

## COMMITTEE COMMISSIONED STUDY FINDS NET BENEFITS OF PROPERLY DONE MANAGEMENT FORECASTS OF EARNINGS

**CAMBRIDGE, Mass., Sept. 15, 2009**—The Committee on Capital Markets Regulation (“Committee”), an independent and nonpartisan research organization dedicated to improving the regulation of U.S. capital markets, today released a study and accompanying set of recommendations finding net benefit from using management earning forecasts (MFEs) in investor communications, if done in the context of a full explanation of the company’s strategy. The Committee conducts its own rigorous research and also supports research by outside individuals and institutions. The Committee sponsored Professor Miller’s investigation into this important market issue, but has taken no position on his recommendations.

Professor Gregory S. Miller of the Ross School of Business Education at the University of Michigan undertook this study to help better define and shape the ongoing national debate over the value and risks of using the MFE tool. His study concludes that forecasting provides net benefits, including better alignment of current market returns with long term performance, even though it acknowledges the risk that managers can abuse them to manipulate short term market action for such “selfish” purposes as pricing or cashing in management stock options. Moreover, Miller found that the more widely used and specific the MFEs, the greater their net benefits.

Recent years have seen a growing debate regarding the role that MFEs should play in investor communications. Some players in the market argue that an increasing focus on earnings guidance, particularly quarterly guidance, has created a myopic environment in both investment markets and operating companies. However, others argue that MFEs are a crucial part of the management communication process. Arguments from both sides have generally relied on impressions or anecdotal evidence.

Harvard Professor Hal S. Scott, the Committee’s President and Director said, “Miller identifies key benefits of MFEs when properly used and creates a useful framework for maximizing these benefits. While the Committee took no position on his findings, it is clear that abolishing earning forecasts by issuers will not abolish the forecasts – it will only mean analyst forecasts will be less informed. He added, “The way to curb short-termism is to make sure earnings forecasts are made in the context of an overall explanation of corporate strategy, which may be focused on earnings over a longer term.”

### **Findings**

Professor Miller’s study found that MFEs have long served as an important information management tool for market participants, including allowing managers to align investor and analysts’ expectations with those of the manager while reducing information asymmetry across trading, and allowing current market returns to more closely reflect longer term operating performance.

The study points out costs associated with MFEs. These include managers using their private information to time MFEs favorably with regards to stock transactions around them. Additionally, they may strategically issue MFEs to obtain favorable option terms.

However, Prof. Miller also found that the empirical literature generally does not support recent allegations that MFEs led to value destroying myopic behavior. In particular, he found the literature shows that the market responds to short term performance whether or not there is prior

guidance. Miller found the converse, that is firms curtailing guidance do not attract significantly increased long term investment policy or demonstrate a reduction in “myopic” behavior.

On balance, while the study concludes that forecasting creates a net benefit, it also reveals that variance in forecasting practices can strongly influence whether firms using MFEs achieve the benefits.

Professor Miller’s study offers a number of specific recommendations to provide for a more effective deployment of MFEs in the market.

The study suggests that management may optimize the value of MFEs by responding to the fact that the market values more precise forecasts, supported by statistical detail, and prizes managerial reputation built on a record of consistently providing accurate MFEs. The market is found to seemingly appreciate MFEs for varying reasons, even though short term MFEs generate the greatest market response. The study found that tiered horizon MFEs appear to help the market understand longer term performance.

The study recommends the adoption of a written policy for detailing when MFEs will be provided, what form they will take and how they relate to the company’s overall disclosure package. This document would commit managers to a policy and provide a framework for discussing the policy with outsiders, thus allowing the market to more fully understand why a given policy is correct for a specific firm. It also would reduce managers’ ability to undertake opportunistic timing of MFEs.

In addition to calling for a written policy, Miller suggests managers design their MFEs to provide forecasts over multiple horizons at a single time. The MFE should be more precise for shorter horizons and get less precise as the time period expands. It should be supported by sufficient detail and provided on a regular basis in order to build a reliable history of guidance. Miller also suggests managers commit to providing an ex-post explanation of why actual results differed from the MFE (or why longer term expectations are being adjusted).

The Committee is a non-partisan group of independent U.S. business, financial, investor and corporate governance, legal, accounting and academic leaders. It was founded in 2005 to study and report on ways to improve the regulation of the U.S. capital markets.

Prof. Miller’s study entitled, “Should Managers Provide Forecasts of Earnings?” is available at <http://www.capmksreg.org/>

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