

**DISCLOSURE OF PROFIT FORECASTS**

**DURING TAKEOVERS:**

**EVIDENCE FROM DIRECTORS AND ADVISORS**

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## FOREWORD

In April 1998 the Auditing Practices Board issued a discussion paper *Prospective Financial Information* to obtain views from interested parties on current issues relating to prospective financial information. The discussion paper also highlights the following developments. Recent rule changes have been made by the London and Irish Stock Exchanges which affect the extent to which assumptions underlying forecasts are required to be disclosed. On the global front, the International Capital Markets Group is carrying out a comparative survey of prospective financial information. In addition, the International Auditing Practices Committee is also developing a new international standard in the area of prospective financial information.

These recent developments demonstrate the continued interest in the topic of prospective financial information of which the issuing of profit forecasts during takeover bids is part.

This research report is published by the Research Committee of The Institute of Chartered Accountants of Scotland as a contribution towards understanding the motivations and reasons why some UK companies include voluntarily a profit forecast in offer or defence documents issued during takeovers whilst others do not. Findings and recommendations contained in this report are based on eleven in-depth interviews with a variety of participants in the disclosure process ranging from directors of bidding and target companies, to advisors and to regulators.

Professor John Baillie  
Convener, Research Committee  
November 1998



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## EXECUTIVE SUMMARY

Takeovers are complex business phenomena, undertaken for a variety of strategic and financial objectives. The progress and outcomes of takeover bids are heavily influenced by the behaviour and motivations of managers in bidding and target companies. Motivations and behaviour vary depending on whether bids are friendly or not.

This research investigates one aspect of managerial behaviour during takeover bids, that of disclosure of profit forecasts. As forecast disclosure is largely unregulated in the UK, this can provide valuable insights into managerial voluntary disclosure decisions. This in turn may be helpful in assisting policy makers to develop regulations governing disclosure of forecasts.

Profit forecasts have been defined as: *'any published estimate of financial results made:*

- (a) *in advance of completion of financial statements up to publication standard ... for any expired accounting period;*
- (b) *for a current (or expired) accounting period;*
- (c) *for a future accounting period'*. (Institute of Chartered Accountants of Scotland, 1978).

The Stock Exchange's (1997) *Listing Rules* state:

*A form of words which expressly or by implication states a minimum or maximum for the likely level of profits or losses for a period subsequent to that for which the audited accounts have been published, or contains data from which a calculation of an approximate figure for future profits or losses may be made, is a profit forecast or estimate, even if no particular figure is mentioned and the word 'profit' is not used.*

Profit forecasts are rarely disclosed by UK managements in routine circumstances such as in annual reports. However, a substantial number of companies issuing prospectuses, either to raise new capital or during

takeover bids, include a profit forecast. This raises the question as to why, in a market generally averse to routine disclosure of profit forecasts, companies involved in takeovers would overcome that aversion and publish their forecasts.

The fact that there is a general culture hostile to routine disclosure of profit forecasts in the UK suggests that companies' motivation will be to make no disclosure unless there are very attractive or compelling reasons. If disclosure of profit forecasts were a routine feature of company behaviour, a decision to make a forecast in a takeover situation would not require any particularly strong motivation.

Forecasts are normally made during takeover bids to support arguments being put forward by directors. The nature of these arguments will differ depending on whether the bid is friendly (*ie* recommended by target company directors) or is contested.

The research is based on eleven in-depth interviews with participants in the decision to disclose a forecast in public company takeover bids. Interviews were conducted in 1993 and 1994.

The eleven interviews were carried out as part of a larger empirical research project which examined disclosure of profit forecasts in 701 takeover bids for public companies listed on the London Stock Exchange in the period 1988 to 1992. Interviewees were selected from a wide variety of backgrounds, firm positions and takeover contexts, to ensure that all the relevant issues could be explored. All interviewees were involved in one or more of the 701 public company takeover bids which were part of the research sample. Eleven interviews were deemed sufficient as a point of saturation had been reached, whereby no additional details were coming out of the interviews.

The object of the interviews was to gain a better understanding of the disclosure process from those who had participated in forecast disclosure decisions taken during takeover bids. In addition, the interviews provide some background on the strategic issues underlying disclosure.

## **Interview findings**

Interview responses are analysed by reference to five themes:

- Factors influencing disclosure;
- Motivations for disclosure of forecasts by bidding companies;
- Motivations for disclosure of forecasts by target companies;
- Role of forecasts in defending against hostile bids; and
- Information disclosed in forecasts.

Managerial motives to disclose or not disclose a forecast will be influenced by whether the forecast is persuasive in supporting arguments of directors. Many factors influence the disclosure decision. Two are particularly important. First, whether the forecast discloses better or worse figures than expected by, say, market analysts is likely to influence the disclosure decision. A separate but related issue is whether forecasts disclose 'good' or 'bad' news. Various other factors are also considered, including the influence of company characteristics on disclosure.

Motivations underlying management decisions to disclose or not disclose forecasts are likely to be different for bidding companies and target companies. Consequently, the disclosure decisions of bidding companies and target companies are separately analysed.

Profit forecasts are issued for the purpose of persuading shareholders to support the arguments of directors. Following this, an interesting question is whether, in fact, they are effective in achieving this objective. There is anecdotal evidence that target companies in contested bids use profit forecasts as a means of fighting off an unwelcome bidding company. Views on whether forecasts are effective defence weapons are examined.

Once a company decides to publish a profit forecast, further decisions have to be made on the detailed information to disclose in the forecast. Relevant to their persuasiveness is the amount of information included in forecasts. The factors and motivations underlying the financial items and assumptions in forecasts are also examined.

- *Factors influencing disclosure* - Interviews revealed that if market expectations of results are inaccurate publication of a forecast is much more likely. Good news forecasts are also more likely, although bad news forecasts may be disclosed in certain circumstances. Advisors are very influential in the disclosure decision. Variability of earnings and the riskiness of the forecast are also important factors.

- *Motivations for disclosure of forecasts by bidding companies* - Results show that bidding companies disclose forecasts mainly to support the price of any shares issued during the bid.
- *Motivations for disclosure of forecasts by target companies* - Target companies in agreed, ie friendly bids disclose forecasts mainly to support directors' recommendations to shareholders to accept the bid, or as a requirement of bidding companies, who want information discussed during bid negotiations validated in the form of a formal profit forecast reported on by advisors and reporting accountants. In contested bids target companies disclose forecasts to get an increase in offer price or to defeat the bid.
- *Role of forecasts in defending against hostile bids* - There was agreement that, in most circumstances, forecasts are not effective defence weapons. They are disclosed by only a minority of target companies in contested bids. Where circumstances favour disclosure, however, most interviewees agreed that a forecast is an effective weapon in a takeover bid.

There was no consensus on what the benefit of disclosure is, although most commentators referred to forecasts in the context of getting an increase in offer price. There was only one mention of publication of a forecast defeating a bid.

- *Information disclosed in forecasts* - Accepting that the amount forecast is most important, interviewees agreed that more detailed forecasts are more credible and provide forecasters with greater protection. Forecasters had a strong preference for including assumptions in forecasts as this offered protection to the forecaster. Users of forecasts were averse to assumptions, recognising that they reduced the reliability and credibility of forecasts, especially non-standard assumptions specific to individual businesses.

## Recommendations of the study

The research identified a number of issues relevant to decisions to disclose profit forecasts during takeover bids. Based on the findings of the research six recommendations are proposed:

- *Profit forecasts should not be made mandatory* - Investors will interpret the absence of a forecast in the worst possible way and are therefore not disadvantaged by their non-disclosure.
- *Public companies should publish quarterly reports* - Public companies would not need to disclose forecasts if they disclosed information more regularly to the stock market and ensured that shareholders and analysts are kept informed of company prospects. Regulators should consider requiring quarterly, as well as interim, reports by public companies.
- *Public companies should adopt consistent disclosure practices for good news and bad news* - There is little regulatory control on how good news or bad news is disclosed. There is evidence that good news may be forecast quantitatively whereas bad news is communicated to shareholders in more qualitative ways. Although desirable, in practice it would be difficult to devise regulations to ensure that good news and bad news is communicated in the same way.
- *Directors' responsibility statements should be included in profit forecasts* - Directors should be required to include a responsibility statement in profit forecasts, similar to the requirements of the Cadbury Report (1992) in relation to annual reports. This statement should clarify the division of responsibilities between directors and those reporting on forecasts.

- *Regulations should specify a minimum level of disclosure in forecasts* - Profit forecasts vary considerably in content. It is impossible to completely standardise the content of profit forecasts. However, UK regulations should attempt to limit the variability of disclosures in forecasts by specifying a standard minimum level of disclosure to apply to all forecasts.
- *There should be better control on disclosure of assumptions* - Interview evidence points to the use of assumptions in forecasts to protect directors in the event of forecasts going wrong. Directors should distinguish between standard assumptions and those specific to the business being forecast. In addition, directors might include a statement explaining the purpose of the assumptions and outlining the consequences if experience is different from the assumptions.

# CHAPTER ONE

## BACKGROUND TO THE STUDY

This research report considers takeovers in the UK, a subject which has attracted considerable interest and attention from academics, practitioners and the media. Few academics or commentators have, however, examined the role accounting information plays in these situations.

Little attention is given to how disclosure choices are made by individuals within organisations. Motivations for disclosure of accounting information by companies are complex and are influenced by management, shareholders and other stakeholders. In the context of takeover bids there is an additional audience to be considered, namely the other party to the bid (*ie* the bidding company or target company).

Profit forecasts are rarely disclosed by UK companies in routine situations. A substantial minority of companies, however, disclose profit forecasts during takeover bids. This raises an interesting question for study. Why, given management's general aversion to disclosing profit forecasts in routine situations, do some overcome this aversion and disclose forecasts in takeover bids? A related question is why, even in takeover bids, do most managements continue not to disclose profit forecasts?

This research study examines the motivations and reasons why some UK companies include voluntarily a profit forecast in offer or defence documents issued during takeover bids while others do not. Findings are based on eleven in-depth interviews which were conducted with a variety of participants in the disclosure process ranging from directors of bidding companies and target companies, to advisors, to regulators. Interviewees were guaranteed anonymity but brief background details are available regarding their involvement in takeovers.

## **Types of takeovers in the UK**

Takeover bids in the UK may be categorised into three groups. Agreed or friendly bids comprise offers made by bidding companies to target company shareholders with the agreement of the target's management. Hostile bids are those where target company management indicate disagreement with the terms of the bid (usually that the price offered is too low). A third category of bids is competing bids. These are bids where there is more than one bidding company competing for the target company. Such bids may be with the agreement of target company management (white knight bids) or may be hostile bids. For the purposes of the discussion in this report, hostile and competing bids are treated as a single category, contested bids.

In a friendly bid, the bidding company negotiates terms of the bid with target company management, which then recommends the bid for acceptance by target company shareholders. This is called a recommended offer. This type of bid is less expensive and less risky since the bidding company has greater access to information about the target company in the course of bid negotiations and in carrying out 'due diligence' work on the target company. If the bidding company needs the continued involvement and cooperation of target company management after the takeover, a friendly bid is essential.

A hostile bid is expensive and may not result in success for the bidding company. The bid may either fail, or a second bidding company may enter the contest and succeed in taking over the target company. Consequently, bidding companies will embark on a hostile bid only if the acquisition is expected to be highly profitable. In hostile bids, however, the balance of advantage lies with bidding companies. Bidding companies control the timing of the approach and are more likely to make a bid when market conditions are in their favour.

## **Characteristics of bidding and target companies**

A number of academic studies have examined the characteristics of acquired, acquiring and non-acquired firms to throw light on the motives for takeovers (Chiplin and Wright, 1987).

UK takeover target companies are characterised, with some variations, as smaller firms, with poorer profitability and with lower market value to book value ratios (Singh, 1975; Kuehn, 1975; Levine and Aaronovitch, 1981; Kennedy and Limmack, 1996). The best indicator is size, in that smaller firms are more likely to be taken over.

Characteristics of bidding companies are less distinct, although there is some evidence that they generally have higher growth rates and are of average to above average profitability. The general conclusion, however, is that there is considerable overlap in the financial characteristics of the three groups and it is not easy to distinguish among them.

## **Types of profit forecasts**

Forecast disclosures are made in takeover documents sent to shareholders who are the primary audience for this information. Forecasts are normally made during takeover bids on a one-off basis to support arguments being put forward by directors. The nature of these arguments will differ depending on whether the bid is agreed (*ie* recommended by the directors of the target company) or is contested.

Profit forecasts may be included in offer or defence documents. If the bid is recommended or agreed by the board of the target company, the offer document will be prepared jointly by both parties to the bid. The offer document may include a profit forecast by the target company, by the bidding company or by both. If the bid is resisted by the board of the target company, defence documents may include a profit forecast of the target company.

Neither the *City Code on Takeovers and Mergers* nor The Panel on Takeovers and Mergers compels directors to make a profit forecast, with one exception: any disclosure before a takeover bid of financial information relating to unaudited results is deemed, under the City Code, to amount to a forecast. A casual statement amounting to a forecast might be made, for example, in informal briefing sessions between company management and financial analysts. Such pre-bid disclosure must be included as a formal profit forecast in the bid documentation. Thus, there are two types of forecast in takeover bids. Most forecasts are made voluntarily, but some are included involuntarily in takeover documents.

Forecasts may be non-quantitative (eg '*Profit will be greater than last year*') or quantitative. Quantitative forecasts may be either range estimates (eg '*forecast profit in excess of £X*' or '*forecast profit not less than £X*') or point estimates (eg '*Profit will be £X*').

## **Interview methodology**

The eleven interviews which form the basis for this report were carried out as part of a larger empirical research project which examined disclosure of profit forecasts in 701 takeover bids for public companies listed on the London Stock Exchange in the period 1988 to 1992. The object of the interviews was to gain a better understanding of the disclosure process from those who had participated in forecast disclosure decisions taken during takeover bids. In addition, the interviews provide some background on the strategic issues underlying disclosure.

The interviews followed a semi-structured approach whereby an outline interview guide (shown in Appendix A) was sent to each interviewee. This gave interviewees some advance notice of interview questions and ensured that the same information was covered in each interview. Interviews were structured in terms of issues addressed by the research, but the informal conversational approach allowed material not anticipated by the interviewer to be introduced.

A broad range of persons involved in the disclosure decision was interviewed from as wide a variety of takeover contexts as possible. Interviews were conducted in Dublin and London during 1993 and 1994. All interviewees were involved in one or more of the 701 public company takeover bids which were part of the larger empirical research project. Eleven interviews were deemed sufficient, as a point of saturation had been reached, whereby no additional details were coming out of the interviews. Interviewees were promised confidentiality and are therefore designated by letter only, as are any companies to which they referred to. Table 1.1 describes briefly each interview.

**Table 1.1 Background of interviewees**

A	Merchant banker who has advised in many takeover bids
B	Merchant banker who has advised in many takeover bids
C	Merchant banker who has advised in many takeover bids
D	Merchant banker who has advised in many takeover bids
E	Corporate finance partner in a big five accounting practice
F	Senior official of the Takeover Panel
G	Director of a forecasting ( $T_1$ plc) target in an uncontested bid
H	Director of a forecasting target ( $T_5$ plc) in a contested bid
I	Director of a non-forecasting target ( $T_8$ plc) in a contested bid
J	Director of a forecasting bidder ( $B_2$ plc) in a contested bid
K	Director of a forecasting bidder ( $B_1$ plc) in an uncontested bid

The eleven interviewees referred to twelve companies which are summarised in table 1.2. Some interviewees were involved in more than one takeover bid.

**Table 1.2 List of companies referred to in interviews**

<i>Description of circumstances</i>		<i>Value of bid*</i> <i>£million</i>
	<b><i>Bidders</i></b>	
$B_1$	Forecasting bidder in an uncontested bid	85-90
$B_2$	Forecasting (involuntary) bidder in a contested bid	15-20
	<b><i>Targets</i></b>	
$T_1$	Forecasting target in an uncontested bid	105-110
$T_2$	Forecasting target in an uncontested bid	35-40
$T_3$	Forecasting target in an uncontested bid	15-20
$T_4$	Forecasting target in an uncontested bid	5-10
$T_5$	Forecasting target in a contested bid	240-245
$T_6$	Forecasting target in a contested bid	20-25
$T_7$	Non-forecasting target in an uncontested bid	50-55
$T_8$	Non-forecasting target in a contested bid	50-55
$T_9$	Non-forecasting target in a contested bid	15-20
$T_{10}$	Non-forecasting target in an uncontested bid	50-55

\* A range of value is given to protect the anonymity of the interviewees

The full text interviews were edited and summarised from 60 to 20 pages of text to remove colloquialisms and repetition, and to focus on the main issues coming from the interviews. The edited summary forms the basis for the interview material included in this report.

