Statement of
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Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing entitled
"Fostering Accuracy and Transparency in Financial Reporting"
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Mr. Chairman and Members of the Subcommittee, I am pleased to submit a statement regarding the issue of earnings guidance, addressed at your hearing entitled "Fostering Accuracy and Transparency in Financial Reporting."

My name is Candace Browning, and I am the Head of Global Securities Research & Economics for Merrill Lynch. Prior to being named to that position in 2003, I was a U.S. airlines analyst for 18 years. During much of this time there was no such thing as quarterly earnings guidance. The role of the analyst was then, and remains today, to provide investors insight into companies and industries that results in sensible and profitable long-term allocations of capital.

Whether evaluating the merits of a new business model in an initial public offering or identifying excess capital that should be reaped for shareholders' benefit, the analyst's role in the capital formation process remains critical to transparent capital markets. Projecting a company's future earnings and tracking shorter-term quarterly performance is important, but in recent years that focus on quarterly earnings has overshadowed the rest of the job.

Quarterly earnings can be tweaked by cutting back on expenses such as advertising and technology investments or accelerating the recognition of revenue. Managing to this short-term orientation presents obvious drawbacks, as highlighted by the US Chamber of Commerce and a recent McKinsey study. (Both argue that quarterly earning guidance fails to reduce short term volatility and can inappropriately create an illusion of stability.) However, the ancillary effects and unintended consequences of quarterly earnings guidance are arguably more damaging and unrecognized.

By providing specific earnings guidance, a company dictates both the measurement stick and the expected outcome. The measurement stick is typically a certain level of earnings – which may or may not be appropriate. And guidance is typically given without regard to important non-operating items such as write-offs or restructuring charges, which should be included because they reflect management's prior decisions regarding allocation of capital. The company's goal is to encourage the market's acceptance of its self-defined measurement stick and then beat the resulting

consensus, thus proving that it is earning higher-than-expected returns and so worthy of further allocation of investor capital.
This process creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company’s operations and performance into a single number – dictated by the company itself.

At Merrill Lynch, analysts are advised not only to discount heavily and to question earnings guidance, but also to analyse what the guidance – and the way it is constructed – says about the management. For example, analysts who follow companies with high operating leverage and little visibility into actual earnings per share know that the reason they give guidance is to ensure that they are able to beat that guidance. At one investor conference recently a spokesman stated proudly that his company either “met” or “beat” their guidance in 56 of the last 59 quarters. That this metric is carefully tracked shows that beating the guidance is what is important, and that the guidance is clearly not accurate and should be heavily discounted. Where cyclical companies with high operating leverage provide guidance, an analyst should question not only the figures, but also the management’s wisdom in providing guidance at all.

But breaking free from company guidance is a tall order. An earnings forecast that contradicts management is highly provocative. Analysts who disagree with companies are sometimes derided publicly and subject to retaliation, such as being excluded from asking questions. Even Thomson First Call presumes that company guidance is correct and asks analysts to confirm their estimates if they fall outside it. For all these reasons, forecasts that contradict companies’ management guidance do not happen as often as they should.

Merrill Lynch believes it would be in the best interests of investors if companies dropped quarterly earnings guidance. Market participants need to see it for what it is – a rough assessment of one indicator of a company’s well-being. Earnings guidance dictates an outcome and discourages debate. Worst of all, this one number cannot possibly convey the subtle forces that shape a wise capital allocation decision and ultimately investors are let down.

None of this means a company should stop providing the marketplace with the financial data needed to make a determination regarding its future expected performance, particularly if it is aware of an adverse development that will dramatically affect its results. Information on long-term goals or targets such as reducing costs, increasing market share, growing capacity and improving return on equity are all examples of healthy objectives that should be communicated to investors. Running a company is a complex task; the dialogue between analysts and companies should reflect that.

I would also like to inform you that Merrill Lynch & Co., Inc. does not provide quarterly earnings guidance.

Thank you for the opportunity to present Merrill Lynch's views on an issue of significant interest to the investor community. I applaud your efforts in seeking more accurate financial insights regarding company performance.