Earnings Guidance

By Michael Kemp

The forces that move share prices aren't always obvious.

Take, for example, the effect of profit announcements. Sometimes news of a larger profit (than the previous year) causes a company's share price to soar, sometimes it causes it to fall. This apparent contradiction can confuse investors new to the share market. However the direction the share price is likely to swing becomes clearer when one appreciates how shares are priced. They dance to a never-ending tune of investor expectations.

So, if the general expectation is for a company to deliver a significantly larger profit, but instead it delivers only a moderately larger one, then the share price often corrects to the downside when the announcement is delivered. However, the announcement of even a modest profit rise can see the share price soar if the expectation was for a flat or negative result.

Which begs the question: should companies be flagging to the market the magnitude of soon-to-be-announced earnings results? Clearly companies develop a feel for what that result is going to be as they tally the figures. And there is no doubt that the important principles of market fairness and efficiency rely upon all market participants being well informed and in a timely manner.

This article focuses on this form of corporate information delivery - earnings guidance – it explores what and why investors are typically told prior to an upcoming profit announcement and whether the information that is delivered measures up.

What is earnings guidance?

Earnings guidance is simply a listed company's prediction of its upcoming financial result.

There's no blanket legislation that requires companies to issue guidance (interestingly there is a misconception among some investors that there is). Despite this many companies exercise their option to deliver it.

However there are circumstances when legislation does require a company to issue profit guidance. This occurs when the ASX's continuous disclosure requirements are triggered. Let's explore.

The ASX's Continuous Disclosure Requirements

ASX listing rule 3.1 is succinct. It states that:

Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.

This rule applies to any event, at any time, that could materially impact a company's share price and is not limited to the effect of an unexpected financial result. For example it could relate to the discovery of a rich new seam of gold for a mining company or an impending class action against a payday lender.

But clearly it also applies when a company first realises that an upcoming profit result will vary materially from the market's expectation. This is a time when a company would be obligated to issue earnings guidance.

Now you'd expect that brief ASX listing rules, such as 3.1 and its associated 3.1A and 3.1B, would be fairly easy to interpret (especially since statutory backed continuous disclosure requirements having been in place in Australia for over 20 years). But that hasn't been the case. So in order to clarify their interpretation the ASX recently released an updated Guidance note 8 specific to continuous disclosure. It's 84 pages long so it takes some reading.

However let's focus on just three important points which are specific to this article:

1. There is no general obligation for listed entities to provide earnings guidance to the market or to release their internal budgets or earnings projections.
2. A company has a legal obligation to notify the market if it becomes aware that its earnings for the current reporting period will differ (downwards or upwards) from market expectations to such magnitude that a reasonable person would expect it to have a material effect on the price or value of the entity's securities.
3. The guidance figures delivered by the company can't be based on an estimate or a rough forecast. They must be based on reliable information.

How are the market's expectations determined?

Of course, this raises a very important point – How does a company determine what the market is expecting its earnings for the current reporting period will be? The guidance note covers this issue well so let me quote:

ASX considers that the best and most appropriate base guide to use for these purposes is:

- if an entity has published earnings guidance for the current period, that guidance;
- if an entity has not published earnings guidance for the current reporting period and it is covered by sell-side analysts, the earnings forecasts of those analysts; and
- if an entity has not published earnings guidance for the current reporting period and it is not covered by sell-side analysts, its earnings for the prior corresponding period.

And it finishes up by adding: Each of these measures is only a guide to what the market is expecting.

What is meant by a material effect?

Guidance note 8 advises that a company has a legal obligation to notify the market if it expects that its earnings for the current reporting period will have a material effect on the price or value of the entity's securities. What is meant by a material effect?

Here the ASX distinguishes between the position for entities that do or do not publish earnings guidance.

For those that publish earnings guidance, it recommends updating that guidance if it expects a material difference between its actual or projected earnings for a period and its published guidance for that period and that Australian Accounting Standards materiality guidance be applied, that is:

- a variation of over 10% should be treated as material and entities should presume guidance requires updating; and
- a variation of less than 5% should be treated as not being material and entities should presume guidance does not require updating,

unless, in either case, there is evidence of a convincing argument to the contrary.

Entities which don't publish guidance need to consider whether the variation to market expectations is market sensitive. That is, disclosure is not expected merely because there is a 5 to 10% variation between actual or projected earnings and market expectations.

Why do companies issue guidance when they don't have to?

If an upcoming profit result is unlikely to materially impact a company's share price then a company isn't obligated to issue guidance. However many do. Why?

It's an interesting question isn't it? Even more so when placed within an historical context. In my soon-to-be released book *UnCommon Sense* I describe the culture that prevailed in US boardrooms over a century ago. Many companies were loath to deliver any form of financial results to the market. Author Louis Guenther described this attitude when he wrote that the representative of one US company complained that financial reports were unnecessary since in making their affairs known companies would "lay their trade secrets before competitors".

Of course attitudes regarding disclosure have changed significantly since then but it still begs the question, why do companies issue guidance when they aren't required to? Commonly stated reasons are that it results in:

- lower share price volatility
- improved liquidity in the stock
- reduced information asymmetry (a complex way of saying that it helps align investor's views regarding the stock)
- a lower cost of capital.

Two commonly stated disadvantages are:

- the time and cost involved in providing disclosure
- it introduces an emphasis on short-term earnings targets fostering myopic managerial behaviour which is detrimental to a firm's long-term growth and value creation.

In relation to the above stated advantages it's important to note there are as many studies supporting them as there are discrediting them.

The bottom line

The ASX's approach to earnings guidance - that it's important in facilitating a better-informed market - makes pure sense. But evidence is thin on the ground that there are advantages beyond this.

There appears to be little advantage in making guidance mandatory. It's important to remember that stock valuation requires a long-term view, not a short-term one. And to enforce a blanket requirement could encourage short-termism, i.e. to introduce a game whereby managements display short-term targets which are then used by investors to make short-term judgments.

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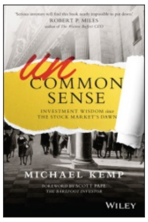

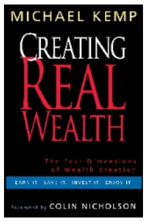

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.

