors and quasi-indexers respond positively to it. Brochet, Loumioti and Serafeim (2014) find that firms that issue Earnings Guidance tend to focus on the short-term in their conversation with sell-side analysts during conference calls. Brochet, Loumioti, and Serafeim (2014) show that such short-term language in conference calls increases transient ownership and decreases dedicated institutional investor ownership.

As a result, we conclude that Earnings Guidance is associated with a more short-term oriented investor base⁶, which could further reinforce short-term pressures on the company. Such short-term pressures could then result in both accruals and real earnings management as discussed in the previous section.

Analyst herding

Another negative implication of Earnings Guidance, with associated costs to market's operational efficiency, is the impact it has on analysts' expectations and their distribution. Specifically, a concern is that analysts may not

perform their job as they should; with freedom of opinion and freedom of disagreement. Following guidance, analysts' expectations are concentrated within a narrow range around the guided number, failing to ask questions that would capture tail risks and notify the market accordingly.

Research suggests that analysts do amend their analysis and follow managerial guidance to become more aligned with managers' expectations (Ajinkya and Gift 1984; Waymire 1986; Jennings 1987). Recent data suggest that 60 percent of analysts revise their analysis within five days of management guidance (Cotter et al. 2006) and as a result forecast accuracy increases whilst forecast dispersion is reduced even when guidance is confirmatory and the consensus mean is not altered (Clement et al 2003). We also observe that analysts' forecasts are more accurate for firms that guide whilst their expectations are also more pessimistic (Hutton, 2005). Thus, it could be implied that managers may be purposely biasing the guidance to increase the likelihood that they will meet or exceed analysts' forecasts. This argument gains further support when considering i) the large penalties associated with missing analyst forecasts (Skinner and Sloan, 2002) and ii) the fact that managers are more likely to provide guidance when the analyst community is highly optimistic and dispersion is low (Cotter, Tuna, Wysocki 2006).

At the same time, analysts also have incentives to cooperate and revise their forecasts from their true beliefs. Firstly, many analysts are already highly dependent on managerial guidance to develop their analysis. In May 2008 the CFA Institute surveyed its members, and found that 46 percent of sell-side and 32 percent of buy-side analysts said that they "always use" quarterly guidance in developing company analysis. Secondly, managers can indirectly pressure analysts to align their expectations (Francis and Philbrick, 1993; Lim, 2001). Specifically, analysts who decide to develop their own independent analysis may face obstacles to do their jobs. Various incidents have been reported in the business press, including management ignoring analysts at investor conferences and generally not providing information the analysts are asking for. At extreme cases there have also been allegations of analysts losing their jobs after writing negative reports about their company's favored clients (Richardson, Teoh, and Wysocki, 2004). Hong, Kubik, and Solomon (2000) find that less experienced analysts are more likely to lose their job for making bold forecasts that deviate from the consensus. Finally, conflicting incentives between analysts and their own firm's may result in trade-offs between the quality of investment research and securing investment banking deals (Laderman, 1998).

It is important to note that Earnings Guidance can seriously impair the efficient functioning of the analyst labor market as well. In the presence of guidance, high quality analysts will find it more difficult to differentiate themselves from lower quality peers. Forecast accuracy, one of the easiest and most public ways to signal analyst quality, is unlikely to differ among high and low quality analysts since everybody has been given guidance by the company. As a result, lower quality analysts tend to remain on the job longer and higher

6. See Section 3.3 for further empirical findings produced by KKS Advisors showing the relationship between Earnings Guidance and shareholder base.

quality analysts might be rewarded for their skills and expertise at a slower rate.

In sum, Earnings Guidance increases analyst herding and is an obstacle to healthy disagreement among analysts, an essential ingredient, of the price discovery process in capital markets. Such behavior is at the cost of open and efficient markets and discourages dialogue and circulation of additional information and differing opinions.

Insider trading

An additional concern raised by market participants is that managers' financial incentives are strongly linked to the short-term performance of their firms. At the same time managers remain unaccountable for future performance of their firms, which is impacted from decisions they had taken during their tenure. Consequently, long-term performance is not sufficiently incentivized under current compensation structures. As a result, managers may engage into questionable practices and utilize tools supporting their own financial interests at the expense of the firm's long-term prospects.

The literature provides us with strong evidence to support the argument that managers face increasing incentives to care about the firm's stock price after earnings are announced especially if compensation is tied to it. Specifically, a number of regulatory and institutional changes have shifted managers' focus to capital market's short-term performance. Firstly, post 1991, the SEC (effectively) removed restrictions for managers to hold shares of stocks acquired through an option exercise for at least six months before selling by changing the starting date of the six-month holding period from the exercise date to the option grant date. Thus, managers became increasingly aware of the timing that they are allowed to exercise their stock options and sell their shares. This has usually been happening within a narrow window immediately after earnings announcement (Bettis et al., 2000; Jeng, 1999). In the 1980's, equity based compensation accounted for less than 20 percent of CEO compensation. After the 1990s the equity-based compensation of managers rose steadily. By 1994 it had increased to nearly 50 percent (Hall and Liebman, 1998) and by 2003 equity-based compensation grew to nearly 60 percent of CEO's total compensation (Bebchuk and Grinstein, 2005).

Moreover, the literature provides various evidences supporting the argument that managers use Earnings Guidance as a tool to shift market expectations in their favor, and maintain favorable stock market valuation, exactly when needed the most.

- i) Increased incidents of insider trades in the week immediately after quarterly earnings announcement (Sivakumar and Waymire, 1994)
- ii) Insider transactions take place after voluntary disclosures had a favorable impact on share price (Noe, 1999)
- iii) Managers with greater levels of equity-based compensation issue more frequent guidance (Nagar et al., 2003)

- iv) Managers may issue guidance to temporarily depress the firm's stock price around stock option award periods (Aboody and Kasznik, 2000)
- v) Managers/firms who are net sellers of stock after an earnings announcement have provided more pessimistic guidance (Richardson, Teoh, and Wysocki, 2004)

Managers' compensation structure significantly impacts managerial decisions. As such, Earnings Guidance may be used as an effective tool by managers to support their own financial incentives.

Perceived Benefits of Earnings Guidance

Despite all the aforementioned drawbacks associated with Earnings Guidance, many managers choose to communicate their earnings forecasts. So the question arises - what are the perceived benefits of doing so and do they truly outweigh the associated costs?

The rationale for Earnings Guidance and the arguments in favor of the practice can be summarized as follows. Providing Earnings Guidance directly communicates managers' private beliefs about the future earnings implications of all their private information. As a result, the belief is that information asymmetry between managers and the market is reduced and expectations are aligned, reducing potential earnings surprises at the time of announcement. Additionally, successful Earnings Guidance enhances management's perceived credibility and investors' confidence in their ability, resulting in lower cost of capital, and enhanced corporate investment and growth. Further, due to the high dependence of analysts on managerial guidance, discontinuing guidance raises concerns that analyst coverage will decrease and consequently lower the firm's visibility and liquidity. Finally, managers are mindful of potential litigation risk increase in the presence of bad news which has not been proactively communicated to the investment community. Over the next pages we review evidence to assess the robustness of these arguments.

Information asymmetry reduction

Proponents of Earnings Guidance cite information transparency as one of the main benefits of maintaining guidance. It is argued that guidance is an important source of market information since credible and regular disclosures reduce information asymmetry and help to lower cost of capital.

Perceived Benefits of Earnings Guidance

1. Information asymmetry reduction
2. Increased analyst visibility
3. Reduced stock price volatility
4. Lower litigation risk

Healy and Palepu (2001) showed that any form of voluntary value-relevant disclosure reduces information asymmetry. Through voluntary disclosure managers attempt to signal the quality of their firms to the market and develop a well-informed analyst and investor base by providing firm specific information (Pownall and Waymire, 1989). Considering the strong price reaction at the time of guidance announcement⁷, it is fair to assume that the market is indeed provided with new information (Foster, 1973; Jaggi, 1978). Subsequently, the market's response at the time of earnings announcement is reduced (Das, Kim and Patro, 2008; Skinner and Sloan 2002). Further, literature also finds evidence that Earnings Guidance can lower information asymmetry (Ajinkya and Gift, 1984; Collier and Yohn, 1997), which leads to lower information gathering costs (Diamond 1985) and lower cost of capital (Lambert, Leuz, and Verrecchia 2007).