In general the interviewees are not identified with quotes, except where knowledge of the interviewees' background is relevant in understanding the implications of the quotation.

The interview evidence is analysed under five issues or themes relating to profit forecast disclosure during takeover bids. The five themes are:

- factors influencing forecast disclosure;
- motivations for disclosure of forecasts by bidding companies;
- motivations for disclosure of forecasts by target companies;
- role of forecasts in defending against hostile bids; and
- information disclosed in forecasts.

This chapter has introduced some background information on takeovers and on the methodology of the study. Chapter two summarises the regulations governing takeovers generally and those relating to profit forecasts.

Discussion of the interview material begins in chapter three with consideration of factors that influence the disclosure decision. Two factors are particularly highlighted: the influence of market expectations of profitability on disclosure; and the influence of the news content of forecasts. Sundry other factors influencing the disclosure decision are also dealt with in this chapter.

Motivations underlying management decisions to disclose or not disclose forecasts are likely to be different for bidding companies and target companies. Consequently, the disclosure decisions of bidding companies and target companies are analysed separately in chapters four and five. Target companies in contested bids may issue profit forecasts as a defensive tactic. Chapter six discusses whether forecasts are effective defence weapons, *ie* whether they alter the outcome of bids. Once the decision has been taken to disclose a forecast, management must then decide what information to include in the forecast. This issue is examined in chapter seven. The report concludes with some recommendations in chapter eight.

## CHAPTER TWO

### REGULATION OF TAKEOVERS

The conduct of takeovers and of activities during takeovers are closely regulated by the Panel on Takeovers and Mergers and, for bidding companies which are listed, by the Stock Exchange. It is therefore appropriate to provide brief details of these regulations as background to this study and to the environment in which takeovers take place.

Although these regulations have not changed significantly for a number of years, there have been a few changes relevant to the matters considered in this report between the period of the research and writing this report. These include changes to the insider trading rules and to the Stock Exchange's *'Listing Rules'*.

The research studied takeover bids in the period 1988 to 1992. Interviews with individuals involved in some of these bids took place in 1993 and 1994. Since then the Criminal Justice Act (Great Britain 1993) and the Stock Exchange's *Guidance on the dissemination of price sensitive information* and revised *Listing Rules* have come into force.

Through its *Guidance*, the Stock Exchange has been seeking to ensure that information is disseminated to the market as a whole, with a knock on effect on the extent to which companies can guide analysts. Management are not free to communicate information privately to brokers and analysts. Rather than steering analysts' expectations, companies are now expected to make public announcements, for example, quarterly trading statements. The degree to which the *Guidance* has led to a major change in practice is difficult to determine, although there is little evidence to suggest a substantial increase in the frequency of formal profit forecasts.

In summary, unless a forecast has previously been placed on public record, the regulations do not require disclosure of profit forecasts during takeover bids. Where companies, however, choose to make this disclosure some guidance is given regarding the content of the forecasts.

## Regulations concerning disclosure of information generally

Regulations concerning disclosure generally (and including disclosure of profit forecasts) by publicly quoted companies in the UK are contained in the Stock Exchange's *Listing Rules* (the 'Yellow Book') (London Stock Exchange, 1997), the Stock Exchange's *Guidance on the dissemination of price sensitive information* (International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 1995) and *The City Code on Takeovers and Mergers* (Panel on Takeovers and Mergers, 1993).

### Stock Exchange regulations

Under the continuing obligations of the *Listing Rules*, a company must notify the Company Announcements Office of 'any information necessary to enable holders of its listed securities and the public to appraise the position of the company and avoid the creation of a false market in its listed securities' and of 'any major new developments in its sphere of activity which are not public knowledge ...'. Further clarification of this obligation is provided in guidance notes on the dissemination of price sensitive information (International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 1995).

One interviewee in the study commented on this as follows:

*The only legal or regulatory obligation to disclose bad news is that a company must follow the continuing disclosure obligations of the listing requirements. The Code says that all relevant information has to be given to shareholders to enable them to make an informed decision. But the continuing requirements of listing really have to be the barometer which decides whether or not information should be disclosed.*

### City Code on takeovers and mergers

The City Code is based on a number of general principles together with a series of rules expanding on the general principles. In addition, notes are provided giving more detailed practical guidance on the application of some rules.

General principle 3 of the City Code on Takeovers and Mergers requires that *'Shareholders be given sufficient information and advice to enable them to reach a properly informed decision and must have sufficient time to do so. No relevant information should be withheld from them.'* (Panel on Takeovers and Mergers, 1993).

## **Regulations concerning publication of profit forecasts**

There are few legal regulations affecting publication of forecasts. The Financial Services Act outlaws fraudulent or reckless forecasts. The Act also contains regulations to safeguard against misleading forecasts. One interviewee referred to this legislation in the context of whether good news or bad news forecasts are disclosed.

*It is a criminal offence, under Section 47 of the Financial Services Act, to create a misleading impression that gives rise to a false market in securities: for example, if the directors have (or have previously) released information that gives the impression of how things are going to turn out. If they now know things are going to turn out to be very different, they are under a legal obligation to correct that impression. So, in some cases, news drives disclosure of information.*

## **Stock Exchange regulations**

The Stock Exchange's *Listing Rules* (the 'Yellow Book') regulate publication in prospectuses for new issues of shares and in connection with acquisitions, takeovers and mergers. These regulations were amended in September 1997. Chapter 12, paragraphs 12.21 to 12.27 deal with profit forecasts.

The Stock Exchange's (1997) *Listing Rules* state:

*A form of words which expressly or by implication states a minimum or maximum for the likely level of profits or losses for a period subsequent to that for which the audited accounts have been published, or contains*

*data from which a calculation of an approximate figure for future profits or losses may be made, is a profit forecast or estimate, even if no particular figure is mentioned and the word 'profit' is not used.*

Except where an issuer has previously placed a profit forecast on public record, the Stock Exchange does not require publication of a profit forecast, but sets out certain regulations where a forecast is disclosed.

Any profit forecast or estimate of results published must be reported on by the auditors or reporting accountants and the financial advisors or sponsors. Section 12.24 requires that:

*A profit forecast or estimate ... must be reported on by the auditors or reporting accountants ... The accountants must report in the document their opinion as to whether:*

- (a) the forecast or estimate has been properly compiled on the basis stated; and*
- (b) the basis of accounting is consistent with the accounting policies of the issuer.*

Principal assumptions underlying forecasts must be stated. At the time this research was carried out, only those assumptions relating to matters outside the control of the directors, and which could have materially affected achievement of the forecast, were permitted to be disclosed.

This was referred to in one interview as follows:

*The Stock Exchange has precise rules as to what is allowed and not allowed. There will always be assumptions. I would be very surprised if you can show me many that have other than a few bland assumptions, because the Stock Exchange permits only external assumptions. All the interesting assumptions are the ones that are not published. Items under the control of management cannot be published as an assumption.*

Changes to the *Listing Rules* introduced in September 1997 have now removed the prohibition on disclosure of 'internal' assumptions which should alleviate the concerns of the type expressed. Regulations now permit assumptions for each material factor to be included. The

assumptions must be clearly segregated between those factors for which the directors are responsible for estimating and those factors exclusively outside the influence or control of the directors.

The *Listing Rules* applying when this research was carried out gave no guidance on the financial amount to be forecast. The revised September 1997 regulations state that the forecast or estimate should normally be of profit before tax. Exceptional items and tax charges should be disclosed if they are expected to be high or low. If an amount other than profit before tax is presented, the reasons for so doing must be disclosed and explained clearly.

Profit 'estimates', which relate to a period expired, may only be subject to assumptions in exceptional circumstances. Dividend forecasts must be treated as profit forecasts where the issuer has a known policy of relating dividends to earnings, or where the dividend forecast otherwise implies a forecast of profit.

Where a company has made a profit forecast, and subsequently becomes aware that the outcome will be materially above or below the forecast figure, a further announcement concerning the forecast should be made (International Stock Exchange of the United Kingdom and the Republic of Ireland Limited, 1995). Stock Exchange companies must explain any material differences between the forecast and actual results. A difference is usually regarded as material if it exceeds 10% of the forecast trading results. There may, however, be circumstances (*eg* break even situations) where this or a greater percentage will not be considered material.

## City Code on Takeovers and Mergers

Under the City Code on Takeovers and Mergers, offers do not have to stay open for more than 21 days from the date of posting the offer document. This usually means the defending side has 10 to 14 days to issue a reply which may include a profit forecast. Thus, forecasts made by target companies in contested bid situations are usually prepared under considerable time pressure.

The provisions of the City Code relating to publication of profit forecasts are set out in Section K, Rule 28 of the Code. Rule 28.1 Standards of Care states *'There are obvious hazards attached to the forecasting of profits; but this should in no way detract from the necessity of maintaining the highest standards of accuracy and fair presentation in all communications to shareholders in an offer'*.

With one exception, the City Code does not compel directors to make a forecast. Rule 28.6(b) states that profit forecasts made before the commencement of the offer period should be repeated in the offer document and reported on. Thus, some forecasts are included involuntarily in takeover documents because of Rule 28.6(b). The City Code also requires (Rule 28.6(c)) profit 'estimates' (*ie* published estimates of current period financial performance) to be reported on in the same way as profit forecasts.

The City Code makes it clear that sole responsibility for forecasts rests with directors. Nonetheless, forecasts must be reported on by independent accountants and the company's financial advisors.

All forecasts are subject to an accountant's report, with the exception of a forecast made by a bidding company offering cash only (Rule 28.3(a)). For forecasts made in all other takeover bids *'... the accounting policies and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants'*. The reports must be included in documents containing forecasts.

The auditors/reporting accountants are required to *'satisfy themselves that the forecast, so far as the accounting policies and calculations are concerned, has been properly compiled on the basis of the assumptions made'*. The notes make clear that the reporting accountants are not responsible for the assumptions. The reporting accountants, however, may advise on what assumptions should be disclosed and on their wording. Accountants should not allow unrealistic assumptions to be published nor important ones to be omitted.

Any financial advisor mentioned in the document must also report on the forecast. These reports must, under Rule 28.4, appear in the document containing the forecast, together with statements of consent from those making the reports.

The City Code also influences the content of forecasts. Under Rule 28.7, when a forecast of profit before taxation appears in a document to shareholders, forecasts of taxation, extraordinary items and minority interests must be included (where these are expected to be abnormal or significant). In relation to forecast periods where trading has commenced, Rule 28.8 requires that previously published profit figures, which are available in respect of any expired portion of that trading period, together with comparable figures for the preceding year, must be stated. A forecast of dividends is not normally considered to be a profit forecast, but will be where accompanied by an estimate of dividend cover.

Rule 28.2 states that any document in which the forecast appears must reproduce the assumptions, including commercial assumptions, on which the forecast has been based. The Takeover Panel has a major role to play in what assumptions are published as indicated by interviewee F (a senior Official of the Takeover Panel) in the following comments:

*Where the Takeover Panel feels that the assumptions are inappropriate, we get companies to delete the assumptions. If there are assumptions going into the forecast that the company feels should be discussed with us, then certainly they do consult with the Panel. The assumptions, rather than the quantum, are discussed.*

*The Takeover Panel prevents you from putting in assumptions which would make a nonsense of the whole forecast. You can deal with key factors such as strikes, interest rates, etc. Factors outside your control can be put in as assumptions. There are twin influences in the extent of disclosure of bases and assumptions - the protection influence and the regulatory influence - to give people the necessary information and, at the same time, to protect the makers of the forecast. The advisors play a key role in deciding on the assumptions and bases, but the board and management know what the critical elements in driving the business are. It is a dialogue between those groups.*

## Accountancy profession

The Institute of Chartered Accountants of Scotland published a guidance statement '*Accountants' reports on profit forecasts*' in 1978 which still applies. This statement defines a profit forecast as: '*any published estimate of financial results made:*

- (a) *in advance of completion of financial statements up to publication standard ...for any expired accounting period;*
- (b) *for a current (or expired) accounting period; and*
- (c) *for a future accounting period.'*

The statement does not require an audit of profit forecasts and many reporting accountants emphasise this by including a paragraph in their report that an audit has not been performed.

In November 1990 the Auditing Practices Committee published an exposure draft of an auditing guideline '*Prospective financial information*' which was not progressed. It provided detailed guidance on the work to be performed by accountants in reporting on forecast information.

In April 1998 the Auditing Practices Board (APB) published a discussion paper, '*Prospective financial information*', to provide further guidance on the preparation of accountants' reports on prospective financial information. The emphasis of the discussion paper is on information published by public companies. The APB looks for views from respondents in four areas:

- whether accountants should report on assumptions;
- the adequacy of prospective financial information at present and on whether sensitivities should be included;
- limits to be placed on the ability of accountants to report on certain categories of financial information; and
- what steps should be taken to limit liabilities of those associated with prospective financial information.

## **Insider trading rules and disclosure of information privately**

Already touched on earlier in this chapter are the new (since the period of this study) insider trading rules which further tighten the constraints on disclosure of information privately to, say, brokers. Nonetheless, despite insider trading rules, private disclosure appears to be a feature in many takeover bids. Many interviewees agreed that information is disclosed privately during bid negotiations. This begs the question: why, if information is disclosed privately, is information also disclosed publicly, especially in recommended offers?

*The chief executive of the target company essentially gave us a private forecast at an early stage, both before the terms of the takeover were agreed and at the meetings with the shareholders.*

It is now harder to align market expectations privately.

*A company's market expectations depend on how well you guide them. This has become a very tricky area since the legislation relating to insider information being disclosed selectively to selective groups. It is much more difficult now to manage brokers' forecasts. This has now become a blunt instrument. How can you guide market expectations without giving insider information?*

Some interviewees explained that information can be hinted at without being too specific.

*If there is a bid for a public company, generally private information will not be disclosed. You cannot avoid disclosing forecasts privately (although you might want to do so). T<sub>1</sub> plc did not give a forecast. During the negotiations we talked of the potential earnings, but we were not dealing with specific figures. We had to be creative in talking up the earnings. There is a danger of giving people information not generally available to shareholders and making them insiders if they used the information.*

The danger and consequence of disclosing information privately is that the same information must be given to any other party who bids for the target company. The bidding company has to specifically request the information. Bidding companies in this situation are very dependent on their financial advisors asking the right questions.

*There is a certain reluctance to disclose private information because, if it is disclosed to one party, it has to be disclosed to any other party that comes along afterwards. In an agreed takeover, where the possibility of another bidding company emerging is regarded as remote, it is more likely.*

*An indication of a profit forecast can be given privately to a bidding company. If a hostile bidding company comes along later, you must also give that company the same information but only if it specifically asks for it. A private forecast is made regularly in agreed bids. This private information may need to be disclosed to persuade shareholders it is a good offer.*

*We were very conscious of the insider trading rules and also of giving information to one party and not disclosing it to the market in general. We created a file of information which we gave to every interested party. All got the same basic information and, over and above that, we responded to their specific queries.*

Some companies are very cautious when disclosing information privately and are very aware of the implications of insider trading legislation.

*Due to the length of time discussions with the bidding company went on for, they got more information than the others. We put the bidding company on notice concerning the insider trading rules. But in our opinion, the information was not price sensitive. However, we made the bidding company sign an agreement that they would not trade in the shares during the period of our discussions and afterwards (if the discussions led to nothing).*

## International comparisons

In February 1989, International Auditing Guideline No. 27 (IAG 27) *The examination of prospective financial information* was published which dealt with presentation of forecasts as well as examination of prospective information. In July 1994, International Auditing Guidelines were re-codified as International Standards on Auditing (ISA) and IAG 27 became ISA 8.10.

Unlike UK regulations, ISA 8.10 requires accounting policies to be clearly disclosed and prospective financial information to be prepared on a basis consistent with the historical financial statements, using appropriate accounting principles.

ISA 8.10 added a requirement that any change in accounting policy since the most recent historical financial statements should be disclosed, along with the reason for the change and its effect on the prospective financial information. In all other respects, IAG 27 and ISA 8.10 are almost identical, subject to re-arrangement of sections and small changes in wording.

US regulations are described here as they are generally more detailed than many other countries. US companies which publish earnings forecasts (as they are called there) often do so more regularly than UK companies, often on an annual basis. US earnings forecasts may differ in some ways from UK profit forecasts. US forecasts, for example, are generally not reported on by accountants. US regulations come from the Securities and Exchange Commission and from the accountancy profession.

## US Securities and Exchange Commission (SEC) rules

Earnings forecasts are encouraged but not required by the SEC and when disclosed do not necessarily require an accountant's report. The publication of earnings forecasts in the US has been controversial. A brief historical summary is provided as it points to some issues relating to the legal framework, particularly the 'safe harbour' rule, which are not features of the UK regime.

