Evaluating Earnings with an Eagle's Eyesight: Refining Forecasts with a Risk Lens
Review Risks Leading to Calendar 1Q 2012 Negative Earnings Surprises

24 May 2012

Executive Summary

Risks abound in a changing and complex world. Despite trends toward better risk oversight and management, sixty-eight S&P 500 companies reported negative surprises greater than 5% below consensus in the first calendar quarter earnings season. Knowing "why?" can help any company avoid future negatives and make it easier to seize growth opportunities. In contrast to the compliance and financial reporting risks that hit the headlines, about half of surprises sprung from strategic risks, about a third from operational risks, and just over 11% from strategic or operational risk-driven one-time situations. This suggests investors would benefit if companies increase their emphasis on more performance-driven risk management. These more forward-looking approaches are designed to ask "what if?" in dynamic business environments and prepare for unfolding situations – the world of strategic and operational risk.

Need

The point of risk management is to manage risk to business performance, making it safer to seize opportunity in a changing world. Risk to performance can be measured in operational or financial terms. In financial terms, risk to return is primary for investors. This risk can be expressed many ways, including risk-adjusted period or future returns, risk to share price growth or share price volatility. Period earnings are in each of these notions. Thus, it is important for investors to understand where risk lies – and how companies are managing that risk.

The complication is that companies generally do a poor job of communicating risk factors, and risk oversight and management to investors. Annual report / US SEC Form 10-K discussions of risk factors are usually long and generic, providing little company-specific insight. In proxy disclosures on risk oversight, our recent review[1] found that just over three-fourths of those S&P 500 member companies sampled fell well below recognized benchmarks.

[1] "Two years after the SEC mandated disclosure on Board Oversight of Risk, what insight have investors gained? Not Enough. A review of disclosures required by the U.S. SEC Proxy Disclosure Enhancement rule provision on Board Role in Risk Oversight." Analysis Series, ValueBridge Advisors, LLC, 28 February 2012 http://www.valuebridgeadvisors.com/ESROPD022812.pdf

Investors chronically wonder, "How well is a company *really* managing its risks to return – and my share returns?" Sadly, this is not surprising, as proxies are often written by lawyers as compliance documents rather than as business strategy and execution communications to investors.

Given this information gap, earnings releases describing negative surprises can enlighten investors because a release usually includes explanation of specific risks that were realized and response(s) taken. Negative earnings surprises are especially interesting to analyze given the clear tendency of companies to guide low and the strong majority to meet or beat consensus estimates. Further, releases give investors a glimpse into management quality by understanding where a company sees risk to business performance and is managing those risks to take advantage of opportunities and avoid threats.

The more explanation management provides, the more it communicates to investors how well management: knows its business (environment and capabilities), was aware of dynamic situations, understood what warning signs could look like, proactively looked for warnings signs, promptly acted on those warning signs, and was effective in avoiding, slowing, containing and stopping the unfolding situation. Of course, many other risks also arose that didn't cause enough damage to catch blame in a release. Investors hope that management action to respond to risks causing negative surprises extends to management of all risks to business performance. In short, more thoughtful earnings release explanations based on how a company uses it capabilities to engage the environment (assuming management walks their talk) can increase investor confidence in future value creation.

Looking at companies in aggregate provides insights to types of risks that actually damaged companies and where added focus is required from management, boards and investors.

Thus, this review of negative earnings surprises in the opening of calendar 2012 hopes to shed light on risks to return and stimulate improved focus on managing those risks.

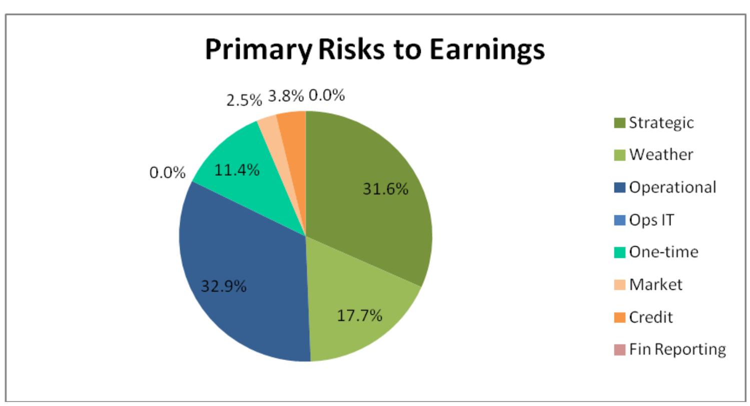
Study

Companies reviewed were S&P 500 members that missed earnings consensus by greater than 5% in reports released during the 90 days ended 18 May (68 companies). These were reviewed for type of risk to which the company attributed the miss. A primary and, if applicable, a secondary risk category were identified. For more information on company selection and categories please see the Methodology section.