However, we should remind ourselves that Earnings Guidance can be misleading to begin with. As discussed in the previous section, managers are in control of the type and timing of information they provide and could tailor it to service their own incentives. For example Kasznik (1999) and Hribar and Yang (2010) suggest managers use abnormal accruals to reduce errors in overestimated guidance. As a result the credibility of guidance itself is questioned. Further, standalone quarter numbers do not provide any information on the path and conditions in which they were achieved or the longer term drivers of the business. Not surprisingly, guidance is more impactful when complemented and rationalized by further supported information.

Stopping Earnings Guidance should not be associated with less disclosure. Firms that stop providing guidance may increase other forms of disclosures to make up for the lack of guidance information. However, Houston, Lev, and Tucker (2007) find that firms that stopped giving Earnings Guidance actually have not increased the number of qualitative disclosures. We argue that managers should disclose impactful, meaningful and value-relevant information to investors in order to reduce information asymmetry. Specifically, voluntarily disclosure contributing to that direction could consist of: i) information around the challenges and opportunities, financial and nonfinancial, faced by the industry in the expected macroeconomic environment and ii) the firm's strategic plan to successfully address them in order to position the firm in a competitive advantage situation.

To summarize, Earnings Guidance prepares the market for next quarter's or next year's financial numbers. However, managers should increase the quantity and quality of value relevant financial and nonfinancial disclosure to materially reduce the information asymmetry. That would provide market participants with insightful information about a company's long-term competitiveness.

Increased analyst visibility

Managers argue that one of the benefits accompanying the practice of Earnings Guidance is increased analyst visibility. It is argued that a significant number of analysts rely on managerial forecasts not only to update but also to develop their analysis. As a result, there is a concern that by ceasing to provide guidance, analysts may lose interest in following the firm and that those continuing may have greater difficulty in forecasting its earnings.

As already mentioned, analysts do indeed rely to a large extent on guidance provided by managers. Often an analyst's success is measured by how close his expectations are to the announced numbers. As a result, analysts are keen not to be constantly seen as outliers and skeptical increasing the tendency of analysts to herd. Managerial forecasts provide analysts with a guide/range of where their expectations should be and as a result analysts respond accordingly with the purpose of increasing their accuracy. The fact that analysts require firm's guidance to, more precisely, perform their job, may well also be one of the main reasons why the number of covering analysts is higher for firms that provide more frequent Earnings Guidance (Graham et al. 2005; Wang 2007). Considering also that institutional investors are representing a large percentage of the users of analyst reports, managers also consider Earnings Guidance as a tool to increase the liquidity of the stock. Indeed, increased company disclosures are associated with larger investments to the firm (Diamond and Verrecchia 1991; Kim and Verrecchia 1994). However, as we discussed earlier in this report, Earnings Guidance disclosures are highly correlated to increased transient institutional ownership (Bushee, 1998). Further, evidence suggests that firms followed by more analysts are less likely to give up Earnings Guidance (Houston, Lev, Tucker 2007).

Despite those arguments, research has shown that Earnings Guidance is not a pre-condition for analysts covering a firm. More precisely Chen, Matsumoto and Rajpogal (2011) find no significant decline in analyst following for firms that stopped issuing guidance. Further, detailed investigation of companies that stopped providing guidance by rationalizing the reasons of their decision (i.e.: Coca Cola in 2002), does not suggest a reduction in analysts covering the stock (Houston, Lev, Tucker 2007). It is important to note that companies explain the impetus behind their decision to abandon guidance and how they are planning to fill the potential information asymmetry that Earnings Guidance was filling. Supporting this argument are the results of the 2008 survey by the CFA, where 70 percent of the analysts replied that it would be a better practice for firms not to provide quarterly Earnings Guidance (CFA Institute, May 2008). Instead, the vast majority agreed that it would be more helpful for the company to communicate on longer-term strategic priorities and also provide information around industry developments, trends, market conditions, and other nonfinancial drivers of performance.

7. 15% of the variation in quarterly stock returns occurs around guidance announcements compared to less than three percent for earnings announcements and about six percent for analyst forecasts (Beyer, Cohen, Lys and Walther 2009).

Thus, we conclude that Earnings Guidance is not the one and only reason for increased analyst coverage and by no means does absence of Earnings Guidance mean decreased numbers of analysts following the firm. It is the amount and quality of information provided that is of paramount importance and appreciated by analysts, much more than short-term guidance.

Stock price volatility

Another argument frequently used by managers to defend the earnings management practice is that guidance reduces stock price volatility. Managers argue that Earnings Guidance will reduce share price volatility both i) at the time of the announcement, since the probability of a negative surprise is smaller given analysts' consensus has been shifted towards managerial guidance and ii) overall, since the credibility of the management is enhanced based on successful guidance.

However, as it had been previously discussed, issuance of Earnings Guidance attracts more transient investors, who trade in and out of the stock in a speculative manner (Bushee, 1998), which could potentially result in increased volatility and sharper movements at announcement (Bushee and Noe, 2000; NIRI 2004). Additionally, after investigating the impact of Earnings Guidance on overall historical realized volatility, evidence suggest that the absence of guidance actually does not have an effect on overall volatility (measured as the standard deviation of returns 3 months before and three months after earnings announcement). The only impact to a measure of uncertainty is higher analyst forecast dispersion (Chen, Matsumoto and Rajgopal 2011). Further, evidence suggest that the share price volatility of companies that start issuing guidance is as likely to increase as to decrease compared with companies that do not (Hsieh, Koller and Rajan, 2006). Hsieh, Koller, and Rajan (2006) conclude to this result by comparing the ratio of the standard deviation of monthly excess total return to shareholders in the year of initiating guidance to the previous year and found virtually no difference between companies that do or don't offer guidance. Finally, evidence suggests that guidance has also little impact on the implied volatility used to price options, with negative news contributing to higher volatility (Rogers, Skinner, and Van Buskirk, 2009).

As a result, we conclude that Earnings Guidance could introduce higher volatility at the moment of earnings announcement, because of the attraction of transient investors speculating on the outcome. Additionally, there is no evidence suggesting that guidance contributes to long-term volatility reduction.

Litigation risk

One of the main concerns that managers and investors have is the firm's exposure to litigation risk. Litigation risk is of paramount importance to managers given the obvious consequences to the firm's liquidity position and reputation as well as the large stock price drops it is accompanied with (Francis, Philbrick and Schipper, 1994; Grundfest and Perino, 1997). It is believed that one way to efficiently

manage litigation exposure is through preemptively communicating bad news to the market. That would reduce the probability for the company to be sued or at least reduce the magnitude of the settlement in case a lawsuit cannot be avoided.

The basis of the lower litigation risk argument is the disclosure and communication of bad news in a timely manner to the market participants. The rationale of preempting bad news is that early communication will weaken the claim that managers acted improperly by failing to disclose the information promptly, thus lowering the probability of a lawsuit. Further, in the case of a lawsuit, voluntary disclosure could reduce the potential loss (Skinner, 1997). Additionally, an early warning will avoid a single, large stock price drop upon earnings announcement which alone is a reason to trigger a lawsuit against the firm (Francis, Philbrick and Schipper, 1994; Grundfest and Perino, 1997). Obviously, what is of importance is the disclosure of the bad news. This does not suggest that bad news should be preempted in the form of Earnings Guidance. In the rare cases of seriously bad news the company may also wish to communicate in advance the financial impact of the lawsuit, but this again does not justify Earnings Guidance as a regular practice.

Additionally, academic literature provides us with mixed evidence on whether voluntary disclosure of bad news deters or triggers litigation. For example, Francis et al. (1994) find that early disclosure increases the probability of a lawsuit. The argument here is that the system may not be able to distinguish between guided numbers missed due to forecasting errors and the ones missed due to deliberate management bias (Healy and Palepu, 2001). Further, Field et al. (2003) suggest that early disclosure of bad news, in the format of earnings warnings, could prevent certain types of lawsuits.