Prior to 1971 the SEC was hostile to the inclusion of forecast data in the financial statements of companies. In November 1971 the SEC announced it was considering changing its position and in 1973 it withdrew its long standing prohibition of prospective information in SEC filings (Securities Act of 1933, Release No 33-5362, *Disclosure of projections of future economic performance*, February 1973).

A commission was established in 1976 which recommended that the SEC encourage publication of financial projections. In 1978 a statement was issued requiring voluntary compliance only (Securities Act of 1933, Release No 33-5992, *Disclosure of projections of future economic performance*, November 1978).

Under SEC rules, disclosure of prospective financial information is generally voluntary. Companies are required to file the information only if it has been disclosed to selected outside parties. To prevent forecasts being disclosed only when favourable results are expected, once a company has elected to file prospective information it must give good reason for any decision to discontinue the practice.

SEC rules do not establish minimum disclosure requirements but recommend forecasts of sales or revenue, net income and earnings per share. Disclosure of underlying assumptions is encouraged but is only required when needed for a proper understanding of projected results. The period covered by the forecast depends on the company's circumstances. The SEC has no specific requirements to update predictions of future results although there are rules that require the full and prompt disclosure of material facts regarding the financial position of public companies. There is no requirement for the forecast to be reviewed by an independent accountant.

### **'Safe harbour' rule**

The problem of liability for inaccurate projections was particularly acute in the US. In June 1979 the 'safe harbour' rule was enacted giving issuers protection from the liability provisions of the Federal Securities Laws for disclosure of projections, management's plans and objectives and any disclosed assumptions (Securities Act of 1933, Release No 084, *SEC safe harbour rule for projections*, June 1979). The SEC's 'safe harbour'

rule shifts the burden of proof from the defendant to the plaintiff, who must prove that the forecast information was disclosed in bad faith or without a reasonable basis. Thus, the issuer of a forecast is not liable for predicted results not materialising unless the plaintiff can establish that the forecast or projection was prepared without a reasonable basis or was disclosed in bad faith.

Protection for forecasters has been further strengthened in law by enactment of *The Private Securities Litigation Reform Act of 1995* which implements the 'safe harbour' rule for forward looking statements. The Reform Act defines a statement as '*forward looking*' if it contains projections, plans and objectives, or predictions of future economic performance. The Reform Act provides two alternative '*safe harbours*' for such statements. A forward looking statement will not form the basis for liability:

- if it is identified as a forward looking statement and is accompanied by meaningful cautionary statements identifying important factors that could cause a material difference from actual results;
- if the plaintiff fails to prove that the forward looking statement was made with actual knowledge that the statement was false or misleading.

Although the '*safe harbour*' rule provides some protection, forecasters are not immune from litigation. For example, shareholders must be made fully aware of the tentative and speculative nature of forecasts. Releasing forecasts only when there is favourable information to communicate might be construed as evidence of bad faith or misleading disclosure. Care is also needed in choosing and disclosing appropriate assumptions underlying forecasts.

### **American Institute of Certified Public Accountants (AICPA) pronouncements**

In response to the SEC's drive for more '*soft*' information, the AICPA began to prepare guidelines for auditors on the examination of forecast information in the mid 1980s. The AICPA has published a number of documents on financial forecasts. Those applicable currently are:

- *Statement on standards for accountants' services on prospective financial information: Financial forecasts and projections.* October 1985.
- *Guide for prospective financial statements.* 1986.
- *Questions concerning accountants' services on prospective financial statements.* 1989.

These AICPA pronouncements give guidelines for the preparation and presentation of financial forecasts and for accountants' services in relation to forecasts. US guidelines are more restrictive than the UK regime in recommending a format for forecasts and in specifying minimum disclosure. As in the UK this includes significant assumptions but, in contrast to UK regulations, significant accounting policies should also be disclosed. Illustrative prospective financial statements are provided in the guidelines.

## Summary

Regulations in the UK dealing with disclosure of profit forecasts are flexible. Companies can choose not to disclose a forecast during a bid. Minimal regulations apply to the content of forecasts disclosed. Thus, in practice, where forecasts are prepared, a relatively limited level of disclosure is found (usually profit before tax), together with a reference to the principal assumptions, supplemented by further disclosure only where necessary to the message intended to be conveyed. There are requirements for reports on profit forecasts by reporting accountants and sponsors/financial advisors, which have a substantial effect on the quality of published forecasts.

In contrast, in the US, forecast disclosure is encouraged so much so that regulators introduced a 'safe harbour' rule to give forecasters some protection from litigation if the forecast goes wrong. In addition, the accountancy profession applies more rigorous standards in specifying minimum disclosures in forecasts. There is, however, no requirement for any form of reporting on the forecast information, and consequently very little reporting in practice.

# **CHAPTER THREE**

## **FACTORS INFLUENCING THE DISCLOSURE DECISION**

This chapter analyses interview responses in an attempt to identify factors influencing profit forecast disclosure during takeover bids. The influence of market expectations on disclosure is discussed first, followed by the influence of the news content of forecasts. Other factors, including the influence of company characteristics on disclosure are then dealt with.

Academic researchers have examined a wide variety of company characteristics associated with disclosure of profit forecasts. The most common firm characteristics found to be relevant are size (Ruland, 1979, Cox, 1985; Lev and Penman, 1990; Kasznik and Lev, 1995) and earnings volatility (Imhoff, 1978; Ruland, 1979; Cox, 1985; Waymire, 1985; Lev and Penman, 1990). Bigger companies, with less volatile earnings, are more likely to disclose forecasts.

### **Effect of market expectations of firm profitability on disclosure**

Prevailing market expectations of company results are reflected in the forecasts of analysts and brokers which are frequently reported in the financial press particularly if a takeover bid is underway. Forecasts may be issued by companies in an effort to move prevailing market expectations toward management's forecasts of future earnings. Aligning market expectations with company expectations is likely to be more important, and to have greater economic consequences, during takeover bids than in routine disclosure situations.

There is anecdotal evidence (see, for example, interview comments on page 31) that under pressure from, say, an unwanted takeover bid, management can 'find' additional profits and disclose a more bullish forecast, compared with normal annual results. In such cases, brokers' forecasts are more likely to be out of line and need adjustment.

Academic evidence supports the proposition that forecast disclosure guides market expectations (Ajinkya and Gift, 1984; Skinner, 1994), although Ruland *et al* (1990) found that managers' forecasts tended to confirm rather than correct analysts' forecasts.

Most interviewees consider market expectations to have a considerable influence on disclosure of forecasts. Forecasts may be disclosed to align shareholder expectations with management's knowledge and expectations of company results. Forecasts that are below, as well as above, market expectations may be disclosed.

*Market expectations are also important. If the information in the market is not accurate, you need to convince the market concerning the share price. This is done with a profit forecast. Any results that are very much out of line with market expectations need to be communicated with the market.*

## Interview findings

One interviewee guessed that 80% of brokers' estimates were 'in the right ball park' and that there was no need to publish a forecast in these circumstances. He added that a general description of the company's circumstances, rather than a formal profit forecast, can be used to align market expectations.

*What is the market expectation of the current position of the company? Is it important to the bid that that impression be changed? Will a forecast, rather than a general description and information, add anything to market perceptions? If the brokers' estimates are roughly in the right ball park, you don't need to do an awful lot to change or correct them. You could hypothesise that 80% of brokers' estimates are probably on the mark. Then there is no need for the publication of a forecast. Where the company perceives the market not to have a true feel for its potential, or the brokers' estimates to be on the low side, a forecast would certainly be something which the directors look at.*

One interviewee remarked that the requirement for a contingency in making a forecast might reduce forecast profits below market expectations, such that a forecast would not be disclosed.

*To make a formal profit forecast and to get the accountants to sign off might involve too much of a contingency which could lead to the forecast decreasing profits relative to the forecasts and expectations of analysts.*

Some interviewees suggested that the market ratings of larger companies would be more accurate and that larger companies consequently had less need to disclose forecasts to align market expectations.

*Bidding companies tend to be bigger and therefore tend to have firmer market ratings. Their market expectations are more accurate.*

Companies with very variable earnings would have a greater need to align market expectations.

*The more variable the earnings, the more likely they are to be out of line with market expectations, and the more likely there is to be a forecast. With variable earnings, it is more difficult to forecast but it is more imperative to do so. The imperativeness more than counterbalances the difficulty with forecasting.*

The ability of companies to communicate well with the market and with analysts reduced the need to make a forecast.

*Companies with characteristics such as good public relations, where the management are able to sell themselves, will not need to make a forecast as market perceptions will be generally correct. These are likely to be larger companies, so that larger companies are less likely to make a forecast.*

## **Role of good news and bad news on disclosure**

It might be thought that firms with good news would be more likely to disclose a forecast. However, North American research findings are mixed.

Some studies have found a tendency for firms with good news to disclose forecasts (Patell, 1976; Penman, 1980; Ajinkya and Gift, 1984; Lev and Penman, 1990; Clarkson *et al*, 1992; and Clarkson *et al*, 1994). These researchers, however, also reported several bad news forecasts.

Other researchers (Ajinkya and Gift, 1984; Waymire, 1984; and McNichols, 1989) did not observe an overall tendency to report good news. They showed that incentives existed for management to disclose both good and bad news. Consistent with these findings (Ruland *et al*, 1990) studied errors in forecasts made by analysts looking at companies which did and did not issue forecasts and found no evidence that management concentrated on releasing good news.

Some researchers have provided evidence that firms were more likely to disclose bad news than good news (Baginski *et al*, 1994; Pownall *et al*, 1993; Skinner, 1994; Frankel *et al*, 1995). Variations in findings may be due to the nature of the forecasts analysed - point, range, open-ended (*ie* bounded from either above (upper-bound) or below (lower-bound)) and qualitative forecasts. There is evidence that bad news is disclosed in more qualitative forecasts and good news is disclosed in point and range forecasts. Reasons suggested for disclosure of bad news include litigation deterrence and protection of the reputation of managers.

The news content of forecasts is of paramount importance in the disclosure decision. Mixed views were expressed on the influence of bad news and good news on disclosure. The interview comments in the next section tend to indicate that bad news will not be disclosed as readily as good news, especially in the case of target companies in contested bids.

The interview findings are now discussed under the headings of good news and bad news.

## Good news

Interviewees frequently suggested that a forecast would only be disclosed if there was good news to report to shareholders. The comment below implies that, had T<sub>5</sub> plc not had good news to report, a forecast might not have been disclosed.

*The forecast was significantly higher than brokers had been led to believe and were expecting. T<sub>5</sub> plc had failed to meet brokers' expectations on previous occasions. We had the offer document and could show that the profits would be a lot higher than in the offer document. We knew that the extra profits forecast would blow the bid out of the water. The information in the offer document, in press remarks and rumours generally, will drive whether a forecast is made or not.*

One interviewee indicated that companies are restrained from forecasting excessively good news because the forecast may be attacked by the other side.

*Whether forecasts disclose good or bad news depends on whether the company has good news in reserve. The forecast is usually above market expectations. It is open to the other side to attack the profits in the forecast; for example, if the company's profit margin has increased for no obvious reason.*

Good news is relative. How you define 'good' news is an issue raised in the following comment. A forecast drop in profits could be construed as a bad news forecast or, if the drop is less than the market is expecting, it could be a good news forecast.

*If there is local opposition, it is always a good news forecast in a contested bid. Good news can be relative. If the market, for example, is saying that profits will be halved and if the drop is not so much, you might make a forecast.*

In addition to suggesting that a forecast would only be disclosed if there was good news to report, some interviewees argued that bad news forecasts would never be disclosed in contested bids.

*You will never get a target company in a contested bid making a bad news forecast. The target company will be trying to make the best case and putting the best foot forward.*

## Bad news

Some interviewees suggested that bad news forecasts would not be disclosed.

*The news contained in the forecast is very important. If the forecast contains bad news, it will not be given unless it is only fractionally down on expectations.*

*A forecast would not be disclosed if profits were going to be lower than market expectations.*

*I cannot see a company putting out a forecast that shows profits falling off. That can only reduce the price being offered. Directors are driven to ensure that, if they recommend that shareholders accept the price, whether the bid is friendly or unfriendly, they must be satisfied that they have secured the best price.*

Bad news may be disclosed other than through a profit forecast. Qualitative statements by the directors which suggest bad news without making a forecast are common in takeover documents.

*I think the forecast would either be giving good news, or trying to contain bad news. If there is such uncertainty surrounding the circumstances, then a forecast would not be the way in which a company would go. The company would deal with the matter through discussion of the actions that would be taken to contain the problem. Directors would not wish there to be an incorrect impression as to the true position of the company, even if there is bad news to be disclosed. It's a little difficult to know precisely when there is a need for the release of information to correct an impression in the market, because you can never be absolutely sure what the impression is that the market as a whole has.*

There are circumstances, however, where bad news forecasts might be disclosed. Such a case is where directors are recommending acceptance of the bid and disclose a bad news forecast to persuade shareholders to accept the bid.

*The news contained in the forecast is definitely important. The company will want to get poor performance news into the market. It might have to make a formal profit forecast justifying reasons why the board recommends shareholders to accept the offer.*

*On the offeree side there are generally two reasons for disclosing a forecast. Firstly, if its performance is unlikely to match that anticipated by the market, the board may recommend acceptance of the offer and may provide a forecast justifying reasons for accepting a low offer compared to expectations.*

Some interviewees, referring to the news in agreed bid forecasts, highlighted the need to bring bad news into the open.

*News is an influence on disclosure. Management is taking a risk unless it has signalled bad news to the bidding company. This is especially true if management end up continuing to work with the bidding company's organisation.*

If, however, companies do not disclose a forecast, this may be interpreted as being bad news. In the absence of information, the market may interpret non-disclosure in the worst possible way.

*If the news is very bad in a contested situation, there might be more pressure and less inclination to make a forecast. Not disclosing a forecast casts doubt on the profitability.*

*I suppose it is possible that the forecast isn't good and they don't want to make a forecast which confirms that the company is having some difficulty.*

Bad news forecasts may be used for tactical or strategic reasons to frighten off the bidding company, referred to by one interviewee as a 'scorched earth tactic'.

*I can think of one or two cases where bad news was disclosed, where a scorched earth policy was adopted. Say offeror A announces an offer for company B, but needs to go to its own shareholders to get approval for the issue of new shares. Company B knows it is going through a bad time, and may indeed already have indicated something like that to its*

*own shareholders. Company B comes out with a forecast which is even worse than the market is anticipating. The hope is that the offeror shareholders will, as a result of the forecast, question the judgment of their own management and not agree to the issue of new shares. It puts an onus on the offeror to justify why it is making the offer. It might also give the offeror the opportunity to invoke a material changes condition, which is one of the standard conditions in offer documents, which allows the offeror to withdraw from the offer if there has been a material change at the time of the offer.*

## **Advisors**

The term 'advisor' is not defined in the Stock Exchange's *Listing Rules* nor the Takeover Panel's *City Code on Takeovers and Mergers*. Advisors (sometimes called 'sponsors') are normally corporate brokers or investment banks, but may be other professional advisors.

Regulation places a significant emphasis on the role of the advisor in influencing the board's decision to issue a forecast. The interviewees were asked specifically about the role of advisors.

*The advisors are the most important. They are conscious of the shareholders' need to be advised of any significant information. Also, the advisors will be advising the board concerning tactics. The board at the end of the day will decide. The company will end up with a committee of the board, in consultation with the advisors, and this committee will really be making the decision.*

*The board is put there by the shareholders to look after their interests. The board is, therefore, the most influential. The board is required by regulations to be properly informed. Therefore, directors surround themselves with advisors. The board will be advised by the advisors and by management who will also be influential.*

One interviewee (a merchant banker) suggested that the advisors, rather than the board, made the big decisions in bids, including whether to disclose a forecast.

*The board are unlikely to block a forecast if it has been supported by the management of the company and the advisors. Management are a blocking mechanism if they are unable to make a forecast. Boards of companies think that they have a say in what happens in a bid. In fact, it is the advisors who make the decision and call whether to make a forecast or not.*

Interviewees distinguished between the work of the reporting accountants and that of the financial advisors. Two suggested that the accountants have a greater influence on the decision to issue a forecast.

*The advisors (both merchant bankers and accountants) will put up a plan. The policy to defend is probably that of the merchant bankers. The accountants do more, what we call, rule 3 advice - advising the shareholders and board. The accountants will get involved in the number crunching because, although you might think that it is a good idea to use a forecast, the numbers may not warrant producing a forecast. Ultimately, the decision has to be that of the board.*

*The decision to disclose a forecast will not be made by the accountants. It will be decided by the merchant banks. The final determinant on whether there can be a forecast, of course, will be the reporting accountant, whether he can report on the forecast. I think it is not uncommon for there to be quite vigorous debates on whether or not it is appropriate for a forecast to go in. Very occasionally, a merchant bank will be very keen for a forecast but, if the accountants feel that it is difficult to support a particular forecast, then it won't go ahead.*

*The advisors will have it on the agenda of things to discuss at an early stage in the process. If the bid is contested, a forecast is more likely. The accountants are involved in the decision as they give an opinion on the forecast. If the accountants cannot sign off, they will not go ahead with the forecast. The merchant bankers cannot sign off without the accountants.*

It could be argued that it is in the interests of advisors and accountants to recommend that a forecast be disclosed. Most interviewees did not think that advisors would recommend the making of a forecast to boost

their fees. The advisors were especially vigorous in refuting this suggestion and indicated that they would choose the tactic most likely to succeed as they would want to continue as advisors to the company after the bid.