Results

Realized risks to earnings:

- Strategic risks were about half of negative earnings



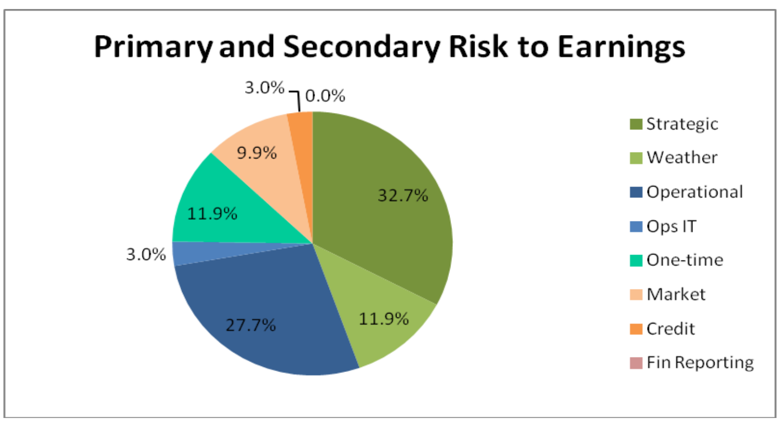
explanations in the quarter. Many negative surprises came from energy companies affected by the mild US winter. To avoid distorting the strategic risk category, weather risks were separately identified. Thus, strategic risk in general related to business environment and model was pointed to in just over one-third of all reports. In addition, companies pointed to weather as primary in another almost 18% of negative surprises.

- Operational risks related to people, process and systems that implement strategy were the next largest category of primary causes to negative surprises – just under one-third of all reports. Looking more closely, information technology related operational risks were reported as secondary in just over 3% of reports. Explanations given of operational risks suggest a greater impact of information technology.

- Stemming from strategic and/or operational risks are one-time impacts (merger, acquisition, divestiture, restructuring, discontinued operations and legal settlements). For clarity, these are called out separately. These comprised just over 11% of primary causes for all negative surprises.

- Market risks (foreign exchange and general market returns) were 2.5% of primary causes for negative surprises. In viewing both primary and secondary causes, market risk expands to just under 10%. Credit risks were 3% of primary causes for negative surprises, all at banks.

Variations in management's discussion of the surprise were notable in several respects:



- Some companies led with the bad news, others led with good news. Some made it difficult to find the risk cause of the bad news (or saved it for the earnings call discussion or even the call question and answer period).
- Some went to greater lengths than others to position the surprise in the context of prior earnings releases and/or guidance by using phrases such as "as anticipated" or "as previously reported."
- Depth of explanation of cause in terms of environment, company position in the environment and company capabilities.
- Extent and combination of risk responses taken. Some stressed benefits already realized, others noted benefits to come.

- Extent of action to substantively reposition in the environment and/or strengthen capabilities versus financial engineering (here meaning reactive repurchase or distracting dividends that are undertaken to improve EPS calculations rather than substantively growing profitable revenue).

Implications

In comparing so many negative earnings surprise releases, patterns emerged suggesting implications for both investors and companies. These implications are in both form and substance. In form, the variations companies take in positioning these surprises suggest that companies are either not very thoughtful in how they communicate, simply unaccustomed to explaining negative surprises given that the vast majority of companies normally meet or exceed consensus, or unclear on what to describe because investors and analysts don't clearly communicate to companies. These communication difficulties ultimately reflect on substance. With this in mind, it may benefit both investors and companies to more fully consider several implications.

Investors and Analysts:

- Form: Describe a helpful presentation format to companies. Make clear that companies are viewed with more integrity when they are more direct with bad news. Further, describe the detail needed to provide confidence that a company understands the risk(s) and responded to reduce risk to future performance.
- Substance: Communicate what "good" looks like in risk responses, including whether the realized risk was truly isolated or part of an ongoing situation. To what extent are cost cutting, share repurchase or dividend changes beneficial? Or, are they weak substitutes for a healthy business model that drives growth in market share and revenue? These points are particularly important for investors to communicate who have a longer term outlook.

Companies:

- Form. Consider whether your release actually reflects your management style and culture. Are you "up front" or playing "hide and seek"? For example, while the release opened with news of sequential improvements in backlog, Jacobs Engineering Group directly addressed three drivers of its miss. Contributing to confidence is a willingness of the CEO to be quoted with the bad news statement rather than pushing that to the CFO or COO. For example, while not the lead line of the release, the CEO of Republic Services delivered the bad news.
- Substance: Consider the extent of focus on risk to business performance objectives. Are business activities always viewed through a "risk lens" – in good times and bad?
    - Given that most risks to earnings (and return) are strategic and operational, do your proxy and annual report discussions of risk oversight and management describe a robust approach to managing the full range of risks to return (including dependencies and interactions across your extended enterprise) in contrast to a retrospective, reactive, compliance or audit-type approach more appropriate for risks to reporting quality?