Therefore, we conclude that the argument of lower litigation risk does not rationalize regular Earnings Guidance. Surely, disclosing, in a timely manner, bad news is a practice contributing to enhanced transparency. In cases where the financial impact is considered as material, it may also be a good practice for the firm to issue an earnings warning. However, even in such rare cases, regular Earnings Guidance is not justified.

Perceived Benefits vs. Actual Costs – Conclusion

On the basis of the above evidence, we conclude that the actual costs associated with the practice of Earnings Guidance outweigh, significantly, the benefits. Specifically, the perceived benefits are either not justified by the empirical evidence (i.e., reduction of stock price volatility, increased analyst visibility) or do not justify regular adoption of the practice (i.e., information asymmetry reduction, lower litigation risk exposure). Furthermore, the Earnings Guidance practice introduces real costs to the company as behaviors related to it (i.e. earnings management, insider trading) can severely harm the firm's reputation, while the attraction of a shorter term oriented investor base can harm the firm's long-term growth prospects.

Earnings Guidance – Perceived Benefits

Proponents of Earnings Guidance argue that the practice provides companies, analysts and investors with various benefits. Evidence do not confirm the validity of the argument

Perceived Benefits	To Whom	Rationale	Comments
Reduced Information Asymmetry	<ul style="list-style-type: none"> Firm Investors Analysts Society 	<ul style="list-style-type: none"> Voluntary disclosures reduce information asymmetry <ul style="list-style-type: none"> Earnings guidance reveals private information Earnings guidance separates firms: creates a separating equilibrium within an industry 	<ul style="list-style-type: none"> Earnings guidance could be misleading itself It's the overall amount of disclosure that contributes to information asymmetry reductions and not earnings guidance
Increased Analyst Visibility	<ul style="list-style-type: none"> Firm Investors 	<ul style="list-style-type: none"> Analysts rely on managers' guidance <ul style="list-style-type: none"> They may lose interest in following the stock Greater difficulty in forecasting earnings 	<ul style="list-style-type: none"> No evidence suggesting lower analyst coverage for firms rationalizing decision to stop guidance It's the overall amount and quality of disclosure that matters
Lower Volatility	<ul style="list-style-type: none"> Long term investors Firm 	<ul style="list-style-type: none"> At earnings announcement <ul style="list-style-type: none"> Reaction of the market less intense as information has already been priced in Overall <ul style="list-style-type: none"> Credibility of management is enhanced through successful guidance 	<ul style="list-style-type: none"> EG attracts transient investors <ul style="list-style-type: none"> Source of higher volatility No evidence confirming lower volatility <ul style="list-style-type: none"> Following EG initiation volatility as likely to increase as to decrease Following EG stoppage: Increase in analyst forecast dispersion
Lower Litigation Risk	<ul style="list-style-type: none"> Firm Investors Society 	<ul style="list-style-type: none"> Early disclosure of bad news will lower the probability of a lawsuit or reduce the size of settlement 	<ul style="list-style-type: none"> This argument does not justify frequent guidance Mixed evidence that disclosure of bad news actually reduces litigation risk

Earnings Guidance – Real Costs

Managers tend to give up EG as they realize the practice comes at the expense of the firm's long-term growth prospects and might cause questionable managerial practices

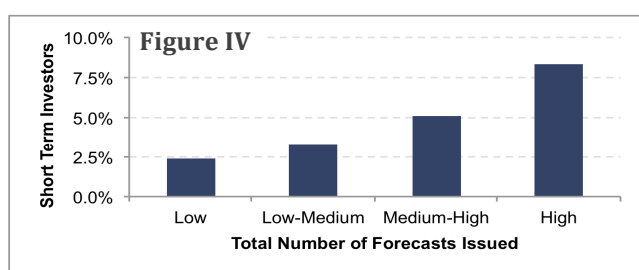
Costs	To Whom	Rationale	Comments
Earnings Management	<ul style="list-style-type: none"> Firm Investors Society 	<ul style="list-style-type: none"> Self-imposed constraints result in reduced flexibility and pressure to meet targets <ul style="list-style-type: none"> Real earnings management <ul style="list-style-type: none"> Foregoing positive NPV projects Accrual earnings management <ul style="list-style-type: none"> Opportunistic use of accounting rules 	<ul style="list-style-type: none"> Incentives to manage announced earnings <ul style="list-style-type: none"> Poor compensation structures Higher cost of capital for missed forecasts EG is associated with: <ul style="list-style-type: none"> Increased fraudulent practices Suboptimal behavior for long term strategy
Attract Transient Investors	<ul style="list-style-type: none"> Long term investors Long term oriented firms 	<ul style="list-style-type: none"> Earnings guidance: <ul style="list-style-type: none"> Emphasizes near term performance Distracts market's attention from firm's long term prospects 	<ul style="list-style-type: none"> EG acts as a magnet to transient investors Firms that give up guidance cite loss of long term investors and need to refocus to long term strategic plan Dedicated investors' stock ownership is not related to EG
Analyst Herding	<ul style="list-style-type: none"> Analysts Investors Society 	<ul style="list-style-type: none"> Managers guide analysts' expectations towards beatable targets Analysts not allowed to conduct their job <ul style="list-style-type: none"> With freedom of opinion and freedom of disagreement 	<ul style="list-style-type: none"> Analysts have incentives to cooperate as they may face obstacles to do their jobs Analysts not able to think out of the box, capture tail risks and notify the market
Insider trading	<ul style="list-style-type: none"> Investors Society 	<ul style="list-style-type: none"> Managers have financial incentives tightly linked to short term performance of their firms 	<ul style="list-style-type: none"> Long term performance not sufficiently incentivized with current structures Lack of long term financial accountability Defined time window managers could exercise options / sell stock – after earnings announcement

3.3. Empirical Findings on Earnings Guidance and Short-Termism

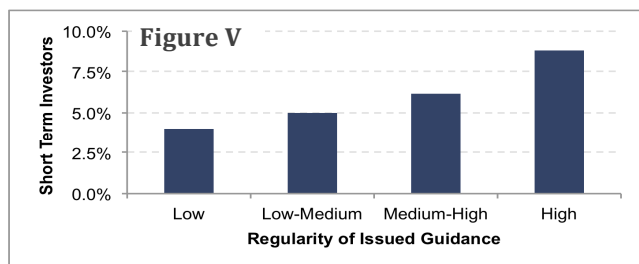
Formulating and executing a sustainable strategy requires the support of a long-term investor base. If firms that issue Earnings Guidance have a relatively short-term oriented investor base, it might be an impediment to the future long-term competitiveness of the business. In order to empirically test the validity of this hypothesis we perform a quantitative study, analyzing the shareholder base of 9,122 US companies as well as the companies' behavior around Earnings Guidance.⁸ Specifically, we investigate the relationship between a short-term investor base^{9,10} and:

- i. The total number of issued forecasts: the number of quarterly earnings forecasts released by the company between 1996 and 2012. Our sample for this analysis consists of 9,122 firms.
- ii. The regularity of issued forecasts: We define as regularity the number of unique quarters over the analyzed period that guidance was provided for. Regularity is not a meaningful measure for firms that have issued quarterly guidance for very few quarters, so we calculate regularity only for firms that issued their first and last quarterly forecast across three calendar years. Our sample with available data consists of 2,695 firms.
- iii. The intensity of issued guidance: intensity represents the average number that a unique quarterly forecast has been revised within a quarter. Our sample with available data consists of 2,695 firms.

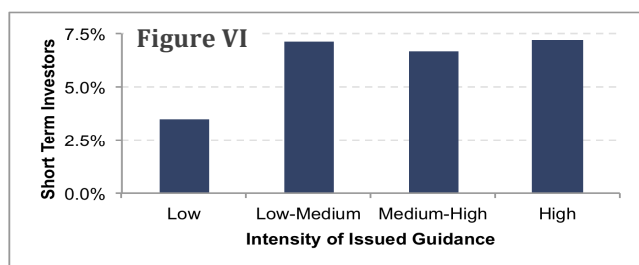
We collect our data from Bloomberg, company websites, and the website of the SEC.