*I think it is a bit cynical to suggest that disclosure of a forecast is driven by advisors wanting fees. The advisors are employed to (let us keep it as a defence) to defend the company. If they defend the company successfully, they will have an on-going relationship with that company which will undoubtedly generate more fees as time goes by. I do not believe that disclosure is advisor prompted.*

Some of the advisors reported that the fees charged for forecasts were low by comparison to the overall fees charged during bids.

*Merchant banks, by signing off on forecasts, take a lot of responsibility. Under the Takeover Code there is a lot of responsibility. Bankers don't normally like to take on additional responsibility for the fun of it. They are not driven by fees. The fees charged aren't necessarily governed by the presence of a profit forecast during a bid.*

*I don't think it is true that advisors are driven by fees in recommending disclosure of a forecast. In a bid, there would be no extra fees specifically for a profit forecast. The fees are contingent on the success of the bid. A profit forecast will be used if it is helpful in this respect. If anything, all the advisors get from a profit forecast is increased exposure. You don't get paid specifically for the profit forecast.*

There was no indication that the disclosure of forecasts might be related to the firm of advisors chosen.

*I do not expect that you will find any relationship between the choice of advisors and whether or not there is a forecast. The choice of advisors normally arises from a long standing relationship with a company. I do not expect that you will find, for example, a relationship between the big accounting firms and the presence or absence of a forecast.*

*I expect that you will find that smaller firms will be just as willing to give an opinion on a forecast.*

## Risk of forecasting

There were mixed views on whether the risks involved were a deterrent to disclosing forecasts. In a takeover, directors may be tempted to make more bullish forecasts than in other situations.

*Takeover really gets you much closer against the wire because the directors would be failing in their obligation to the shareholders if they put in a fuzzy, low forecast. So somehow you have got to get it right.*

*In making a forecast, the company will turn up every stone and get every last bit out of the forecast. It is a lot easier to shave up market expectations. If the market expectations of profits are increased by say 20%, we will only put in 15-17% increase in the document. If the forecast profits show a drop of 20%, we are more likely to put in a drop of 30%. It is easier to forecast upwards than downwards.*

*Forecasting is quite useful but it has got to be quite bullish. Uncertainty and bullishness tend not to sit happily together and it is probably in those circumstances that forecasts don't go out, or if it is not going to tell people anything that will enhance prospects by the parties.*

There was a view that directors have a responsibility to get the best prices for shareholders of the target company. This may not be achieved if the forecast is too conservative. Thus, directors are under pressure to make as good a forecast as possible, and at the same time make a forecast that will be achieved.

*You can get the forecast wrong both ways, over forecast as well as under forecast. One is nearly as bad as the other. From the point of view of advisors, reputation is important, and this is tied in with the reaction of the Takeover Panel and with litigation. From the point of view of the company credibility rather than reputation is important.*

Conversely, some interviewees thought that directors would try to avoid making an inaccurate forecast and might include some leeway in the forecast to ensure that it was achieved.

*Neither the financial advisors nor the accountants would have put their names to the forecast if it wasn't OK. In our type of business unless something very untoward happened, there was no problem with making a forecast. We pulled back a little to leave a buffer in case of trouble.*

*The management of companies under threat of takeover are in a very difficult situation. If it gets down to haggling over price, the management would not want to put down a forecast which under their new masters would not be made.*

The conflict between the board on the one hand, which will generally want to make a bullish forecast, and the advisors on the other hand, who want to avoid as much risk as possible, was noted by one interviewee.

*The advisors will always say that it is essential to meet the forecast and will be urging caution. They will advise that a margin of error will be built in to make sure that the forecast is achieved. As far as the board is concerned, it will want to pull out all the stops and make the forecast as certain as possible and, also, achieve its objective of beating off the unwanted bid. If the target company beats off one bidding company and subsequently fails to make its forecast, the market will not believe it next time round if a new bid comes up.*

Loss of reputation, particularly that of the advisors, seemed to be the greatest fear in relation to the forecast not being met. Adverse press comment was the most immediate concern, the threat of litigation and investigation by the Takeover Panel were also highlighted.

*Pride and reputation are much more important than fear of litigation. Fear of litigation is not in the decision to make the forecast, but affects the quantum of the forecast. It does not put one off making the forecast, except if systems and controls are not in place, but it will influence the degree of conservatism. Closeness to the year end is a very important factor. Fear of getting a forecast wrong has never been a reason for not doing a forecast.*

*The fear of litigation is there. But a greater fear is the fear of the Panel and the effect that a missed forecast will have on the business. A missed forecast may lead to a Takeover Panel enquiry.*

Advisors fear litigation more than directors as they are more likely to be sued if the forecast goes wrong.

*Litigation is feared, as is the reputation of the advisors. It is very rare that it could be shown that there has been negligence. Irrespective of negligence, there would be press commentary if the forecast is not achieved. It is not an individual decision to disclose or not disclose a forecast, so career/job prospects are relatively unimportant. The Takeover Panel is not really that important.*

*Advisors fear litigation as they seem to be the ones that get sued. The company fears for its reputation, and management for its job prospects. There isn't much precedent for target companies getting sued, as the bidding company by this stage owns the target company. In effect, it would be suing itself. Therefore you have a go at the advisors instead.*

One way of reducing the risk of litigation is to include assumptions in the forecasts. Using assumptions in this way was frequently mentioned in the interviews. The role of assumptions in making forecasts is dealt with in more detail in chapter seven.

*There is quite a fear of litigation, but in the final analysis, if you have to make a forecast, you do so. You try to broaden the assumptions which are published with the forecast to get off the hook as much as possible.*

*This depends on how wrong the forecast is. Any prudent board will try to put in as many assumptions as possible to cover themselves. What is as important, apart from the forecast, is the attack on their performance. You cannot do that unless you have a source for that attack. This leaves one equally open to litigation.*

## **Other influences**

Sundry other factors may influence disclosure of forecasts including: the other party to the bid; quality of management; variability of earnings; forecasting systems; industry; size; and management ownership.

## Other party to the bid

The bidding company in agreed bids may make it a condition that the target company should disclose a forecast.

*The other party to the bid. Disclosing a forecast is an element of the negotiations and is a test of seriousness and sincerity of the target company in making the forecast.*

*The other party to the bid is very important. What the other party is doing will encourage the target company to make a forecast.*

## Quality of management

Management was not mentioned as being important by many interviewees. The following remarks, however, suggested that the quality of management affected the ability to make reliable forecasts and this, in turn, would influence the disclosure decision.

*Jointly the board and the advisors are influential. Management don't have any role except where there is overlap between management and presence on the board. The quality of the management affects the ability to deliver a profit forecast. But the management per se will not make the decision whether or not to disclose a forecast.*

## Variability of earnings

Variability of earnings was referred to by most interviewees as influencing disclosure. The more variable the earnings the more imperative and at the same time the more difficult, it was to make a forecast.

*Variability of past earnings was a problem for the target company. They couldn't make a forecast in the end.*

*With variable earnings, it is more difficult to forecast but it is more imperative to do so. The imperativeness more than counterbalances the difficulty with forecasting.*

The role of income manipulation in smoothing profits to reduce earnings variability was mentioned.

*Markets don't like very variable earnings. Some companies have a bit of reserve accounting and smoothing. With volatile earnings a forecast is very difficult if not hazardous.*

Industry will also affect the ability to forecast earnings.

*Variability of earnings is the main one. Our earnings are mainly fixed. This is linked to the industry we operate in.*

## Forecasting systems

It was suggested that good systems were a pre-requisite in making a forecast.

*Reasonably good systems are essential to forecasts. There has to be a reasonably good basis for the directors' assertion that profits are going to be what they say they will be. You couldn't make a forecast in a company that doesn't have proper reporting systems.*

*I would link sophisticated forecasting systems and variability of earnings. It depends on how good your systems are in taking variable earnings into account, given that you are probably only forecasting for four to six months of unknown information. Economic conditions are tied to variability of earnings. Management would not normally want to risk a forecast (or a bid) at a low point of the economic cycle.*

It was also suggested that larger companies would usually have better forecasting systems and may find it easier, and less costly, to forecast.

*With a large company, there will be good accounting systems. With better systems, it is much easier to make a forecast. If the systems are bad, we have to do work to make up for those bad systems. The influence of outside events is important, but you can cover a lot of things in the assumptions. We will not attach our name if the systems and controls are not good, unless we cover ourselves in a big way.*

## Industry

The industry in which a company operates will influence whether a forecast is disclosed. It is common for bidders to purchase technical know-how *via* takeovers (for example, purchase of research and development companies, computer software companies). Bidders are not as interested in the earnings of these companies and are less likely to look for a profit forecast. Similarly, some companies (for example, exploration companies) will be purchased for assets rather than earnings. Asset valuations will be much more important in these companies than profit forecasts.

*The type of company will determine whether a profit forecast is made or not. Property companies will not make a profit forecast. They will be revising asset values. You should exclude property companies from your sample.*

## Size of company

Size of company, in itself, was not considered to be a significant influence, except that larger companies with good public relations would be more accurately perceived by the market and were less likely to have to disclose a forecast to align market expectations with those of the company.

*Companies with characteristics such as good public relations, where the management are able to sell themselves, will not need to make a forecast as market perceptions will be generally correct. These are likely to be larger companies so that larger companies are less likely to make a forecast.*

## Management ownership

The extent of management ownership was important as it reflects the possible conflict of interest between, on the one hand, management and shareholders and, on the other hand, management and bidding companies.

If management ownership is not significant, management would be more interested in job security, career *etc* rather than in the value of the shares. If management ownership is significant, bidding companies may be concerned that management would be interested in getting the best price for their shares, and may talk up the price excessively. The following comment implies that forecasts by such management owned companies are less reliable. The influence of non executive directors in reducing this conflict is brought out in the third comment below.

*There is always going to be nervousness where management actually own the company because clearly they have something to gain from the consequences of the forecast.*

*The extent of ownership of a company by management is undoubtedly important. You have to be careful of vested interest situations.*

*In hostile bids, the one casualty you can be certain about is the management. In putting in a forecast in a hostile situation, the management would be wishing to put their best foot forward. The protection is the board where the board is not management dominated. Independent board directors are not given to putting their necks on the block for management.*

## **Summarising the evidence**

Market expectations are a very important influence on disclosure, both when expectations are above as well as below forecasts. The reasons offered by interviewees as to why market expectations and company profits might/might not diverge are summarised in table 3.1.

Market expectations are generally accurate which would explain why only a minority of companies publish forecasts. In the larger research project of takeover bids in the period 1988 to 1992 (of which this research is part), a forecast was disclosed in 197 (28%) out of 701 bids. Out of 1,402 bidding and target companies, 226 (18%) disclosed one or more forecasts.

The suggestion that market expectations of larger companies are likely to be more accurate is also confirmed by research findings. Bidding companies have been found in prior research to be significantly larger than target companies. Their market ratings are likely therefore to be more accurate than the market ratings of target companies. Consistent with this, bidding companies disclose significantly fewer forecasts than target companies (only 67 (27%) of the 250 forecasts obtained in the larger research project were bidding company forecasts). The news in forecasts appears to have a big influence on whether a forecast is disclosed. It should not be assumed that the news in forecasts must be good for a forecast to be disclosed. In recommended bids forecasts are used by directors as a means of supporting their recommendation to shareholders to accept the bid. Directors may feel it necessary for shareholders to know the news is bad to persuade them to accept the offer as reasonable, given company prospects as shown by the forecast.

**Table 3.1 Reasons for divergence and non-divergence between market expectations and actual profits**

**Reasons for divergence**

Very variable earnings

More bullish profit calculations

**Reasons for non-divergence**

80% of brokers' forecasts are '*in the right ball park*'

Larger companies will have firmer market ratings

Market perceptions of companies with good public relations will generally be correct

A variety of other influences on disclosure were suggested by interviewees and these are summarised in Appendix B. Advisors were most frequently mentioned, with variability of earnings, economic conditions and boards of directors considered important also. Related to economic considerations, the news content of the forecasts was mentioned. Less important were size of the firm and quality of management.

Chapters four and five to follow discuss twelve cases in which eight forecasts disclosed. Of these forecasts, one was an involuntary forecast, four were good news forecasts, two were bad news forecasts and one forecast contained neutral (tending towards good) news. The bad news forecasts were disclosed by targets in agreed bids. In some of these cases, had the news been bad it is doubtful whether a forecast would have been disclosed.



## **CHAPTER FOUR**

### **MOTIVATIONS FOR DISCLOSURE OF FORECASTS BY BIDDING COMPANIES**

The interview evidence in this chapter relates to bidding companies only. Two case histories are reported which describe the context and background to the decision to disclose a profit forecast in the particular circumstances of the bid in question. They illustrate the varied motivations giving rise to disclosure or non-disclosure. The companies and interviewees referred to are described in tables 1.1 and 1.2 in chapter one.

In addition to the two case histories, other comments by interviewees are included supplementing the discussion of motivations by bidding companies to disclose forecasts. Disclosure of forecasts by bidding companies is discussed separately for agreed and contested bids. The reasons why bidding companies do not disclose forecasts are also explored.

#### **Disclosure by bidding companies in agreed bids**

##### **B<sub>1</sub> plc: Forecasting bidding company in an uncontested bid**

This case was unusual in that the bidding company, B<sub>1</sub> plc, had made a forecast while the target company in the bid had not. Generally, bidding companies are less likely to disclose a forecast than target companies. One of the main reasons for bidding companies to make a forecast is to support the share price, if shares are being issued in consideration for the target company or if shares are being issued to existing bidding company shareholders to raise cash to pay for the acquisition. In the case of B<sub>1</sub> plc it appeared to have been the listing of its shares for the first time that had motivated disclosure of the forecast.

Interviewee K, a director of B<sub>1</sub> plc, indicated that ease of forecasting profits and the length of time since results had been announced to the market were also influential in a forecast being disclosed.

**Case history B<sub>1</sub> plc (Forecasting bidding company in an uncontested bid) as described by interviewee K**

*We approached the target with a view to merger (in effect) by means of a recommended offer. There was a simultaneous flotation as B<sub>1</sub> plc was an unlisted company taking over a quoted company. It was a long time since we had disclosed results. We disclosed a forecast because we were being listed. It was driven by the flotation rather than the acquisition. The interim results were published and audited in the prospectus, and we rolled in with a forecast for an additional six months. It was very easy for us to calculate earnings and we were happy to do it, as there was going to be a big jump in earnings from the previous year. The areas of potential for movement were fewer in our company. We were making a forecast in the last quarter of the year and we already had audited results for the first six months of the year.*

### Related comments

Other interviewees cited the nature of the purchase consideration as important in motivating disclosure by bidding companies.

*There would be more of an inclination to give a forecast where there are securities or shares involved. If it is a cash offer, then it tends not to be a particularly important issue for the bidding company.*

*The bidding company may want to counteract the publicity concerning the quality of its earnings or the value of their shares. In the case of cash bids, a forecast is usually irrelevant for bidding companies but could be important in relation to the credibility of an offer in a local situation. In paper offers, if the paper is under attack, the bidding company will want to support its paper.*

Interviewees also referred to the need for a bidding company forecast in some circumstances in cash bids, as the following comment illustrates.

*There may be particular circumstances to do with a particular bid why bidding companies would disclose a forecast in a cash bid. It may be if the bid is contingent on the bidding company's own shareholders approving the bid and maybe there has been some dissatisfaction expressed by shareholders with the bid. It is not a standard event.*

### **Disclosure by bidding companies in contested bids**

#### **B<sub>2</sub> plc: Involuntary forecasting by a bidding company in a contested bid**

B<sub>2</sub> plc's forecast was an involuntary forecast and was made under the rules of the Takeover Code. This arose from a statement made inadvertently by the company which was construed as a profit forecast after the takeover bid. The other side to the bid made sure the regulators were aware that the statement made prior to the bid would have to be reported on as a formal profit forecast.

The story of B<sub>2</sub> plc illustrates how involuntary the forecast was and how unhappy the company was to be in a forecast situation. Many interviewees brought out the importance of costs in disclosing forecasts. As interviewee J, a director of B<sub>2</sub>, pointed out, this includes management's time and disruption to the business, as well as payment of fees to advisors.