- How much of the loss was successfully limited by existing risk oversight and management? For example, several companies discussed how the weather impact was minimized by strategic decisions regarding product (including pricing) or customer mix.
- Given that the risk(s) identified in the release caused a miss, does the explanation apply lessons learned to describe how systematic risk oversight and management in future will avoid other lurking gaps?
- Together, these provide insight to the company's potential to more safely seize opportunities.

These significant earnings gaps driven by strategic and operational risk beg for action. This action must be different from what companies are doing today for risk to compliance or financial reporting.

Summary

This review brings into stark contrast the realized risks to return versus the compliance and reporting type risks on which all too typical risk management activities focus. Such approaches just don't get the job done in the complex and changing world of strategic and operational risks that dominate negative surprises. Further, poor strategy can increase risk in operations (much like how a poorly designed product can be more prone to break and more expensive to maintain).

Managing such risks requires an approach designed for: a dynamic environment, stressing understanding of "the business," asking "what if?" and preparation for inevitable "bad things." This risk to performance focus is in contrast to activities designed for checking and reporting on prior events, usually in a more stable environment such as financial systems. In a baseball game, neither an accurate scoreboard nor a strong defense actually scores points. Scoring points is about managing risk to performance.

Methodology

Selection: Companies selected for review were members of the S&P 500 that had greater than 5% negative earnings surprise relative to Zack's consensus estimate. This group was then checked against Thomson Reuters First Call and StarMine estimates to validate that a miss was against all three. The 5% threshold was intended to focus on more significant negative surprises and be outside company guidance ranges (although guidance ranges were not verified). These negative surprises were the more significant given the clear tendency of companies to guide low. Data on negative earnings surprises in the prior 90 days were selected as of after close of markets on 18 May and included 68 companies.

Earnings releases were then reviewed to understand the risk type to which management pointed as primary (and sometimes secondary) causes of the miss. Where management provided little information in the release, information from the analyst call and resulting news story was also used. No attempt was made to validate management assertions. Rather, an objective of this review was to understand the cause(s) to which management pointed to thus evaluate management's actions in past and potential affect on future performance.

The materialized risks where grouped into common categories. In most cases, only one risk (based on management description and financial impact) was identified as primary. In some cases where information was insufficient to distinguish, two risks were identified as primary. In cases where another risk was described by management (but financial impact less), a secondary risk was identified. This led to the two presentations of results – with and without the secondary risk.

Categories: As there has been debate in professional circles about risk category definitions and as there is the practical matter of dependencies between risk categories, a few category clarifications are warranted.

- Strategic risks include those related to the business environment in which the firm operates and strategic decisions, including business model. Thus, broad economic conditions (including pricing), political and country risks, natural conditions, technology changes, social situations, and target markets (customers, countries, products) are included. Weather (specifically mild winter in the US) was cited by so many energy companies expressly dependent on degree-days that weather was identified separately to avoid distorting the view of other strategic risks.

- Operational risk is mostly related to people, process and systems that implement business strategy. This captures most execution risks other than financial risks (market and credit) and financial reporting. Because a few companies specifically discussed operational systems dependent on information technology, a category for IT operational risk was also used as a secondary risk.

- One-time considerations are rooted in strategic or operational risks. As one-time items are common and to avoid distorting the other categories, one-time items were placed into a separate category. One-time items as a primary factor in this period included merger, acquisition, divestiture, restructuring, discontinued operations and legal settlements. Changes in CEO (death, removal, retirement) were reported in several disclosures and succession risk is non-trivial. Yet, CEO situations were not described as a primary or secondary driver of earnings miss.

- Market risk as a primary risk in this survey period was mostly reflected in foreign exchange difficulties for operating companies and investment portfolio strain for financial companies. As a secondary factor, it also included commodities prices and tax affects related to other transactions.

- Credit risk as a primary risk factor in this survey period was confined to financial company lending portfolios. While customer selection and credit product management (significant problems in the financial meltdown) are strategic, especially for financial companies, with the big strategic risk surprises occurring a few years ago, these were classified as credit risk.

- Financial and compliance reporting risks are generally part of operational risks. However, given regulatory attention and potential to cascade, financial reporting situations where treated separately. In reviewed companies in this period, SEC inquiries reported had not yet resulted in a restatement that was described as a primary or secondary cause of a miss.

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