In Figure IV we present the results of our analysis around transient investor ownership and total number of forecasts provided by companies. We find that companies issuing more guidance exhibit a shorter-term oriented investor base. More importantly, the relationship between issued guidance and more short-term investor base is linear.¹¹



In Figure V we show the relationship between the regularity of quarterly forecasts provided by managers and the institutional ownership exhibited by the companies. Our findings suggest that transient ownership increases in a linear manner as regularity of forecasts increases. It is important to note that this relation arises even within just the sample of companies that have previously provided quarterly guidance and excludes companies that have not or have provided minimal guidance in the past.



Finally, Figure VI reveals the connection between investor ownership and intensity of guidance. We observe that managers regularly updating their forecasts exhibit a higher short-term investor ownership. It should be noted that the linearity observed in the previous examples is not present here. It seems that even moderately engaging in updating of quarterly forecasts is enough to attract more short-term investors.

Our empirical findings suggest that companies issuing more frequent and regular guidance exhibit a more short-term oriented shareholder base. These results are consistent with the academic literature which suggests that guidance acts as a magnet to market participants that pressure for short-term results (Bushee, 1998).

8. Data on investor classification can be found here: <http://acct.wharton.upenn.edu/faculty/bushee/IIClass.html>

9. We define as short-term ownership structure the difference between transient and dedicated investors. We use Brian Bushee's classification for institutional ownership (Bushee, 1998). Transient institutions are characterized as having short investment horizon and high turnover to maximize short-term profits also engaging in momentum trading. Dedicated institutions are committed to providing long-term capital and having more concentrated portfolio holdings in a limited number of firms. Quasi-indexers generally follow a passive, buy-and-hold strategy with diversified holdings.

10. We define as short-term investors, the absolute percent difference of transient and dedicated investors.

11. Please refer to the Appendix, Exhibit I for estimates from regression analysis.

3.4. Case Studies – Companies that abandoned EG

Over time managers have realized that a short-term oriented investor base presents an impediment to the formulation and execution of a sustainable strategy. However, managers are still reluctant to abandon the practice of Earnings Guidance, which as previously shown, is highly correlated to a shorter-term oriented investor base. One of the main reasons cited by managers continuing to provide guidance is the negative way in which the market could perceive such a decision. Specifically, managers are afraid that analysts and investors would relate that decision to poor future financial expectations.

Indeed, academic findings suggest that the majority of companies who cease issuing guidance usually are not good performers. Either they do not perform well financially, or their previous forecasts were not accurate (Houston, Lev and Tucker, 2007). Thus, it is important for managers to signal that their decision to abandon Earnings Guidance is not a sign of poor future financial performance.

Over the next pages we present three different case studies of companies that successfully abandoned the practice of Earnings Guidance, each one of them following a different approach:

It is of high importance for managers to appropriately signal that their decision to abandon Earnings Guidance is not a sign of poor future financial expectations



- i. Coca Cola was one of the first major companies that abandoned the practice of Earnings Guidance. In 2002 Coca Cola's board of directors made an executive decision to stop providing guidance. Coca Cola's approach to communicating this decision was carefully designed. Firstly, the company prepared the market by ceasing to provide forecasts of other key performance indicators. Further, the company communicated to the market via its CEO the rationale behind the decision taken from the board. Coca Cola also reassured the market that its financial prospects had not changed and that more meaningful information would replace forecasted numbers.



- ii. Google on the other hand never started providing Earnings Guidance and had made that clear since its IPO letter. Google's founders cited concerns about the pressure to meet short-term numbers and the effects it might have on the firm's strategic plan.



- iii. Unilever changed its practice as soon as a new CEO took office. Paul Polman immediately stood against investors who were speculating with Unilever's stock and communicated with strong language that Unilever wishes to be owned by investors with similar horizon as the company's.

Coca-Cola

On Friday, 13 December 2002, Coca-Cola announced that it would no-longer release quarterly and annual earnings forecasts. The company had started preparing the ground for such an announcement a few months previously when it announced that it would cease providing quarterly unit sales updates, a key measure of the company's performance.

At the announcement of this important policy change, Coca Cola established that the move did not reflect any deterioration in its business. Instead, it confirmed that its outlook for earnings the following year had not changed and that it was *comfortable with the range of analysts' earnings expectations* in 2003. Importantly, Coca Cola's CEO and Chairman, Douglas Daft, reaffirmed the company's long-term growth objectives and disclosed that the decision to stop providing guidance was reached over a *period of several months in discussions* that included *senior management and the board of directors*. Further, he rationalized the decision by calling Wall Street's preoccupation with near-term results a *distraction from long-term planning*. Specifically, he cited that giving short-term guidance to analysts "prevents a more meaningful focus on the strategic initiatives." He continued by saying that "we are quite comfortable measuring our progress as we achieve it, instead of focusing on the establishment and attainment of public forecasts." He added, "Our shareowners are best served by this because we should not run our business based on short-term 'expectations'. We are managing this business for the long-term," implying that short-term forecasts prevented investors from taking a more balanced long-term view of the company's strategies. "We believe that establishing short-term guidance prevents a more meaningful focus on the strategic initiatives that a company is taking to build its business and succeed over the long-run". Coca-Cola mentioned that it will continue to "provide investors with perspective on its

Coca Cola strategically communicated its plans to abandon Earnings Guidance focusing on its shareholder base and the company's long-term objectives

value drivers, its strategic initiatives, and those factors critical to understanding its business and operating environment." Coca-Cola shares closed that day at \$22.92, down 2 cents. Although the announcement seemed to run counter to the prevailing trend in corporate practice of maximum transparency, partially enhanced with Earnings Guidance, analysts said they did not think Coca-Cola's decision would dramatically affect how investors viewed the company.

Like Coke, companies that reduce or discontinue guidance must clearly indicate that poor expectations of future performance are not the reason. The path that Coca-Cola chose to communicate this important news to the market was a thoroughly thought one. Coca Cola had started preparing the ground for such an announcement. Second, the CEO announced this policy change decision. Third, the company explained who was involved in the decision making process and he emphasized that the ultimate decision maker, the board of directors, was involved in the discussions. Additionally, the CEO rationalized the decision by citing the long-term strategy of the company and the value such a decision would add to its shareholders. Finally, Coca Cola committed to full transparency of any important information for shareholders to understand the drivers and the environment of its business.



Google

On August 19th, 2004, Google held its initial public offering. In their IPO letter, Larry Page and Sergey Brin, founders of Google, emphasize the fact that Google as a private company concentrated on the long-term and that it will do the same as a public company as well.

Google is one of the rare examples, especially in the technology industry, that doesn't publicize Earnings Guidance. And it did so from the time it went public. "Although we may discuss long-term trends in our business, we do not plan to give Earnings Guidance in the traditional sense." They rationalize this approach saying: "We are not able to predict our business within a narrow range for each quarter. [...] We recognize that our duty is to advance our shareholders' interests, and we believe that artificially creating short-term target numbers serves our shareholders poorly. We would prefer not to be asked to make such predictions, and if asked we will respectfully decline. A management team distracted by a series of short-term targets is as pointless as a dieter stepping on a scale every half hour. [...] In our opinion, outside pressures too often tempt companies to sacrifice long-term opportunities to meet quarterly market expectations."

Google highlighted its long-term approach in various ways. First, by mentioning that it would pursue projects that are thought to be beneficial over the long run at the expense of short-term earnings, "If opportunities arise that might cause us to sacrifice short-term results but are in the best long-term interest of our shareholders, we will take those opportunities. [...] We would request that our shareholders take the long-term view." The definition of long-term that they refer to exceeds the next quarter or the next fiscal year. "We try to look at three to five year scenarios in order to decide what to do now." Second, as part of its long-term vision and commitment to stay independent of Wall Street analysts and short-term investors, Google set up a dual class equity governance structure intending to preserve the long-term vision of the company and protect its founders from major investors who disagreed with their strategic decision making. The structure was "designed to protect Google's ability to innovate and retain its most distinctive characteristics."