**Case history B<sub>2</sub> plc Involuntary forecasting bidding company (in a contested bid) as described by interviewee J**

*There were two levels of forecast. First we gave a profit warning for the year. The reason for doing this was that the management accounts indicated that the profits already exceeded brokers' forecasts for the company. We did a lot of soul searching before issuing the profit warning. We were afraid it would leak out. We were correcting analysts' forecasts. At the bottom of the profit warning statement we made an extra comment in relation to the following year. We didn't focus on the consequence of this at the time. It was a nice statement to include. As it turns out, this amounted to a profit forecast because we specifically referred to 'further growth in revenues and profitabilities' for the following year.*

*This came back at us as the target's advisors drew the Stock Exchange's attention (we believe) to this statement constituting a profit forecast. This is standard practice in a bid. T<sub>2</sub> plc used this as a delaying tactic. It makes life more difficult. It makes the directors more nervous. We had to get the auditors to report, and a cost factor was involved. It was relatively easy to forecast the business. The directors were happy that the forecast was sustainable. We only had to report, and the auditors only had to verify, that profit would be £1 more than the previous year. As such it was a harmless forecast.*

*The original statement would never have been made had the consequences been foreseen at the time. The paperwork involved to do a profit forecast is huge. Line management had to get involved in the bid. This is very disruptive to the business. There is a greater cost in taking up management time.*

### Related comments

The competitive mood of contested bids, characterised by attacks on management by both sides, is important in motivating a forecast by bidding companies.

*There is no negative public relations about the share price in an uncontested bid so it is less likely the bidding company will have to make a forecast.*

Two reasons are offered in the following two comments as to the benefit of a forecast in contested bids:

- to pre-empt another bidding company entering the contest; and
- to demonstrate the good performance of bidding company management.

*Forecasts are disclosed if it is felt necessary to complete the transaction or to underwrite the value of the consideration. A forecast might be made to shut out contest from another predator rather than a target company.*

*If their back was up against the wall in relation to relative share values, or if they thought the bid was going to fail, or if they were being attacked on the basis of performance, the bidding company might publish a forecast.*

### **Reasons bidding companies do not disclose forecasts**

Most bidding companies do not disclose forecasts. As stated earlier, forecasts by bidding companies in cash bids are considered to be unlikely by interviewees. Bidding companies control and choose the timing of the bid, and therefore have less reason to disclose a forecast to support their share price.

*Bidding companies do not normally make a forecast, especially if cash is offered, unless they want to keep the share price up or for reasons of credibility. In a paper bid, a forecast may be issued to support the price of the shares being offered and to value the bid higher. The bidding company is always in control of the situation so it picks the best time to make the bid and therefore has less reason to make a forecast. It is a poor bidding company that has to prop up its own share price.*

Bidding companies tend to be larger and have firmer market ratings. This affects their disclosure decision.

*Bidding companies tend to be bigger and therefore tend to have firmer market ratings. The market expectations are more accurate. For a target company the takeover bid is a one off transaction. The target company*

*will take one off opposition to maximise value. Once taken over, the company is gone. If the company has good profits it will want to maximise value.*

Bidding companies must consider the wider audience comprising their own shareholders, as well as the shareholders of the target company, in deciding whether to disclose forecasts in paper bids.

*The making of a forecast, especially where the bidding company is much larger than the target company, involves the forecast going out to a much larger audience of shareholders. This results in changing expectations of a much wider group than just the target company.*

Many interviewees, not surprisingly, quoted cost as the primary reason for bidding companies and target companies not disclosing forecasts. Forecasters need to be able to identify clearly the benefits in disclosing forecasts to justify the costs.

Costs include preparation of the forecast, management time involved and the risk of making an incorrect forecast. It could be argued that it would be less costly for larger companies with more sophisticated forecasting systems to make a forecast.

If the forecast is not met there are both monetary cost and reputational cost implications. The riskiness of the forecast is related to the length of time away from the year end, to the reliability of forecasting systems and to the industry of the company.

*In general, companies will try to avoid making a profit forecast. Firstly, it is costly and secondly, it is time consuming, and thirdly, it may come back to haunt them.*

*The cost of the reporting accounting, the hassle, the aggravation concerning documentation, problems at board level. Most directors are reluctant to be involved in a forecast. No one wants to be caught out publicly in getting the figures wrong.*

If the period to be forecast is too long, or if it is too early in the financial year, a forecast would not be published.

*Companies cannot, for legal reasons, give a long term forecast as there is greater uncertainty in the case of a long range forecast.*

*This might arise because it is too early in the financial year. It might be because it is too difficult to forecast the profits of the company. It might be due to the exposure of the board, the merchant bankers, the directors. Merchant bankers may not be willing to sign off.*

In any event, if it is early in the financial year it is likely, according to the following interviewee, that there is little new information to communicate to shareholders.

*If it was close to the beginning of the year, very little would have changed and I would have advised the company not to make a forecast because of the dangers associated with making such a forecast.*

## **Summarising the evidence**

The reasons given by bidding companies for disclosing or not disclosing a forecast are summarised in table 4.1, based on the comments earlier in this chapter and on the summary of interview responses in Appendix B. In order to assess their relative importance, Appendix B shows the frequency of the most common responses. Table 4.1 expands on the concise wording in Appendix B giving a fuller explanation of motivations.

The primary reason bidding companies disclose forecasts is to support the price of any shares issued during the takeover. Other reasons given for making a forecast are ease of forecasting profits and the news in the forecast.

Two reasons given in table 4.1 are related. It is likely that the closer a company is to its year end the longer it will have been since it last reported results to shareholders. Companies prefer to make forecasts close to the year end as this reduces the risk of getting the forecast wrong. It is not clear which is more important, keeping shareholders informed about results or avoiding risk by only forecasting close to the year end.

Three reasons, in particular, were offered as to why bidding companies would not disclose forecasts:

- Forecasts are costly. At a minimum, it has to be reported on by the reporting accountants and financial advisors to the bid, and in cash bids there may be no benefit in making a forecast.
- Bidding companies have less need for forecasts than target companies as they choose the timing of the bid, when market conditions are good for the bidding company.
- Bidding companies tend to be larger, with greater analyst following and better analysts' forecasts. Consequently, forecasts by bidding companies may not be necessary to align market expectations with those of the company.

<b>Table 4.1 Summary of reasons given for disclosure and non-disclosure of forecasts by bidding companies</b>	
<p><b>Reasons given for disclosure of a forecast</b></p> <p>Good news to forecast</p> <p>Closeness to the year end</p> <p>Length of time since results were published</p> <p>Ease of forecasting earnings</p> <p>To support share price of new shares issued by bidding company during bid</p> <p>Involuntary forecast made under the rules of the Takeover Code</p>	<p><b>Company</b></p> <p>B<sub>1</sub> plc</p> <p>B<sub>1</sub> plc</p> <p>B<sub>1</sub> plc</p> <p>B<sub>1</sub> plc;</p> <p>B<sub>1</sub> plc</p> <p>B<sub>2</sub> plc</p>
<p><b>Reasons given for not disclosing a forecast</b></p> <p>Where cash is the consideration</p> <p>Bidding company chooses timing of bid - when share price good</p> <p>Bidding companies are larger with firmer market ratings</p> <p>Cost</p> <p>Management time involved</p> <p>Risk of getting the forecast wrong</p> <p>Downward revision of profit involved</p> <p>Forecast profit does not justify price being offered</p> <p>Too far from year end</p> <p>Unreliable systems</p> <p>Difficulty with forecasting profits of the company</p> <p>Market perceptions are correct</p>	

Table 4.2 summarises motivations for disclosure of forecasts by bidding companies during takeover bids. Motivations differ depending on whether the bid is agreed or contested.

<b>Table 4.2 Motivations for disclosure and non-disclosure of forecasts by bidding companies</b>	
<p><b>Motivations in agreed bids</b></p> <ul style="list-style-type: none"> <li>• To support price of shares being offered to target shareholders as consideration for the target</li> <li>• To support price of new shares issued to bidding company shareholders to raise cash to acquire the target</li> <li>• To put information into the public domain to enable it to be discussed privately</li> </ul>	<p><b>Motivations in contested bids</b></p> <ul style="list-style-type: none"> <li>• To support price of shares being offered to target shareholders as consideration for the target</li> <li>• To support price of new shares issued to bidding company shareholders to raise cash to acquire the target</li> <li>• To put information into the public domain to enable it to be discussed privately</li> <li>• To persuade target shareholders that bidding company management will run the company better than current management</li> </ul>
<p><b>Resistance to disclosure in agreed bids</b></p> <ul style="list-style-type: none"> <li>• Fear of getting the forecast wrong</li> <li>• Costs of disclosure</li> </ul>	<p><b>Resistance to disclosure in contested bids</b></p> <ul style="list-style-type: none"> <li>• Fear of getting the forecast wrong</li> <li>• Costs of disclosure</li> </ul>



## CHAPTER FIVE

# MOTIVATIONS FOR DISCLOSURE OF FORECASTS BY TARGET COMPANIES

This chapter deals with disclosure decisions by target companies and is based on ten case histories in addition to other comments by interviewees about the decisions of target companies. The companies and interviewees are described in tables 1.1 and 1.2 in chapter one. Agreed and contested bids are discussed separately. Reasons for non-disclosure are also considered.

### Disclosure by target companies in agreed bids

#### $T_1$ plc: Forecasting target company in an uncontested bid

Interviewee G was a director of  $T_1$  plc, a target company in an uncontested bid.  $T_1$  plc made a forecast. The length of time that had passed since results had been given to the market appeared to have been a major factor in  $T_1$  plc disclosing a forecast.

#### Case history $T_1$ plc (Forecasting target in an uncontested bid) as described by interviewee G

*There were two reasons. First of all, for Stock Exchange reasons concerning the length of time since the last accounts were published. There is an obligation to give up to date information. There could have been, say, eight months since the company last published any information. Secondly, the shareholders needed to be put in possession of all the relevant facts. A lot had happened since the previous year end. We felt it necessary to provide the shareholders with the same information the directors and management had in making their judgment in relation to the bid. The market was a reasonable guide, but it wasn't enough. The bidding company did not push for a forecast. They did not influence a forecast in any way.*

### **T<sub>2</sub> plc: Forecasting target company in an uncontested bid**

Reasons given explaining T<sub>2</sub> plc's disclosure of a forecast included ease of forecasting and the need to inform shareholders. The comment is not very convincing given that the offer was generous and it is possible some other issues were not being divulged by the interviewee.

<b>Case history T<sub>2</sub> plc (Forecasting target in an uncontested bid) as described by interviewee I</b>
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<i>A forecast was made even though the bid was not contested because T<sub>2</sub> plc was well used to making forecasts. The forecast was not demanded by the bidding company. We were doing forecasts every six months because of our need to raise capital frequently. The main reason was to let shareholders know they were getting full value for their shares. The offer was very generous. The forecast represented what we expected we would make and what in fact we did make in the end.</i>
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### **T<sub>3</sub> plc: Forecasting target company in an uncontested bid**

Directors of T<sub>3</sub> plc made a profit forecast to persuade shareholders to accept the bid price and to inform them that results were not good. The directors were concerned that shareholders be fully informed of the poor performance and prospects of the company.

<b>Case history T<sub>3</sub> plc (Forecasting target in an uncontested bid) as described by interviewee A</b>
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<i>T<sub>3</sub> plc issued a forecast to provide shareholders with information whether to accept the bid. The profits were not as good as the market was expecting.</i>
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### T<sub>4</sub> plc: Forecasting target company in an uncontested bid

Directors in agreed bids are required to show shareholders that they have obtained the best price, and this may be done with a profit forecast. Directors of many target companies in uncontested bids make a forecast to support their recommendation to shareholders to accept the price being offered by the bidding company. This appears to have been the reason why T<sub>4</sub> plc disclosed a forecast. In addition, as is often the case, the bidding company appeared to have insisted on a forecast by the target company. Interestingly the bidding company also made a forecast, probably because shares in the bidding company were being issued as consideration.

**Case history T<sub>4</sub> plc (Forecasting target in an uncontested bid) as described by interviewee B**

*T<sub>4</sub> plc was a recommended offer and probably issued a forecast to convince shareholders that the price was fair and reasonable, to convince the shareholders not to expect too much and to advise shareholders to accept the bid. It was a paper offer so the bidding company's forecast was probably to support their share price. The issuing of a forecast by T<sub>4</sub> plc was not instigated by the financial advisors. The bidding company would not make the bid without a forecast.*

The two motivations identified by T<sub>4</sub> plc influencing disclosure are repeated in the comment below. The interviewee suggested that in a recommended bid making a forecast might earn the target company a better price.

*It might be suggested in the negotiations that if the company makes a forecast to show its sincerity, the bidding company will increase the price. The target company might put out a forecast to entice shareholders to accept the bid.*

## Related comments

One interviewee described how a non executive director in a target company would not recommend the bid to the shareholders of the target company unless the company made a profit forecast.

*I was involved as advisor in an uncontested bid where the target company published a forecast because a non executive director on the board would not agree to recommend the offer. When the forecast was published he then agreed to recommend the offer.*

Forecasts disclosed by target companies as a requirement of bidding companies were referred to frequently by interviewees.

*The purpose of the forecast is to ensure that the market or the shareholders are aware of the company's short term prospects. The bidding company may force a target company to make a forecast as a condition for making the offer.*

*A forecast may be done as part of the price negotiation which may be subject to the offeree making a formal forecast.*

## Disclosure by target companies in contested bids

### T<sub>5</sub> plc: Forecasting target company in a contested bid

This case history was provided by the financial advisor (interviewee B) to T<sub>5</sub> plc, a target company in a highly contested bid. T<sub>5</sub> plc disclosed a forecast during the bid. The forecast was prompted by a statement made by the managing director prior to the bid. During an informal briefing of analysts sometime before the bid the managing director of the company inadvertently made a comment about next year's profits which amounted to a forecast. In this case, and many such instances of inadvertent profit forecasts, the other side to the bid drew the Takeover Panel's attention to this statement which, because it amounted to a forecast, had to be formally reported on by reporting accountants and financial advisors to the target company.

T<sub>5</sub> plc decided to make a new forecast which was substantially greater than in the managing director's comment. T<sub>5</sub> plc was pressurised into making this forecast and might not have done so except for the managing director's inadvertent comment.

It is interesting to see how influential the advisors were in advising on and planning for the profit forecast months before the bid was made. That good news was being reported to the market was also crucial to the disclosure decision. The interviewee made it clear that a forecast would not have been made were it to show 'a bleak picture'.

**Case history T<sub>5</sub> plc (Forecasting target in a contested bid) as described by interviewee B**

*A large part of T<sub>5</sub> plc was held by X and we were on notice that a bid could arise. We were advising T<sub>5</sub> plc before the bid. T<sub>5</sub> plc published a forecast because we advised them to. The company decided on a major rationalisation programme the previous year and consequently knew it would be under threat of takeover. The company decided to spread the cost of the rationalisation over a number of years. They thought that this would be a good defence against a takeover bid. We advised them to take the full hit in the current year and to make sure that they over-provided rather than under-provided for the rationalisation costs. The basis for our advice was that we could forecast in a defence document on a year that had the benefits of rationalisation and none of the costs. Nine months later the bid occurred and we were in a position to make a forecast.*

*A number of factors influenced the decision. We were close enough to the year end to be able to predict the final outcome for the year. T<sub>5</sub> plc had very good controls. We were comfortable with making a forecast. The forecast was driven by the price being too low.*

*The managing director indicated that T<sub>5</sub> plc profits would touch £X million. This was deemed to be a forecast by the Stock Exchange. The bid document hyped this forecast up to £X+2 million. Initially it was just a verbal forecast. It was never reported on. It would have been very remiss of us not to provide a forecast, especially as the bid was contested, unless the forecast were to show a bleak picture. We would have to have informed the shareholders as to the out-turn for the year so they could make a judgment about the offer price.*

### T<sub>6</sub> plc: Forecasting bidding company in a contested bid

The main motivation for disclosure of a forecast by T<sub>6</sub> plc was to align market expectations with company results.

**Case history T<sub>6</sub> plc (Forecasting bidding company in a contested bid) as described by interviewee A**

*T<sub>6</sub> plc had a very chequered management and profitability experience. It had gone through a period of very poor profitability. X had to take over as chairman just before the bid and hadn't had time to show the market that the company had been turned around. It was essential to make a forecast to show the market the improvement that had been made. The pre-tax profit forecast was double the previous year's profits and was three times the previous year's profits after tax.*

To judge by the following comments the primary motivation for disclosure by target companies in contested bids seems to be to get the best value for shareholders.

*A profit forecast may be made in a hostile bid where the offeree is justifying a higher value for the company. A profit forecast is one of the only ways of communicating hard information to shareholders.*

*As far as the target company is concerned, then it really doesn't matter whether it is shares or cash, the interest is to get the best price for the shareholders.*

*Shareholder value - it must be. There must be some confident expectation of increasing shareholder value. All the other items you list are relevant factors, but must be subsidiary to the main issue of enhancing shareholder value.*

## Related comments

There is anecdotal evidence that target companies in contested bids use profit forecasts as a means of fighting off unwelcome bidding companies. T<sub>5</sub> plc, T<sub>6</sub> plc and T<sub>7</sub> plc were target companies in contested bids. It is interesting to note that few of the interviewees referred to forecasts as a means of defending hostile bids. T<sub>5</sub> plc, however, disclosed a forecast to show the price offered was too low. The following comment suggests that profit forecasts are more important as a means of getting best value for shareholders than as a defence mechanism.

*It comes back to whether it is necessary and appropriate to get the best value for the shareholders. It is often suggested that this sort of defence is to avoid being taken over. That will be a motivating factor, but the obligation/responsibility of the directors is to get the best deal for the shareholders, so it all comes back to that issue.*

Disclosure may be motivated by strategic considerations. The following comment shows that a forecast might be used to encourage a white knight into the contest.

*Forecasts are disclosed to talk up the price and possibly encourage a third party to the arena. Shareholders get better value if there is a contested situation. Shareholder value is the most important element, but it is not the only element.*

## Reasons target companies do not disclose forecasts

Many of the reasons for not disclosing forecasts, reported in the previous chapter on bidding companies, also apply to target companies. Target companies are more likely to disclose forecasts. Target companies are not in control of the timing of the bid and may have a greater need to inform the market.

*Target companies are not in control of the situation. Issuing a forecast is one plank to their defence.*

### T<sub>7</sub> plc: Non-forecasting target company in an uncontested bid

The story of T<sub>7</sub> plc illustrates circumstances where a forecast might not be disclosed, the bid was agreed and from the target company's point of view the price offered was generous.

The reason T<sub>7</sub> plc did not make a forecast was primarily because the bidding company did not demand a forecast, although this is not explicitly stated by the interviewee. As the price was so attractive directors of the target company had no difficulty in persuading shareholders to accept the bid and there was no need to issue a forecast to support the price being offered for the shares.

<b>Case history T<sub>7</sub> plc (Non-forecasting target in an uncontested bid) as described by interviewee B</b>
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<i>T<sub>7</sub> plc had agreed a fabulous price for the company. We didn't want to issue a forecast which might show up the generous price offered by the other side. Issuing a forecast wasn't an issue in the bid. The company wanted to take the money and leave quietly.</i>
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### T<sub>8</sub> plc: Non-forecasting target company in a contested bid

T<sub>8</sub> plc's case highlights the issue of costs *versus* benefits of disclosure. The benefits could not be identified but the cost of disclosure, risk of getting the forecast wrong, was recognised clearly. Disclosure of a forecast is only made where it will improve the forecaster's chances of success. A forecast will not be disclosed unless there are clear benefits.

**Case history T<sub>8</sub> plc (Non-forecasting target in a contested bid) as described by interviewee I**

*A profit forecast was strongly considered. Our mentality was that, unless we could establish a clear benefit for publishing a profit forecast, there was no point in doing one. There were a lot of accountants around the table. One automatically associates a forecast with risk. And the automatic tendency is to stay away from a forecast unless clear benefits are obvious. If we had felt that a profit forecast would have led to any reasonable chance of the offer being increased or being overtaken by anyone else, then we would have published a forecast. But we believed neither. The bidding company had gone to the top of its range.*

*There was no pressure from the bidding company to make a forecast. The bidding company had what they believed was an exceptionally good feel for the quality of the T<sub>8</sub> plc business and its profit stream. We gave them access to budget projections and much more financial information not normally available in a hostile bid.*

The following comment considered this issue differently. Rather than say that the forecast has no benefit, the interviewee referred to the forecast as '*an obstacle ... to get in the way of the transaction*'.

*Reasons why a target company wouldn't make a forecast might be because management and the directors are so enthusiastic about the proposed transaction. If they feel the takeover is absolutely the right thing for the company, and for their own personal careers, they won't want any obstacle to be created to get in the way of the transaction.*

### T<sub>9</sub> plc: Non-forecasting target company in a contested bid

This comment on why T<sub>9</sub> plc did not make a forecast emphasises the importance of reliable forecasting systems and reliable forecasting prior to the bid. Without these accountants and financial advisors would have difficulty in reporting on forecasts, as would directors in making forecasts.

**Case history T<sub>9</sub> plc (Non-forecasting target in a contested bid) as described by interviewee J**

*We found out afterwards when we had taken over T<sub>9</sub> plc that a forecast was being prepared. I don't know what the major stumbling block was, but it subsequently issued a defence document without a forecast. I guess the board wasn't happy with going with the forecast. T<sub>9</sub> plc hadn't lived up to previous budgets. I don't know whether the advisors were a problem. I imagine the lawyers were warning the directors on their legal liabilities.*

### T<sub>10</sub> plc: Non-forecasting target company in an uncontested bid

The reasons given by interviewee K, a director of the bidding company, for T<sub>10</sub> plc not making a forecast were opposition from one of its own non executive directors and difficulties the advisors would have had in reporting on a forecast backing up information given privately during bid negotiations.

After the takeover, the results of the target company were so bad that litigation ensued. The comments by the bidding company indicated some regret that a forecast had not been extracted from the target company, given subsequent performance.

**Case history T<sub>10</sub> plc (Non-forecasting target in an uncontested bid) as described by interviewee K**

*Once the terms were agreed in principle there was an expectation that the target would publish a forecast. It was proposed in the financial advisor's checklist that the target would give a forecast, but they came back saying that they did not want to give a forecast. The reason they gave was that they did not give a forecast when they had floated the company originally. That, and also that one of their non executive directors did not want to be involved in a profit forecast. As it turns out, they (their advisors, accountants and merchant bankers) would never have been able to stand over a profit forecast. They would have had difficulty in producing forecast figures matching the numbers being given privately to us. Our financial advisors were happy to rely on brokers' estimates when a forecast from the target did not materialise.*

**Related comments**

Another reason why target companies would not disclose forecasts is the length of forecast horizon, which can be altered by choosing a shorter forecast period. This, in turn, affects the level of uncertainty and risk in the forecast.

*In general, as advisors, we wouldn't sign a forecast with a very long horizon if we weren't satisfied that the forecast was reliable. If the merchant bank thinks there is too much uncertainty, it will not sign off on the forecast. If it is too far out for a full year's forecast, we will consider a six month forecast instead.*

**Summarising the evidence**

The reasons given for disclosing or not disclosing a forecast are summarised in table 5.1. Appendix B summarises their frequency which gives some indication of views on their relative importance. Table 5.1 expands on the concise summary provided in Appendix B giving a fuller explanation of motivations.

<b>Table 5.1 Summary of reasons given for disclosure and non-disclosure of forecasts by targets</b>	
<b>Reasons given for disclosure of a forecast</b> Good news to forecast To support directors' recommendation to accept bid Length of time since results were published Ease of forecasting earnings Requirement of the bidding company Closeness to the year end To show price offered was too low Market expectations of profits out of line with actual results	<b>Company</b> T <sub>5</sub> plc; T <sub>6</sub> plc T <sub>2</sub> plc; T <sub>3</sub> plc; T <sub>4</sub> plc T <sub>1</sub> plc; T <sub>2</sub> plc T <sub>4</sub> plc T <sub>5</sub> plc; T <sub>5</sub> plc  T <sub>6</sub> plc
<b>Reasons given for non-disclosure of a forecast</b> Forecast unnecessary - good price being offered Unable to make a forecast Avoidance of risk Length of forecast horizon Will not result in a better price for the target If the bid can be defended without a forecast	T <sub>7</sub> plc; T <sub>8</sub> plc T <sub>9</sub> plc; T <sub>10</sub> plc T <sub>8</sub> plc

The most frequent reason offered was to correct market perceptions. Some companies made a forecast because shareholders were not aware of current performance (see especially T<sub>6</sub> plc). This might be because these companies were bad at keeping analysts informed and up-to-date about company performance, allowing market expectations to diverge from management's knowledge of actual and expected performance. This divergence of market expectations could be avoided by more effective and timely communication to analysts of the true value and prospects of these firms. Another reason for this divergence is that, under pressure in a contested bid, companies may be able to 'find' profits which allows them to forecast well in excess of prevailing expectations.

A major responsibility of directors is to get the best price for the shareholders of the target company. If a profit forecast assists in this objective, one may be disclosed. Profit forecasts may be disclosed for tactical reasons in contested bids to get an increase in offer price or to defeat the bid.

Other reasons given for making a forecast is that the forecast is a requirement of the bidding company. Bidding companies may look for a forecast from target companies in agreed bids to validate representations made in the course of bid negotiations. Directors of target companies might issue a forecast to persuade shareholders to support their recommendation to accept the bid.

A number of reasons were offered as to why forecasts were not disclosed. Making forecasts is costly. Where no benefits could be identified, companies saw no need to disclose a forecast. Disclosing a forecast carries the risk that the forecast may not be achieved and companies avoid this risk where possible. Related to the risk associated with forecasts, some companies are unable to make a forecast because advisors may not be willing to report on very risky forecasts. The longer the forecast horizon (days from the date of the forecast to the forecast period end) the greater the risk and the more averse directors are to making a forecast.

Motivations for disclosure of forecasts by target companies during takeover bids are summarised in table 5.2. Motivations differ depending on whether the bid is agreed or contested.

<b>Table 5.2 Motivations for disclosure and non-disclosure of forecasts by target companies</b>	
<p><b>Motivations in agreed bids</b></p> <ul style="list-style-type: none"> <li>• To support directors' recommendation to target shareholders to accept the bid .</li> <li>• Required by bidding company to support information provided during bid negotiations.</li> <li>• To put information into the public domain to enable it to be discussed privately.</li> </ul>	<p><b>Motivations in contested bids</b></p> <ul style="list-style-type: none"> <li>• To persuade target shareholders that the bid price is inadequate</li> <li>• To persuade target shareholders that current management will run the company better than bidding company management</li> <li>• To signal that the target company is going to strongly defend the bid</li> <li>• To get an increase in the bid price</li> </ul>
<p><b>Resistance to disclosure in agreed bids</b></p> <ul style="list-style-type: none"> <li>• Fear of getting the forecast wrong</li> <li>• Costs of disclosure</li> </ul>	<p><b>Resistance to disclosure in contested bids</b></p> <ul style="list-style-type: none"> <li>• Fear of getting the forecast wrong</li> <li>• Costs of disclosure</li> <li>• Alternative defence strategy available</li> </ul>

## CHAPTER SIX

# ROLE OF PROFIT FORECASTS IN DEFENDING AGAINST HOSTILE BIDS

Interview comments in chapters four and five indicated that a forecast would not be made unless the forecaster could identify clear benefits from disclosure. This chapter explores views on whether forecasts are perceived to be beneficial or not in defending against hostile bids.

### **Defence strategies**

Target companies defending against hostile bids have a wide variety of potential defence strategies from which to choose, including disclosure of profit forecasts (Sudarsanam, 1991, 1995). Such a defence tactic is a uniquely UK and Commonwealth phenomenon. Disclosure of a profit forecast represents one of the few actions managers can take without shareholder approval. Forecasts may be used by the directors of a target company either to show that the shares are more valuable than the bid price or to show that target company management is better than bidding company management. It is also possible that disclosure of a forecast by target companies may be a signal to the bidding company that target company management intend to strongly resist the bid. Krinsky *et al* (1988) argued that disclosure of forecasts may allow target company shareholders to search for 'white knights' after a takeover bid is made.

There is evidence from Gray *et al* (1991) that more forecasts are disclosed voluntarily during contested bids. Hostile bids are characterised by attacks on the performance of management. Managements defending their performance are attacked when they do not disclose a forecast to support their claims of good performance.

Casey and Eddey (1986) studied takeover defence strategies of 122 Australian defended bids and after claims that the bid was inadequate found that disclosure of favourable information (profit forecasts and asset revaluations) was the next most popular defence strategy. By including profit forecasts in the '*Disclosure of favourable information*' defence category, Casey and Eddey (1986) assumed implicitly that profit forecasts disclose good news. Disclosure of favourable information ranked fifth out of six defence category strategies in terms of success in defending against hostile bids.

Using an in-depth, case study approach, Jenkinson and Mayer (1991) found that profit forecasts were the most common financial defence tactic.

Sudarsanam (1994) surveyed takeover defence strategies in 238 contested bids for UK public companies during 1983-89. Attacking bid terms was the most commonly used form of defence. Profit forecasts were the second most commonly used defence (45% of target companies made a profit forecast). Only four of the 23 defence strategies identified in the research contributed to a successful defence. Surprisingly, profit forecasts made a slightly negative impact on bid defence. He suggested that profit forecasts do not cover a long period ahead and, thus, do not provide substantial new information to target company shareholders. In addition, they are not highly regarded by investment managers, and the scepticism with which they are received may have blunted their effectiveness as a defence strategy.

In summary, while prior research finds disclosure of profit forecasts to be one of the most popular methods of defence, evidence on its effectiveness is weak.

### **Effect of forecast on outcome of bids**

Publication of a forecast can influence the outcome of bids in two ways: by getting an increase in offer price; and/or through outright defence of the bid.

*The target company is not going to make a forecast unless it is to its advantage. The objective in making a profit forecast is to beat off the bid or to increase the perception of value. If the reason for defending the bid is that the value is too low, a profit forecast is much more likely to prove that the bid undervalues the company.*

A forecast was disclosed by target companies in only 79 (35%) out of 223 contested bids in the larger research project of which this study is part. This would suggest that they are not seen as effective defence weapons in most circumstances. It was difficult to pinpoint the effect of forecasts, separately from all the other events during a takeover bid.

*Forecasts may be disclosed infrequently because they are not seen as very effective weapons by the people making forecasts in those particular cases. Weapon may be an emotive word. There is the argument that shareholders receive volumes of information from both companies so there will be a number of factors which are relevant to success or failure. A profit forecast is one of the factors.*

Where the circumstances suggested that a forecast would be beneficial, and a forecast was disclosed, most interviewees saw them as effective weapons. There was no agreement on their specific benefit. It was not clear whether the objective of the forecaster was to defeat the bid, to get an increase in price or a combination of both.

*The publication of a forecast is more likely to have an effect on the price than on success or failure. In the case of a target company it will be primarily driven by the desire to block out the bid, and if that is not successful, then getting a much higher price. If it influences the price sufficiently, that can actually influence the outcome. Although it may be one of the factors which influence the outcome, it is unlikely to be the primary influence.*

Some commentators (such as above) considered that it was the public relations value of the forecast that was important.

*It is not so much the detailed information as the headline news value of the forecast that is most effective. It is the sentiment being communicated, not specifically the detailed information in the forecast.*

The following interviewee indicated that the forecast, *per se*, should have no effect as underlying facts about the company are unchanged by the forecast. The forecast only discloses those facts.

*Yes, you should see higher bid premiums for target companies that make a forecast. Making a forecast, however, does not necessarily mean that there will be an increase in premium. Which is cause and which is effect? I'm not sure. It is only because the forecast is a reflection of the underlying facts about the company which are not previously known. The forecast is correcting a perception, but is not changing the underlying facts about the company.*

There are times when a profit forecast could fend off an unwelcome bid.

*In a hostile bid, the forecast is a weapon. For example the X-Y bid. Y made a very robust profit forecast. X lapsed the bid. (There were other reasons for lapsing the bid.) The trigger point was the profit forecast. The profit forecast certainly is a weapon, more usually in hostile situations. It is used on both sides. It is a weapon for the offeror where there is a share exchange.*

The forecast would be only one element of a defence strategy by the target company. It was not clear whether, on its own, it would defeat a bid. The following interviewee suggests that it could have the effect of making the bidding company even more aggressive and give it the opportunity to go on the attack using the information in the forecast.

*No, I don't necessarily think that it is, unless the forecast says something really surprising. A forecast is generally not material and will not on its own defeat a hostile bid. It might only make the aggressor more aggressive. I don't know of any forecast that has defeated a bid. If I was the aggressor, I would attack the forecast.*

## Tactics and strategy underlying disclosure

Tactics are very important. Bidding companies may deliberately make a low opening offer in the expectation of increasing the offer price during the bid. The bidding company may expect in advance that the target company will disclose a forecast and plan to increase the offer thereafter. It is not clear whether the forecast is part of a ritual or whether it, of itself, makes a difference.

*Yes, it is very effective. The market effectively values a company on its view of current and future earnings. The bidding company will leave a price increase to after the forecast. It is difficult to say whether the forecast made a difference because you don't know how much of the price increase relates directly to the publication of a forecast. The forecast is an effective weapon as it lets the market know what the profits are. The forecast is usually above market expectations.*

Reference was made to disclosure of forecasts being made for tactical reasons.