The lack of Earnings Guidance decision had been severely scrutinized, especially the months following the IPO, when Google's results were beating analysts' consensus forecast by more than 10 percent and analysts forecasts varied widely (For comparison, in 2006, Thomson Financial polled analyst annual EPS estimates for eBay, which does provide estimates, and the range was \$0.98 - \$1.06. The range for Google's annual EPS was \$8.09 - \$9.70.). Citigroup cited concerns that Google didn't have specific financial metrics as long-term targets. Jefferies argued that since Yahoo! and eBay provide guidance that alone is a reason for these companies to trade at a premium over Google. Credit Suisse First Boston mentioned that the lack of guidance apart from higher dispersion to analyst estimates would also result to a discounted valuation that would be growing as the non-guidance policy is being continued. The opening bid for a share at Google stock was \$85. As of July 2013, Google's stock was trading above \$900.

Since its IPO Google has stayed firm on its original decision not to provide guidance, citing EG's short sighted nature and called its investors to take a long-term view

- "Although we may discuss long-term trends in our business, we do not plan to give Earnings Guidance in the traditional sense"
- "We believe that artificially creating short-term target numbers serves our shareholders poorly. We would prefer not to be asked to make such predictions, and if asked we will respectfully decline."
- "In our opinion, outside pressures too often tempt companies to sacrifice long-term opportunities to meet quarterly market expectations."

"A management team distracted by a series of short-term targets is as pointless as a dieter stepping on a scale every half hour." - Google 'Owner's Manual'

Unilever

On the 5th of February 2009, the recently appointed CEO of Unilever, Paul Polman, announced together with the firm's end year results that the company would cease providing guidance to analysts. Specifically, Polman cited two main reasons for this decision: the uncertainty around the recession's extent or speed of recovery and the fact that 2010 targets were set "at a very different time in very different circumstances". However, the real impetus behind Polman's decision can be found in the sentence following the announcement: "We need to ensure that we focus on creating the long-term value in today's climate". He concluded that the short-term priorities set, such as protecting cash flow and margins, are in the long-term interest of Unilever's stakeholders. Over the next months and years Mr. Polman has stood his ground. Specifically, with any given opportunity Polman has highlighted Unilever's long-term business values, has used strong language against short-term investors, and has taken action to reshape the shareholder base of Unilever.

Polman summarized his beliefs during his Harvard Business Review interview in 2012 where he mentions: "We think that increasingly, businesses that are responsible and actually make a contribution to society in its positive sense, make it part of their overall business model, will be very successful". The first and one of the most important steps Unilever took towards this approach was the stoppage of guidance. "We've created an environment for our business to be a little bit more longer time focused. We abolished quarterly profits. We don't give guidance anymore. We changed our compensation systems for the long-term", Polman mentions. He argues that consumer-facing businesses need to rip up their business models and start again – working in partnership with local producers, NGOs and governments in ways that are sustainable. "Unilever has been around for 100-plus years. We want to be around for several hundred more... I'm not driven and I don't drive this business model by driving shareholder value. I drive this business model by focusing on the consumer and customer in a responsible way, and I know that shareholder value can come," he told The Wall Street Journal.

Polman has also used very strong language against short-term investors. During the 2010 Davos summit, Polman said that short-term City speculators were damaging the long-term needs of business. "They would sell their grandmother if they could make money. They are not people who are there in the long-term interests of the company". Further, Polman has added: "I don't criticize hedge funds, they undoubtedly have a role to play otherwise they wouldn't be there, but they might not have a role to play with companies like ours." This attack to short-term investors was part of Polman's strategic plan to reshape Unilever's ownership structure. "If you buy into this long-term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us," he said. "If you don't buy into this, I respect you as a human being, but don't put your money in our company."

Polman also emphasizes that Unilever's communication has by no means been reduced following Earnings Guidance drop. Instead of quarterly reporting "We spent a disproportionate amount of time discussing our longer term strategy and we tend to spend a disproportionate amount of time of attracting the right shareholder base. [...] you need to attract a shareholder base that supports your strategy, not the other way around."

As a result of the announcement's impudence, the market punished Unilever's stock, driving it down by more than 10 percent (outpacing the downward push of FTSE 100). Then the stock rebounded. By late 2012, its price was over 50 percent above Polman's starting price (a period in which the FTSE 100 had risen about 30 percent).

Unilever stopped providing Earnings Guidance as soon as its CEO changed, adopting an aggressive strategy against short termism in an effort to reshape its shareholder base

- "They would sell their grandmother if they could make money. They are not people who are there in the long-term interests of the company" - *Paul Polman*
- "Unilever has been around for 100-plus years. We want to be around for several hundred more" - *Paul Polman*
- "You need to attract a shareholder base that supports your strategy, not the other way around" - *Paul Polman*
- "If you buy into this long-term value-creation model, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company." - *Paul Polman*

4. The Future

The Earnings Guidance landscape could significantly change by altering the practices followed by a few key players. Specifically, change could happen by altering the behavior of a few influential companies that have a shareholder base not aligned with their sustainable strategy

4.1. Long-term thinking – Sustainability as the new status quo

Various key messages can be extracted from the previous sections, including:

- i) Earnings Guidance has become a popular practice across industries since the mid-1990s. However, a constantly increasing number of managers is keen to abandon the practice
- ii) Companies that are more frequent and more regular guiders exhibit a more short-term oriented investor base
- iii) The perceived benefits of the practice are not supported by empirical evidence
- iv) Managers that have adopted the practice have increased incentives to engage in short-term driven decisions (such as questionable practices or suboptimal behavior) at the expense of the long-term prospects of the company

Many corporate executives and investors are concerned about the possibility of Earnings Guidance infusing short-term thinking in corporate management. A short-term thinking can be a significant impediment to the incorporation of long-term goals in the design of the firm's strategy and the successful formulation and execution of a sustainable strategy. A sustainable strategy is one that creates value for shareholders in the long-term by contributing to a sustainable society (Eccles and Serafeim, 2013). Following the definition of the Brundtland commission, a sustainable society is one that satisfies the needs of the current generation without putting at risk the well-being of future generations. Therefore, a sustainable strategy incorporates a variety of Environmental, Social and Governance (ESG) factors that are important in the value creation process of the firm.

There are many reasons why managers should not ignore ESG factors when planning the firm's strategy. Recent examples of companies that failed to manage their ESG profile include Foxconn, UBS, and BP. Such cases highlight the costs of ignoring ESG issues not only from a financial perspective, but from a reputational perspective as well. Managers often overlook the preservation of the company's license to operate as a pre-requirement for the company's success. This licence is granted (and can also be withdrawn) on a daily basis by the company's employees, the communities in which it operates, its regulators, the governments, and the environment. Thus, disregarding ESG factors worsens the risk profile of the company.

On the other hand, integrating ESG issues into the corporate strategy allows companies to understand their business more holistically, reduce externality risks, and also increase their financial performance. Indeed, evidence suggests that companies proactively addressing material ESG topics financially outperform their peers (Eccles, Ioannou and Serafeim, 2011). However, adaptation of a sustainable strategy needs to be carefully designed, as better ESG performance does not necessarily imply better financial performance. Companies need to undertake major innovations in products, processes and business models to ensure that one is not happening at the expense of the other (Eccles and Serafeim, 2013).

4.2. The Next Generation of Corporate Communication

The ultimate goal is to replace communication practices that restrict managers and companies to short-term targets with new ones aligned with the firm's long-term strategic plans.

Management's commitment to concentrate on long-term objectives is the first important step towards a sustainable strategy. Equally important is the way this strategy shift is communicated to the market. For managers giving up the practice of Earnings Guidance, it is especially important to justify and rationalize their decision and respond to questions such as "if not Earnings Guidance, then what?" The ultimate goal is to replace communication practices that hold managers and companies hostage to short-term targets with new ones aligned with the firm's long-term strategic plans.