*In a contested takeover there is a debate about the consideration, so the timing of the forecast, and the fact that a forecast is made, are bound to be driven by strategic motivations. A forecast can be important in the effect it has on the other side.*

*Where it is a strategic decision, it will come back to judgments as to whether or not the market has the right perception of the business. A strategic reason for disclosing a forecast can only be to correct a wrong impression in the market.*

The timing of disclosure was thought to be important for public relations and information management reasons.

*The timing of the forecast depends on the circumstances. If you have a choice of arguments, you won't use them all at once. The shareholders will get bored after the first one or two documents. A drip feed approach is used which can be quite useful to keep peoples' attention. You issue new stories at regular intervals. During the bid, the timing of disclosure*

*was measured. The forecast was not included in the first defence document. I think it was in about the third circular. Each circular had a different theme. We kept these themes going for public and shareholders' attention. We decided to keep our powder dry and to keep points back for the full period of the bid which was approximately 60 days.*

### **Reasons why forecasts are not effective**

Interviewees gave reasons why forecasts were not effective. Credibility and reliability of forecasts was important. The following comment refers to a forecast that was not credible for two reasons: poor quality management; and the long range nature of the forecast.

*The target company's management hadn't performed well. The target company made a forecast and the defence was unsuccessful. It was a long range forecast and consequently lacked credibility in the market. It was not as effective a weapon because of what the market thought of the management, and the long range nature of the forecast did not help. I say this with the benefit of hindsight.*

The five advisors interviewed were strongly of the opinion that forecasts have strategic value. They stated that they incurred very high risk and earned little from their association with forecasts.

Some people argue that a forecast has relatively little value because it is made so near the year end and is so short term that it discloses little new information to the market. If the forecast is more distant from the year end, it may lack credibility.

*Forecasts can be made up to six months before the year end. A forecast will lack credibility for a period any greater than nine months from the year end.*

*Short term forecasts probably are of use because they put into the public domain in an official way the next year's profits. There will be circumstances where that is helpful.*

*That's a good question because I think very few offerors would say that they are buying the company for one year's profits. They are obviously looking at the company as a going concern for many years into the future. So what relevance is one year? Well, it can depend, I suppose, on where in the cycle a target company, or indeed an offeror company, is. So it may give shareholders a feel for which way their company is moving.*

## **Summarising the evidence**

This chapter has analysed and discussed the effect of forecast disclosure on the outcome of bids. Forecasts by target companies can be useful in contested bids in either obtaining a price increase or in fending off an unwanted bidding company.

It is clear that, in most circumstances, forecasts are not considered to be effective defence weapons. They are disclosed by only a minority of target companies in contested bids. Where circumstances favour disclosure, however, most interviewees agreed that a forecast is an effective weapon in a takeover bid.

There was no consensus on what the benefit of disclosure is, although most commentators referred to forecasts in the context of getting an increase in offer price. There was only one mention of a forecast defeating a bid.

Interviewees were unable to identify the specific benefit of forecasts. In some cases there was doubt whether the forecast itself was responsible for any price increase obtained. There was some evidence of game playing and strategy during bids, in which disclosure of profit forecasts plays a part in the ritual.



## CHAPTER SEVEN

### CONTENT OF PROFIT FORECASTS

Chapter two has shown that regulations governing the content of profit forecasts allow companies considerable flexibility in what they say in their forecasts. Forecasts in takeover documents must be reported on by accountants and by the financial advisors to the takeover, therefore they have become somewhat standardised as to format but not as to content. Specific disclosures vary from one line forecasts to forecasts covering two to three pages of detail. This chapter analyses views of interviewees on, firstly, the detailed amounts disclosed and, secondly, the assumptions disclosed.

In addition to examining the motivations and factors behind disclosure and non-disclosure of profit forecasts, this research also examines management decisions and motivations underlying the detailed information reported in the forecasts after the initial decision to forecast is taken. Motivations to disclose forecasts, and motivations to disclose information in forecasts, may be different. Having made the decision to disclose a forecast, it is interesting to examine the subsequent process whereby management decide what to include in the forecast.

Takeover documents are used not simply to inform shareholders about aspects of firm activities but to persuade shareholders to support management by either voting in favour of the bid (bidding company shareholders or target company shareholders in friendly bids) or by rejecting the bid (target company shareholders in hostile bids). Thus, the quality of forecast disclosures, and not just the information in forecasts, is important in persuading shareholders to support management. Consistent with this point, some commentators (*eg* Sudarsanam, 1994) suggest that forecasts are for such a short period in the future that they convey very little new information to the market.

## Background information

Forecasts have two distinct parts. Firstly there is the forecast itself which may be a qualitative statement (*'profits will be greater than last year'*) or may contain forecast profit and loss account amounts. The second part contains the assumptions underlying the forecast, which vary from no assumptions to numerous assumptions disclosed.

Forecasts generally disclose two distinct types of information: financial information; and assumptions underlying the forecast. Increased disclosure of financial information in forecasts is likely to be useful to users in understanding the forecast and in adding to its credibility. Intuitively, one would expect that increased detail in forecasts would add to their credibility. The overall message (*ie* the forecast profit/loss) is the same regardless of the amount of detail disclosed in arriving at the forecast. Alternatively, details disclosed in addition to the forecast amount may represent key factors driving the forecast result which directors want users to be aware of in understanding the forecast.

Assumptions, on the one hand, may provide more information on how the forecast is arrived at, but, on the other hand, may qualify the certainty of achieving the forecast. The forecast will only be achieved if the underlying assumptions on which the forecast is made hold true. Forecasters may attempt to deal with uncertainty in forecasts through the disclosure of assumptions.

Dev (1973) provided some examples of the variety of wording used in UK forecasts. Montgomerie and Walker (1992), in a descriptive study, examined the accounting policies and disclosure of items in a selection of UK profit forecasts. Hartnett (1990) examined disclosure frequency, form and content and manner of presentation of 22 Australian forecasts. Hartnett, like Dev (1973), found considerable variation in the terminology used in the forecasts.

Most US studies are based on management disclosures of point and range forecasts of annual earnings. An exception is Pownall *et al* (1993) which examined the stock price effects of alternative types of management earnings forecasts that differ by form (interim and annual forecasts and point, range, minimum and maximum forecasts) and horizon.

## Detail in forecasts

Forecasts vary from one line to forecasts covering two to three pages of detail. There was no consensus on whether it was better or worse to disclose numerous items. Disclosing many items may:

- 'give a better explanation to readers';
- 'be only a matter of optics'; or
- 'leave you wide open to attack from the other side'.

Views regarding the detail included in forecasts vary depending on whether the interviewee is speaking from the perspective of a preparer or a user of forecasts.

## Forecast preparation

There are mixed views on the advantages and disadvantages of detailed forecasts to preparers of forecasts. A lot of detail is useful in offering greater protection to the forecaster or the advisors.

*I would prefer a forecast with a lot of detail. It gives a better explanation to readers and more protection to the forecaster. However, the more assumptions, the more excuses are provided for getting the forecast wrong. This affects the validity and credibility of the forecast. If I saw a one line forecast, I would query how that forecast was obtained and I would be a little bit hesitant about it.*

*T<sub>1</sub> plc's forecast contained considerable detail, thus greater protection for the advisors. We showed the calculations so that if the forecast wasn't achieved, there was a way out. If it was said that the forecast wasn't achieved, we could point to the reasons because we had disclosed the calculations.*

Conversely, more detailed forecasts provide ammunition and make it easier for the other party to the bid to attack.

*Disclosing a lot of figures leaves you wide open to attack from the other side and is only a matter of optics. It suggests that a lot of work went into the forecast but, on the other hand, the forecast may contain a lot of caveats which reduce its usefulness.*

### Forecast reliability

The greater the detail in forecasts the more credible the forecast. Forecasts can be manipulated by, for example, leaving out items such as defence costs. Unless the forecast is detailed, this type of omission cannot be detected.

*I prefer a more detailed forecast because I think there is less scope for fancy footwork. At the end of the day, what is achieved is the most important consideration. Some forecasts exclude items (eg bid defence costs). Exclusions that give the ability to load costs is an area for concern.*

One interviewee referred to the importance of the profit figure being forecast and not its make up. Reliability, he argued, is more dependent on the caveats (ie assumptions) in the forecast, rather than the detail disclosed.

*I disagree that the more detail disclosed in the forecast the better the forecast. It depends on the caveats that are inserted in the forecast. The only number that matters is the bottom line.*

### Assumptions

Most forecasts disclose the assumptions underlying the forecast which provide more information on how the forecast is calculated.

## Forecast preparation

In relation to forecast preparation assumptions are seen as being used to reduce the risk of litigation, 'to get off the hook', 'to cover themselves' (see full quotes in chapter three). Assumptions are carefully chosen to give the greatest protection to forecasters, as the following comments illustrate:

*You cannot use economic conditions as an excuse for not making a forecast. You can build some into the assumptions. If the bid had taken place during the currency crisis, a forecast would have been very difficult. We would have had to put in assumptions about exchange markets. This would not stop the making of a forecast, but might result in including as benign assumptions as possible in the forecast.*

*We disclosed assumptions to the extent we needed to have caveats in case something went wrong. We looked at the variables that could have affected the forecast, especially those that could have affected it adversely. It was a combination of that and what the merchant bankers and accountants wanted. We kept the assumptions to a minimum as far as I can recall.*

The following comment describes how assumptions are chosen.

*Choice of assumptions is a joint decision between the company, the accountants and the merchant bankers. The Takeover Panel has rules on what can be assumed.*

Sometimes there is conflict between advisors and management on what assumptions should be disclosed:

*We always had major problems with the advisors in this area. All our first draft forecasts spelled out the real material assumptions but by the time the forecast got published, these assumptions had become meaningless and were converted to fairly standard assumptions. The real assumptions affecting the company get compromised and standardised. The advisors go to great trouble to standardise the assumptions. This makes it very hard for investors to understand and appreciate the forecast. For our*

*own security, we went to great lengths to spell out the assumptions in detail but the advisors watered down everything, and by doing so created risk. If a forecast goes wrong, one has a problem if one can't point to which assumptions failed. By using conservative assumptions, we could have made the forecast look as bad as we liked in order to persuade the shareholders to accept the bid. I would have more confidence in a forecast with no assumptions. I would regard no assumptions as being an underwriting of the forecast. Assumptions are caveats, get-outs.*

### Forecast reliability

In relation to readers of forecasts, assumptions provide excuses for getting the forecast wrong. Many interviewees referred to their preference for no assumptions in forecasts.

Both comments below distinguish between standard assumptions and 'sensitive' or 'specific' assumptions. As stated in chapter two, at the time this research was carried out, regulations only permitted assumptions relating to matters outside the control of the directors to be disclosed. Following changes to the *Listing Rules* in September 1997, 'internal' assumptions relating to factors for which the directors are responsible may now also be disclosed. This would appear to increase the scope for 'sensitive' or 'specific' assumptions.

*A forecast with no assumptions is preferred, other things being equal. It gives a better impression of certainty that the forecast is achievable. You look to see the really sensitive assumptions.*

*Forecasts that contain no assumptions are of more value than those that have lots. These provide protection to advisors, the board and management. The press pay very little attention to these disclosures. Forecasts with few caveats are much more useful. Assumptions introduce doubt into the forecast. There are a number of very similar standard assumptions used in forecasts. The ones to be interested in are those specifically related to the company. Advisors will choose assumptions and bases that give the best result for the company. Specific assumptions are chosen to give particularly good results.*

Large numbers of assumptions in forecasts undermine their reliability.

*A huge number of assumptions underlie the forecast. When you do a forecast, you don't get into detail as this queries the validity of the forecast. You get down to a group of items so basic that the company cannot know about them in advance, which will affect the forecast. Companies can assume the forecast out of credibility. Assumptions vary from industry to industry. The more assumptions (provided they are not put out to abuse the forecast) the better, as they enable the reader to assess the prudence and validity of the forecast. They also extend protection of the board.*

## **Summarising the evidence**

This chapter has analysed interview comments on information in forecasts. Forecasts comprise two parts: the detailed forecast itself and the assumptions underlying the forecast.

Views on the disclosures contained in forecasts were mixed and depended on whether interviewees were talking as forecasters or as readers of forecasts. In general, there seemed to be a preference for detailed forecasts as these provide more protection to the forecaster and are perceived as being more credible by readers of forecasts.

Almost all interviewees expressed concern at assumptions in forecasts. Forecasters acknowledged that assumptions are carefully chosen to offer them the maximum protection and to reduce the risk of litigation. Readers of forecasts expressed a preference for no assumptions, which would result in more reliable forecasts.

Concern was expressed at the impact on the amount forecast by excluding items from forecasts or by choosing key assumptions that undermine forecast reliability.



# CHAPTER EIGHT

## CONCLUSIONS AND RECOMMENDATIONS

This chapter summarises the main conclusions arising from the interviews under the themes of:

- Factors influencing disclosure;
- Motivations for disclosure of forecasts by bidding companies;
- Motivations for disclosure of forecasts by target companies;
- Role of forecasts in defending against hostile bids; and
- Information disclosed in forecasts.

It then considers implications for policy makers based on these research findings. Recommendations arising from the discussion and interview findings are suggested. Finally, issues are identified which may require further consideration.

### **Factors influencing disclosure**

• Prevailing market expectations about company profitability are highly influential in the disclosure decision. There is some evidence from interviewees that target companies in contested bids, fighting for the best price for shareholders, will be more bullish than normal in forecasting profits. Prevailing expectations of profitability will not be as bullish. Disclosure of profit forecasts will be one way of changing analysts' expectations and of moving expectations upwards in line with management's more bullish perspective. This would account for a greater frequency of profit forecasts during contested bids.

It is also clear from the interviews that larger companies are followed more closely by analysts. Market expectations for larger companies are therefore more accurate. In general, bidding companies are considerably larger than target companies. As a result, analysts' forecasts for bidding companies are likely to be more accurate. This might also account for the less frequent disclosure of forecasts by bidding companies.

Bidding companies were seen as choosing the timing of bids to take place when circumstances were advantageous. Bidding companies in these situations would have less need to disclose a forecast. If a forecast were disclosed it is more likely that it would be a good news forecast.

Most comments on the news content of forecasts related to target companies. In agreed bids, there was no suggestion from interviewees that company management tended to disclose good or bad news. Either type of forecast was possible depending on the circumstances of the bid. Forecasts disclosed by target companies in response to the requirements of bidding companies are more likely to be reasonably bullish, good news forecasts.

Bad news forecasts were referred to particularly in the context of recommended bids where directors were trying to persuade shareholders that the price they had negotiated for the target company was adequate given likely performance in the future.

In contested bids, interviewees were clearly of the view that target companies would only disclose good news forecasts. Target company management would be trying to achieve the best price for shareholders. Some interviewees suggested that bad news would be communicated in other softer, more qualitative, ways. There were references to a '*scorched earth tactic*' whereby pessimistic profit forecasts were disclosed to scare off unwanted bidding companies.

US regulations referred to in chapter two, which relate to annual forecast disclosure by management, require companies, once they opt to disclose forecasts, to provide adequate explanation if they wish to discontinue the practice. This is to prevent companies disclosing forecasts only when the news in the forecast is favourable. Such a rule would be difficult to apply in the one-off circumstances of a takeover bid.

Other factors were particularly emphasised as being important in the disclosure decision. While recognising that companies' boards of directors have overall responsibility for decisions taken, it is clear from the comments that tactics and decisions during takeover bids are heavily influenced by, if not dictated by, the advisors to the bid. Financial advisors, such as the merchant bankers, are especially influential in relation to bid tactics and strategy. The reporting accountants appear to dominate the decision to proceed to disclose a forecast because their support for issuing a forecast is crucial.

A second highly influential factor is the risk entailed in disclosing a forecast. If the directors, or more importantly the advisors, consider the risk to be too high, a forecast will not be disclosed. The level of risk, in turn, is affected by the forecastability of the profits which is affected by the variability of the firm's earnings, its forecasting systems, the industry of the firm, size of the firm, closeness to the year end *etc.*

The level of management ownership is another issue which may affect the likely conflict of interest between management and shareholders or management and the other party to the bid.

## **Motivations for disclosure**

The analysis of motivations for disclosure of profit forecasts is based on the common sense assumption that a decision on whether or not to disclose a profit forecast in the course of a takeover bid is likely to be profoundly influenced by a single dominant consideration, namely whether such disclosure would help or hinder the success of the forecaster, however success is defined. Success from the bidding company's point of view can be defined as completing the takeover at minimum cost. Success, from the target company's point of view, can be defined as maximising the cost of the takeover to prevent it occurring or, to maximise the return to target company shareholders. In these circumstances it would be expected that any decision to disclose a profit forecast would be taken predominantly by reference to whether disclosure would materially assist the forecasters' prospect of success.