But how can managers frequently update market participants with information that is material to the long-term prospects of the company? In order to successfully do so, the firm's short-term financial and nonfinancial performance needs to be put in context with the overall long-term plan. By defining key milestones contributing to a more sustainable strategy, managers will be able to efficiently balance short and long-term performance. That would also allow them to communicate the firm's long-term competitiveness through frequent interactions with the market. Further, management will establish and maintain credibility not by trying to achieve short-term targets but by successfully executing the overall strategy. Ideally, this new communication channel would also serve as a value-enhancing tool, since it could provide management with new information and align the time horizons of a corporation's strategy with those of its investors.

An action framework for CEOs

Moving towards Sustainable Capitalism requires companies to practice integrated management where all forms of capital are present and enhanced. A critical component of integrated management is Integrated Reporting both as a mechanism to communicate performance and to act as a discipline for the effective execution of integrated management. As part of Integrated Reporting, we advocate that companies adopt a practice of Integrated Guidance. With this practice, companies would regularly provide market participants with information conveying management's view of how the different forms of capital are enhanced or depleted. As these different forms of capital are the engines behind the value creation process, they have a great impact on the long-term competitiveness of the company. We are mindful that the market can perceive stopping Earnings Guidance as a negative signal in some cases, either because it will be interpreted as a sign of increased uncertainty about future economic conditions or a sign of opacity and bad governance. We propose a seven-step process for CEOs to follow in order to successfully stop Earnings Guidance while also minimizing any negative perceptions during transition from earnings to Integrated Guidance. Specifically, we propose the following steps:

1. To signal that the decision to stop guidance is not a signal of increased uncertainty or deteriorating economic conditions, a CEO can announce the drop of Earnings Guidance and at the same time, along with the CFO, confirm guidance numbers for the same quarter but also issue one last guidance number for the next quarter.
2. The CEO should be the one that announces the decision to stop Earnings Guidance. This will be a clear signal that the organization takes this decision seriously and understands the risk of short-termism.
3. The CEO can clearly articulate why the company is ceasing Earnings Guidance issuance. The explanation should justify why frequent and regular guidance is inconsistent with the long-term sustainable strategy of a company.
4. The CEO should get the "board on board" of this decision. By highlighting that the board of directors agrees with this decision it is less likely that market participants will perceive this action as an attempt to hide something. Moreover, it shows that the board of directors is knowledgeable and engaged with the company's long-term vision.
5. The CEO can communicate a five-year strategic plan for the company defining milestones, why these milestones are important to achieve and the actions that need to be taken in order to be successful. This will enhance confidence in the management of the company and will make clear the strategic priorities of the company.
6. The CEO should announce the adoption of Integrated Reporting. Integrated Reporting not only enhances the information environment of the firm but it also serves as a discipline mechanism to ensure that the company has a long-term sustainable strategy.
7. As part of adopting Integrated Reporting the CEO can announce the adoption of Integrated Guidance. Integrated Guidance does not seek to provide numeric forecasts about specific metrics regularly. Rather it informs market participants about changes over time in a firm's different forms of capital and their impact on the future competitiveness of the company.

The Role of the CFO

Abandoning the practice of Earnings Guidance is a strategic decision directly affecting one of the responsibilities of the CFO. Consequently, the CFO needs to be fully on board and understand the strategic importance of this decision. It is crucial for the board of directors and the CEO to emphasize that the decision is unrelated to the CFO's overall performance. Additionally, it should be highlighted that the CFO's responsibilities are by no means being reduced. To the contrary, the CFO is an integral part of the firm's long-term plan. The CFO will be in charge of identifying a set of strategic financial benchmarks, which will be communicated to the investment community, as part of the firm's new communication plan. The progress on the firm's strategic plan will be measured against those measures and the CFO will be responsible for overseeing the successful implementation towards them.

As previously suggested, at the time the firm announces the abandonment of Earnings Guidance, the CFO can reaffirm, together with the CEO, guidance numbers for the same quarter but also issue one last guidance number for the next quarter. The CFO could articulate and establish the business case of how this decision will contribute towards a more efficient use of her time, as preparing guidance numbers is a time consuming and a resource demanding process, and will allow the CFO to perform her job more productively, as restrictions imposed by Earnings Guidance will cease to exist. Additionally, the CFO can identify key, material, financial metrics that are of strategic importance to the firm's future financial prospects. Importantly, as part of the long-term oriented plan, the CFO should have significant involvement in the preparation of the firm's integrated report and guidance (defined below) and she will be responsible for understanding the linkage between nonfinancial and financial performance.

A holistic corporate communication model

Integrated Reporting

An integrated report explains the company's financial performance in the context of its ESG performance, how the two reinforce each other, and where potential tradeoffs exist.

Integrated reporting refers to the combination of financial and nonfinancial performance in a single document and ideally reveals the relationship between the two. Via an integrated report the company changes the way it communicates not only with its investors but overall with its stakeholders. Increased transparency contributes towards the firm's engagement efforts and allows for a more open dialogue where the company is not just presenting results but also listening to its stakeholders and actively seeking feedback on its performance.

Additionally, an integrated report explains the company's financial performance in the context of its ESG performance, how the two reinforce each other, and where potential tradeoffs exist. By discussing the social and environmental impact that the company's operations have, as well as by reviewing its governance structure, managers can identify misalignments and areas that could be improved. As a result the integrated report contributes towards the formulation and execution of a strategy that enables creation of value for shareholders over the long-term while contributing to a sustainable society.

Through an integrated report, investors will receive quality information that matters. The integrated report provides them with information about industry developments and trends, market conditions, and other nonfinancial drivers of long-term performance. Despite being published annually, managers won't have to wait a full year to communicate on significant developments discussed in the report. As part of their increased transparency efforts, managers can utilize tools provided by existing technology and engage with stakeholders as often as they wish. Via the company's website and through the utilization of social networks (whose influence in the corporate world is rapidly increasing), managers can immediately reach out to multiple audiences and provide updates and news relevant to the firm's strategy and performance. Importantly, such communication channels allow managers to receive immediate and constructive feedback and proactively adjust their approach based on stakeholder reactions.

Earnings Guidance is a way of communicating, to a specific audience of the market, financial short-term performance expectations. It still plays a crucial role to the market valuation of the company, the type of investors the company attracts, the company's cultural identity, and its managers' behavior. By replacing EG with another form of meaningful, forward looking information, managers will touch upon all stakeholders, identify potential areas of development, increase transparency around the long-term prospects of the company, and as a result enhance shareholder value.

Integrated Guidance

The objective of this new communication strategy is to support long-term oriented investors into their decision allocation process by providing them with relevant and meaningful information that would make them aware of all the risks and opportunities they are exposed to, by investing in the firm.

“After Earnings Guidance, what?” is the question that managers will be called to answer immediately after the announcement of Earnings Guidance abandonment. Integrated Reporting is a step towards meaningful communication with the firm’s stakeholders. However, the investment community and other market participants would appreciate a complementary, new form of direct and quantifiable guidance that would help them assess the firm’s future prospects. As a result, we propose a new form of guidance that managers could adopt; Integrated Guidance (IG).

The objective of this new communication strategy is to support long-term oriented investors into their decision allocation process by providing them with relevant and meaningful information that would make them aware of all the risks and opportunities they are exposed to, by investing in the firm. We believe that the firm could provide the market with Integrated Guidance as frequently as annually, however depending on the horizon of its strategic plan it could be as infrequent as every three years. Depending on market and business model dynamics IG might or might not be needed as all relevant information might be communicated through the normal reporting process. However, in some cases, changes in regulations, market conditions, customer behavior, product demand, and other fundamental dynamics give rise to demand for IG.

IG utters information driven by the firm’s vision and mission, towards all of its stakeholders, and highlights progress towards these goals. It’s a communication tool that builds upon the credibility of the firm and its management, discusses the driving forces of the business, the ethics under which the company operates, the opportunities and risks it faces and clearly sets financial and non-financial targets that form the backbone of the firm’s long-term strategic planning. Specifically, Integrated Guidance contains information on:

1. Overview of material financial and nonfinancial performance of current business lines: Disclosure of this information would allow the firm to reassure stakeholders that the current business model is delivering towards its planned goals against everyone impacted by the firm’s operations (investors, consumers, society, and environment). Through IG, the company assesses the financial performance of its existing business lines, compares it with the performance of peers and with market trends and discusses the firm’s positioning and future potential. Additionally to financial performance the company also discusses the impact its businesses have on society and the environment and how this impacts the company’s reputation, growth, and risk profile.
2. Outline of future business plans: Provide market participants with a high level, overview of how the company is innovating to establish/maintain a long-term competitive advantage. This section may contain information on strategic new investments/entrances either in the form of products, geographical penetration or anything else that would significantly alter the outlook of the company. The management could rationalize its decision to allocate capital (in any available form, i.e., human, natural, financial, intellectual, physical and social) by explaining the expected impact of those decisions to the firm’s financial and nonfinancial metrics, how these decisions fit to the firm’s overall long-term strategy, and how they would contribute to the firm’s competitiveness. For example, Unilever in its “Introduction to Unilever, March 2013” report allocates its “Our Strategy” section to the importance of innovation. When referring to innovation, Unilever does not constrain its definition only to new products, but expands it to include the importance of an efficient corporate structure, successful employee engagement and disciplined cost policy. In the same report the company discusses the positive impact its strategic decisions have to communities and rationalizes its focus on entering new geographical markets by discussing the impact to its brand and to the company’s financials.¹²

12. See: http://www.unilever.com/images/Introduction-to-Unilever-2012-final_tcm13-283368.pdf.

3. Description of a set of quantifiable performance targets: These targets should be both financial and nonfinancial and concentrate on meaningful, for the company, metrics that matter to its long-term competitiveness. Financial targets may be in the form of long-term deleveraging plans, cumulative profit and dividend distribution expectations, and margin targets. Moreover, the company should set and communicate targets measuring its performance on nonfinancial metrics such as the impact of its operations to the environment and its contribution to society. Furthermore, the company should define targets allowing investors to assess whether the company has a flexible, efficient and productive governance structure in place.

Following the 2008 financial crisis, an increasing number of companies started communicating on longer term strategic plans with a time horizon of approximately 5 years. Enel Spa, an Italian utility company, published in March 2013 its “2013-2017 Plan.”¹³ At the top of Enel’s “key priorities” agenda over the next 5 years is balance sheet strengthening. Enel communicates transparently on how it is planning to achieve its target by providing cumulative cash flow expectation targets (along with details of their expected sources), dividend distribution plans and planned investments. As a result, an investor understands the key performance indicators for the company and also has all the relevant, financial, information that is of material importance to take a well informed decision. Furthermore, Nestle in its 2012 “Nestle in Society” report provides various key performance indicators that are of material importance to Nestle’s specific operations and quantifies their historical evolution, their current status and, importantly, sets future (c. 5 years) targets for them by articulating the expected impact they would have to Nestle’s operations.¹⁴

4. Assessment of own performance: This would allow management to enhance its credibility by emphasizing its commitment to targets it has set and measure its progress towards its strategic plan. Managers should compare the current status of metrics that had been established in previous IGs and discuss why targets may not had been achieved, and elaborate on the impact that achieved targets had to the firm’s overall positioning.
5. Presentation of all relevant risks the company is exposed to: The risks should cover financial, nonfinancial and operational exposures. As firms grow bigger and have a global reach, their exposures to, noncore, financial risks increase rapidly and may have adverse impact to their financials (i.e., multinational companies’ foreign exchange exposures may be so material that currency movements may wipe out any profits driven from business growth). In an IG the company identifies and quantifies their magnitude, and articulates the steps taken to manage them. Moreover, risks related to nonfinancial externalities and could put the firm’s license to operate under pressure should be discussed and assessed (i.e., dependence on water and other commodities, changes in consumer preferences, impact of regulation on the business). For example, one of the industries highly exposed to noncore market risks is the aerospace industry. The industry operates globally and companies bill clients (usually) in US dollars. EADS, a European aerospace company, owner of Airbus (an aircraft manufacturing company) updates frequently its investors about its exposure and transparently communicates all the steps it takes to minimize the financial impact from foreign exchange movements over a 5+ year horizon. Furthermore, Pirelli, a multinational manufacturer of tires, in its March 2013 “ESG Investor Briefing” presentation quantifies challenges it faces driven from nonfinancial externalities, such as regulatory, supply chain, environmental, security and social risks.¹⁵ This analysis forms an integral part of its Enterprise Risk Management (ERM) assessment and drives strategic decisions the company undertakes.

As a result, via Integrated Guidance investors will have a holistic understanding of the firm’s overall performance, business model and plan, risk exposures, quality of management and also a measurable way to assess the company’s progress towards its committed targets.

13. See: http://www.enel.com/en-GB-static/investors/presentations/doc/2013_01/Enel_2012_Results_2013-2017_Plan.pdf.

14. See: http://www.nestle.com/asset-library/documents/library/documents/corporate_social_responsibility/nestle-csv-full-report-2012-en.pdf.

15. See: http://www.pirelli.com/mediaObject/corporate/documents/common/investors/PIRELLI_Global_compact-UN/original/PIRELLI_Global_compact-UN.pdf.

4.3. Reshaping the Landscape

How effective change will come – An Action Framework

Having established the importance of sustainability at the core of a firm's strategy, and identified the need for new, innovative, more informative and comprehensive ways of communication, the next question that arises is "how to effectively change practices of long standing norms". An efficient and impactful execution plan is as important as realizing the need for it. Fortunately, globalization is supporting a time efficient and impactful strategic action plan towards this direction. In brief, the EG landscape could significantly change by altering the practices of a few key players.

Globalization has concentrated economic power within a group of large companies who are now able to change the world at a scale historically reserved for nations. Indicatively, just 1,000 businesses are responsible for half of the total market value of the world's more than 60,000 publicly traded companies¹⁶. This vast concentration of influence should be the starting point for any strategy of institutional change. Firms who lead their sectors and alter the practices they follow will change the behavior of thousands of other companies by creating a domino effect.

On that basis, the selection of companies identified as ambassadors of this new era of communication and strategy is crucial. To successfully identify the appropriate companies, a three-step action plan could be followed:

- | | |
|---|--|
| <ol style="list-style-type: none">1. <u>Select stronghold industries of Earnings Guidance:</u>
The first step in changing the landscape of EG is to acknowledge the sectors with the highest frequency of Earnings Guidance. Changing corporate guidance practice in those industries will signal guiders across sectors about the forthcoming wave of change and the reduced weight allocated to the importance of the practice. Industries that have traditionally been fond users of Earnings Guidance include the Consumer, Retail, and Extractive Industries sectors.2. <u>Filter for industries material to the ecosystem:</u>
Approaching companies within sectors that are the most important to global economic activity will signal to the market that the drivers of global prosperity are worried about the implications of EG to the ecosystem. | <ol style="list-style-type: none">3. <u>Identify key players with a problem:</u>
The companies chosen should exhibit a number of characteristics. Initially they need to be large enough and be perceived as leaders within their industry. That means that their practices, approaches, and behaviors set the industry benchmarks and are followed by their peers. Further, they need to be frequent users of Earnings Guidance, issuing forecasts on a regular basis and with increased intensity. Additionally, the companies should exhibit an increased transient investor base, higher than the industry's average. Finally, the management of the company should be sufficiently long-term oriented and communicate the long-term plans of the company. By default, in order for these strategic plans to successfully realize, they require the support of a loyal shareholder base. |
|---|--|

These steps will ensure that the companies identified are in need of change, and that an alteration in those companies approach to EG will have an impact on the way other companies perceive the practice and its benefits. However, convincing managers to change such long standing behavior is not as straightforward. Market participants (that also represent the biggest part of their investor base) are expecting these companies to provide this kind of information. Nevertheless, the same approach could be applied here as well. Managers are largely aware of the drawbacks of the practice. By acting collectively, a few key long-term investors could encourage managers to proceed by assuring their support and commitment to the firm's long-term strategy. Similarly, by leveraging the power of collective action, managers of companies could simultaneously decide to abandon the practice, rationalize their decision by quoting the long-term implications it has to the strategy of their firms, and collectively replace Earnings Guidance with alternative and more meaningful communication.

16. This situation has emerged very quickly (Eccles and Serafeim, 2012). In 1980 the world's largest 1,000 publically listed companies made \$2.64 trillion in revenue, or \$7.0 trillion in 2011 dollars, adjusted using the consumer price index. They directly employed nearly 21 million people, and had a total market capitalization of close to \$900 billion (\$2.4 trillion in 2011 dollars), or 33 percent of the world total. By 2011 the world's largest 1000 companies made \$34 trillion in revenue. They directly employed 68 million people, and had a total market cap of \$30 trillion.

Recommendations to members of the capital market ecosystem

Asset Managers

Investors need credible, timely, and value relevant information in order to allocate capital efficiently across investment opportunities. Their ability to do so will be enhanced in an environment without regular Earnings Guidance where corporations are striving to maximize the long-term profitability of their businesses rather than short-term financial results.

In a new regime where more meaningful information about the long-term drivers of the business is communicated through Integrated Reporting and guidance, investors need to have the tools to collect, analyse and embed this information into valuation models. Many investment houses have already developed significant capabilities to do so. Others are lagging behind. We urge all investment houses to develop the necessary capabilities, by training their investment professionals and giving them the tools to understand the value relevance of the information produced by integrated reports.

Brokerage Houses

It is no secret that the business model of sell-side research is under significant pressure. Sell-side research has been frequently criticized as lacking relevance and objectivity. We believe the new regime, where regular Earnings Guidance is absent and more integrated information is communicated, represents a great opportunity for sell-side analysts to add value to the efficient functioning of markets by producing innovative research and disseminating information to market participants.

Sell-side analysts can develop sophisticated valuation models to integrate material sustainability issues on an industry basis. Materiality of these issues varies by industry and sell-side analysts, as industry experts, have a competitive advantage in helping asset managers embed material sustainability issues in their capital allocation decisions. Identification of the material sustainability issues for each industry is an effort undertaken by the Sustainability Accounting Standards Board (SASB). We suggest that sell-side analysts get involved in the industry working groups, according to their industry expertise. This will enable them to develop the capabilities to serve their clients in the buy-side by producing research that analyses companies' long-term sustainability through an integrated analysis of all material issues.

Stock Exchanges

Stock exchanges are platforms that allow the formation of liquidity in trading of financial securities. Investor confidence is critical in order to create liquid markets that can be trusted by all parties involved. We suggest that stock exchanges take a leading role advising the companies listed in their platforms to increase transparency by adopting Integrated Reporting and widely disseminating information that provides relevant

long-term information. This will increase investor confidence and allow for more informed investment decisions.

Significant efforts are already under way for this to happen. The Sustainable Stock Exchange initiative organized by the UNCTAD, the UN Global Compact, the PRI and UNEP-FI now includes the Bovespa (Brazil), BSE (India), EGX (Egypt), Istanbul (Turkey), Johannesburg (South Africa), MCX (India), and Nasdaq (US). These stock exchanges "voluntarily commit, through dialogue with investors, companies and regulators, to promoting long-term sustainable investment and improved environmental, social and corporate governance disclosure and performance among companies listed on our exchange."¹⁷ We suggest that all stock exchanges commit to promoting long-term sustainable investment and improved environmental, social and corporate governance disclosure.

Accounting Firms

Accounting firms should be very interested in the practice of Earnings Guidance and in the future practices that affect corporate transparency. Accounting firms do not render any kind of an opinion on the numbers companies provide as part of Earnings Guidance. However, they do have a role in auditing the actual earnings figures. If these figures are being altered to meet forecasted earnings then auditor's work is fundamentally more difficult.

Rarely bending the rules lead to outright fraud, although this does happen. Accounting firms take the position that the basic audit is not designed to detect fraud, particularly if the most senior level of management is complicit in this. When it is discovered, the accounting firm is sued and often pays out large settlements. So-called "practice protection costs" are the single largest cost item outside of partner compensation. To the extent that the elimination of Earnings Guidance would reduce fraud in financial statements, the accounting community would find this attractive.

To the extent that companies couple Integrated Reporting with the elimination of Earnings Guidance, the issue arises of whether the integrated report will receive a positive integrated assurance opinion. There are a number of barriers to doing this, such as the absence of generally accepted accounting and auditing standards for nonfinancial information, but these can be overcome as the example of KPMG providing a positive assurance on Philip's integrated report represents. Assurance of integrated reports represents a major revenue opportunity for the accounting firms, a potentially important one given the pricing pressures they are facing for the standard audit, which is now regarded as a commodity. Perhaps more importantly, integrated assurance opinions will increase the relevance of the accounting profession since these opinions will be on a broader range of information that is important for long-term performance.

17. <http://www.sseinitiative.org/partner/the-commitment/>

Regulators

There are a number of ways in which regulators can play a role in shaping the Earnings Guidance practice. After all, it was regulation in the U.S. that first prohibited this practice and then made it possible. The SEC could go “full circle” and simply eliminate it again. While we aren’t recommending this and believe it is not a politically feasible approach - or even an effective one - regulators do have an important role in facilitating other activities, such as Integrated Reporting, that help replace Earnings Guidance with information that will be more useful.

Companies, especially in the U.S., are concerned about the legal liabilities of additional voluntary disclosures. Similarly, accounting firms are concerned about the additional legal liabilities that could come from providing an audit opinion on a broader range of information. Regulations which provided some type of “Safe Harbor” on additional disclosures and limited the liability of accounting firms for properly executed integrated assurance opinions could play a very useful role. In general, we see the role of regulation to be less about setting rules for what can’t be done and more about facilitating the recommendations made in this paper.

Media

Financial news agencies play a significant role in disseminating information to capital market participants, uncovering new information, and analysing information that is communicated by other organizations. Regular Earnings Guidance might be seen as a source of news for the media that are always searching for new information. However, with the rise of the internet and social media technologies the information dissemination role of traditional media organizations is being disrupted.

Similar to sell-side analysts, the media could utilize their expertise in uncovering and analysing information related to financially material sustainability issues that could affect the long-term competitiveness of corporations. As sustainability issue are gaining momentum and they are becoming more important in the competitive arena, media could prove to be very useful as information intermediaries that disseminate information to sell-side analysts and investors, who are then able to integrate this information in their valuation models.

5. Appendix

5.1. Exhibit I

Dependent Variable	Long-term ownership base					
Variables	Estimate	t	Estimate	t	Estimate	t
Intercept	-10.91	-2.85	-0.69	-0.21	0.67	0.21
# of forecasts	-0.18	-14.55				
% of quarters forecasted			-7.14	-8.20	-6.61	-7.42
Intensity of guidance					-1.39	-2.71
Industry fixed effects	Yes		Yes		Yes	
Adj R-squared	6%		7%		8%	
# of firms	9,122		2,695		2,695	

We define as long-term investors, the difference between the percentages of shares held by dedicated (low portfolio turnover and small number of portfolio holdings) and transient investors (high portfolio turnover and large number of portfolio holdings). # of forecasts is the total number of guidance provided by the companies since mid-1990s. % of quarters forecasted is the percentage of financial quarters that the firm has issued guidance. Intensity of guidance is the number of forecast updates within a financial quarter. Source: Bloomberg, KKS Advisors.

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The logo for the Generation Foundation, featuring the word "generation" in a bold, lowercase sans-serif font, with "foundation" in a smaller, lowercase sans-serif font directly below it. The text is white and set against a dark blue rectangular background.

generation
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The Generation Foundation (the 'Foundation') was part of the original vision of Generation Investment Management LLP (the 'LLP') since the firm was founded in 2004. Charged with the mission of strengthening the field of Sustainable Capitalism, the Foundation's funding is based on receiving a distribution from the LLP's annual profitability. There are four channels through which we implement our mission. The first, which is our principal platform for activity, is a partnership model whereby we collaborate with individuals, organizations, and institutions in our effort to accelerate the transition to a more sustainable form of capitalism. In addition, the Foundation also supports select grant-giving related to the field of Sustainable Capitalism, engagement with the local communities where we operate, and an employee gift-matching program.

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