Moreover, to the extent that there is a general culture which is hostile to routine disclosure of profit forecasts, it might be expected that bidding companies and target companies would not be motivated to make disclosure unless there are very attractive or compelling reasons. If disclosure of profit forecasts were a routine feature of company behaviour, a decision to make a forecast in a takeover situation would not require any particularly strong motivation.

Analysis of the interviews illustrated that the motivations underlying disclosure are complex and varied and depend on the individual circumstances of each bid. In some cases, events occurring prior to the bid might motivate disclosure.

### Bidding companies

The primary motivation for disclosure by bidding companies is to support the price of shares offered during the bid (either to its own shareholders or to target company shareholders). Forecasts may also be used by bidding companies as a means of putting information into the public domain. In contested bids, a forecast may be used as a means of persuading target company shareholders to accept the bid.

If the bid occurs close to the year end of the bidding company a forecast is more likely as the risk of the forecast being wrong is lowest. Ease of forecasting and the news in the forecast also influence disclosure.

Forecasts are rare in cash bids. In the larger research project based on takeover bids during the five year period 1988 to 1992, 49% of bids were cash bids. It is not surprising, therefore, that the frequency of disclosure of forecasts by bidding companies is much less than by target companies.

Bidding companies are larger and many are followed by analysts. Consequently, accurate analyst forecasts and therefore market expectations are available. In addition bidding companies choose the timing of the bid, when market conditions are good for the company. In these circumstances there may be less need for a forecast.

## Target companies

Motivations for disclosure by target companies are complex and depend on whether the bid is agreed or contested and on the behaviour of the bidding company. The most commonly cited reason for disclosure of a forecast by target companies is to correct market expectations of the company's profits - particularly in situations where the target company has not kept the market and its shareholders informed of current performance.

In agreed bids, two motivations in particular were identified as driving disclosure. Firstly, forecasts were disclosed to support the directors' recommendation to shareholders to accept the bid. Many forecasts in these situations were bad news forecasts. Secondly, forecasts by target companies in agreed bids are frequently a requirement of the bidding company.

In contested bids, the management of target companies is interested primarily in getting the best price for the shares. A forecast may assist this objective by persuading target company shareholders that the bid price undervalues the company. Such forecasts are more likely to disclose good news. In this respect, forecasts are often used tactically in the battle of words during the takeover bid.

A less common motivation cited for disclosure is to defeat an unwanted bid. In contested bids, when target company management are under attack, the forecast also has a role in persuading shareholders in target companies to support management and in putting the bidding company under pressure.

Some factors act against disclosure of forecasts, in particular, the risk of the forecast being incorrect (which, in turn, is more likely the longer the date of the bid from the forecast period end). In addition, making forecasts is costly (they have to be reported on, and substantial management time is involved in preparing a forecast). Unless target company management can identify benefits a forecast will not be disclosed.

## **Role of forecasts in defending against hostile bids**

Given the infrequency of forecast disclosure, forecasts in most circumstances appear not to be considered as very effective weapons in contested bids. If, however, forecasters are willing to incur the costs of making a forecast, there must be some perceived benefits to their disclosure in certain circumstances. Interviewees cited two benefits in particular. The main benefit of forecasts is to get the best price for shareholders by forcing the bidding company to increase the offer price. There were only one or two references to the forecast being used purely as a defence tactic to see off the bidding company. Interviewees were unsure of the specific reasons why publication of a forecast (rather than any other tactic during a bid) influenced the outcome (increased price/defeat of bid) of a bid.

## **Information disclosed in forecasts**

Two types of information are disclosed in forecasts: the detailed disclosures in the forecast; and the assumptions underlying the forecast. Views on these types of information varied depending on whether the interviewee was taking the forecaster's perspective or the user's/reader's perspective.

From the forecaster's perspective, there were mixed views on whether more detail should appear in forecasts. In the final analysis, the amount forecast is most important. Disclosing additional details of the make up of the forecast amount was considered to provide more protection to the forecaster in the event of the forecast not being achieved. From the user's perspective, more detailed forecasts were easier to understand and were considered to be more credible and reliable.

Forecasters had a strong preference for assumptions in forecasts as these offered more caveats to get the forecaster off the hook in the event of problems subsequent to the forecast. Sophisticated users expressed the firm view that forecasts without assumptions were preferable. Assumptions were seen as weakening the certainty and reliability of forecasts.

## Implications for policy makers

Takeover bids are situations where there are scope and incentives for alternative tactics and strategies by bidding and target companies. One tactic is the selective release of information during bids. This raises a question: Does this flexibility to release information selectively put shareholders at a disadvantage?

## Provision of information by directors

Chapter two outlined the regulations in the UK requiring disclosure of information by directors. Directors are required to disclose:

*... any information necessary to enable holders of its listed securities and the public to appraise the position of the company and avoid the creation of a false market in its listed securities.*

*... sufficient information and advice to enable them [Shareholders] to reach a properly informed decision. ... No relevant information should be withheld from them.*

Compared with the US, these regulations are more relaxed. In the US, shareholders may take class action suits; lawyers work on a contingent fees basis; and the loser in a legal action must reimburse the victor's legal expenses. Consequently, legal and regulatory consequences of disclosure or non-disclosure are more serious in the US.

Much of the shareholder litigation relating to corporate disclosures which result in class action suits arises under SEC Rule 10b-5 which makes it unlawful for managers 'to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading'. This rule has been used in 'fraud on the market' lawsuits to sue managers who are alleged to have failed to keep investors apprised of material earnings information. Managers in the US have a duty to 'correct and update' previous disclosures if those disclosures become inaccurate, incomplete or misleading.

The more general wording of the Takeover Code's general principle 3, and because litigation by shareholders is more difficult than in the US, there seems to be a lesser onus on disclosure by management in the UK. It is not clear, however, whether shareholders in the UK are at a significant disadvantage because of this more relaxed regulatory environment.

UK financial markets are significantly different from the US in that over 60% of major UK companies' shares are held by institutions (Stapledon, 1996). Much of corporate communication practice has emerged in response to the growing institutional concentration of ownership. Fund managers and institutional shareholders are more active, informed and sophisticated investors.

The regulations referred to here do not stipulate the form of disclosure. Information on company performance can be disclosed in many ways, only one of which is through a profit forecast. It therefore does not follow that non-disclosure of a forecast implies that directors are withholding relevant information from shareholders. Directors may choose to reveal the information in a format other than a profit forecast.

### Should profit forecasts be mandatory?

Disclosure of profit forecasts is discretionary in the UK. Is this in the best interests of shareholders?

Chapter two dealt with the historical background to regulation of forecast disclosure in the US. In the early 1970s, US regulatory authorities wavered between prohibiting forecasts altogether to making forecasts mandatory. In the end, disclosure was made voluntary, at the discretion of management.

Two reasons are presented in this research report which suggest that investors are not necessarily disadvantaged by non-disclosure:

- If companies choose not to disclose a forecast, this may be interpreted by investors in the worst possible way, as one interviewee stated 'Not disclosing a forecast casts doubt on the profitability' (see chapter three).

- Directors may use other means of communicating information to shareholders. US research has shown that directors tend to use qualitative statements to disclose bad news and profit forecasts for good news disclosures (Skinner, 1994). Such qualitative disclosures are common in takeover documents.

### Should the contents of profit forecasts be more regulated?

It has been argued earlier that the flexible approach to profit forecast disclosure should continue in the UK with companies having a choice to disclose or not disclose. Once companies, however, have decided to disclose a forecast should the content be more regulated?

Chapter seven explained that forecasts can vary from qualitative statements to statements of considerable detail. In the US, the AICPA recommends specified formats and requires minimum disclosures in forecasts. Also, in addition to disclosing assumptions, the major accounting policies followed in preparing forecasts must also be disclosed.

Regulations in the UK dealing with profit forecasts had remained largely unchanged for many years. In 1997, however, The Stock Exchange's *Listing Rules* governing the content of profit forecasts were amended in two important respects:

- 'Internal' as well as external assumptions may now be disclosed; and
- The forecast or estimate disclosed should normally be of profit before tax. Exceptional items and tax charges should be disclosed if they are expected to be normally high or low. If an amount other than profit before tax is presented, the reasons for so doing must be disclosed and clearly explained.

The Cadbury Report (1992) has had a considerable impact on disclosures in annual reports. Annual reports now include directors' responsibility statements. This begs the question whether such responsibility statements should also be included in profit forecasts.

In particular, directors' responsibility statements could clearly distinguish between the responsibilities of directors' and the responsibilities of those reporting on forecasts. Directors' responsibility statements in profit forecasts might also include the purpose of preparing a forecast, confirmation of suitable accounting policies (supported by reasonable and prudent estimates) have been used in preparation of the forecast and confirmation that applicable accounting standards have been followed.

Chapter seven pointed to the way in which directors appear to use assumptions to reduce the risk in forecasts and '*to give the best results*'. There is an awareness that the general reader does not understand the implications of many of these assumptions '*The press pay very little attention to these disclosures*'.

Should regulators consider introducing a '*safe harbour*' rule as in the US? The introduction of such a rule might have benefit for investors in encouraging increased disclosure of forecasts.

The interviewees in this study distinguished between different types of assumptions in forecasts: standard assumptions; and '*sensitive*' or '*specific*' assumptions. Users who have little experience of reading and interpreting these forecasts, such as the ordinary investor or the press, are unlikely to understand the distinction between standard and other assumptions and the nuances of meaning in the carefully chosen wording of these assumptions.

One possible improvement to current regulations is to require forecasters to distinguish general assumptions commonly included in forecasts from those specific to the business being reported on. A second remedy is to require directors to include a statement explaining the purpose of the assumptions disclosed and the consequences if the assumptions are not met.

## **Recommendations**

Six recommendations for the UK are suggested by the preceding discussion and from the interviews:

## Regulation of forecasts

- Profit forecasts should not be made mandatory. Current flexible regulations which allow companies to disclose information to the market in a variety of ways should continue. Were regulators to impose a requirement on all companies to disclose forecasts during takeover bids, they would need to be able to justify the extra costs involved. There is no evidence from this study that investors are disadvantaged by the variety of disclosure choices available. If directors choose not to disclose a forecast, investors are likely to interpret this in the worst possible way. If bad news is disclosed by, say, vague statements by the directors, investors are also likely to interpret this in the worst possible way.
- Public companies should publish quarterly reports. Many companies reported making forecasts to align shareholder expectations with expected company results. This suggests that such companies had not kept shareholders properly informed of company performance. Many companies would not need to disclose forecasts if they disclosed information more regularly to the stock market ensuring shareholders and analysts are kept informed of company prospects. Quarterly, as well as interim, reports are required under SEC rules and regulators should consider a similar requirement for UK public companies. Voluntary forecast disclosure by management is still a feature in the US, so quarterly reports are likely to reduce the need for, rather than eliminate, profit forecasts during takeover bids.
- Public companies should adopt consistent disclosure practices for good and bad news. There is little regulatory control on how good news or bad news is disclosed. There is evidence that good news may be forecast whereas bad news is communicated to shareholders in more qualitative ways. Although regulations would be desirable to ensure that good news and bad news is communicated in the same way, in practice it is difficult to envisage how this would be done other than to require all companies to disclose forecasts.

- Directors' responsibility statements should be included in profit forecasts, similar to the requirements of the Cadbury Report (1992) in relation to annual reports. This statement should clearly distinguish between the responsibilities of directors and the responsibilities of those reporting on forecasts.
- Regulations should specify a minimum level of disclosure in forecasts. Profit forecasts vary considerably in content, ranging from one line qualitative statements to summary quantitative forecast profit and loss accounts. It is impossible to completely standardise the content of profit forecasts. US regulations specify minimum disclosures in profit forecasts. UK regulations should similarly attempt to standardise disclosures in forecasts by specifying a minimum level of disclosure.
- There should be better control on disclosure of assumptions. Regulations should require directors to distinguish between standard assumptions and those specific to the business being forecast. Interview evidence points to the use of assumptions in forecasts to protect directors in the event of forecasts going wrong. In addition, directors might include a statement explaining the purpose of the assumptions and the possible consequences if experience is different from the assumptions.

## Challenges

This report has provided evidence pointing to improvements required in regulations. It has, however, also identified the following issues which require further consideration:

- Why do companies in takeover situations disclose forecasts when in normal trading situations it is unlikely a forecast would be released?
- Is it in the interests of investors for companies who do not routinely disclose forecasts to do so in takeover situations?

- Are amounts forecast during takeover bids different from amounts forecast in routine situations? Are amounts forecast during contested bids different from amounts forecast in agreed bid situations?
- Are forecasts during takeover bids as accurate as forecasts disclosed in other situations?
- Are profit forecasts effective in defending against hostile takeover bids?
- How influential are advisors in the decision to disclose profit forecasts? Is there any evidence of ritualistic behaviour or herding behaviour on the part of advisors in publication of forecasts?



# APPENDIX A

## INTERVIEW OUTLINE

This interview outline was used in interviews with directors, management and advisors of companies involved in takeover bids. Its applicability, therefore, to different interviewees varied.

### Issue for discussion

1. Outline purpose of research study
2. Stress confidentiality
- 3a. Were you ever involved in a bid where a forecast was disclosed?
- 3b. If 'yes', why was a forecast disclosed?
- 3c. Did the company have sophisticated forecasting systems?
- 4a. Why do bidding companies involved in takeover bids generally not disclose a forecast?
  - (i) during uncontested bids
  - (ii) during contested bids
- 4b. Why do target companies involved in takeover bids generally not disclose a forecast?
  - (i) during uncontested bids
  - (ii) during contested bids
- 5a. Why do some bidding companies involved in takeover bids disclose a forecast?
  - (i) during uncontested bids
  - (ii) during contested bids
- 5b. Why do some target companies involved in takeover bids disclose a forecast?
  - (i) during uncontested bids
  - (ii) during contested bids

- 5c. Of the companies that disclose a forecast during a takeover bid, why do more target companies rather than bidding companies disclose a forecast?
6. Who/what is the most influential in the decision to disclose the forecast?
  - Other party to the bid
  - Board
  - Management
  - Advisers
  - Whether the bid is contested or not
  - Market expectations of company profits
  - Regulations requiring a forecast
  - Other
- 7a. To what extent are forecasts disclosed privately rather than publicly during bid negotiations?
- 7b. Why, in an agreed bid, are forecasts disclosed publicly rather than privately?
8. Are there any factors not already mentioned that influence the disclosure of forecasts during takeovers?
- 9a. How influential is the fear of getting the forecast wrong?
- 9b. What is most feared if the forecast is wrong?
  - Litigation
  - Reputation
  - Career/job prospects
  - The Takeover Panel
  - Other
10. Which of the following is relevant in influencing the disclosure of a forecast?
  - Size
  - Extent of ownership of the company by management
  - Leverage
  - News contained in forecast
  - Industry in which the firm operated
  - Sophistication of forecasting system
  - Variability of earnings
  - Economic conditions in which forecast was made

- Age of the company
  - Other
11. In contested bid situations, do you think the publication of a forecast has a material influence on the outcome of the bid?
  12. What influenced the extent of disclosure of the bases and assumptions underlying the forecast?
  13. Who else should Niamh Brennan talk to about this research project?



## APPENDIX B

### FREQUENCY OF INTERVIEW RESPONSES

Motivations for disclosing a forecast	Interviewee											Total
	A	B	C	D	E	F	G	H	I	J	K	
<i>Bidding and target companies</i>												
To correct market perceptions	*	*	*	*	*		*					6
To back up share valuation	*											1
Length of time since last disclosure to the market							*					1
Ease of forecasting											*	1
<i>Bidding companies</i>												
To support value of paper consideration	*	*	*	*	*			*				6
<i>Target companies</i>												
To get the best value for shareholders				*	*				*	*		4
Condition of the bidding company	*	*	*									3
Get an increase in price	*	*								*		3
Beat off the bid	*									*		2
Justifying the offer (especially low offer)		*										1
<b>Total</b>	6	5	3	3	3		2	1	1	3	1	<b>28</b>

Motivations for not disclosing a forecast	Interviewee											Total
	A	B	C	D	E	F	G	H	I	J	K	
<i>Bidding and target companies</i>												
Downward revision of profit involved		*	*			*		*				4
Cost	*									*		2
Difficulty with forecasting profits of the company				*				*				2
Market perceptions are correct	*			*								2
Management time involved										*		1
Risk of getting the forecast wrong	*											1
Forecast profit does not justify price being offered								*				1
Too far from year end		*										1
Unreliable systems		*										1
<i>Bidding companies</i>												
Where cash is the consideration	*	*				*						3
<i>Target companies</i>												
Will not result in a better price for the target		*							*			2
If the bid can be defended without a forecast		*										1
<b>Total</b>	4	6	1	2		2		3	1	2		21

Factors influencing the disclosure decision	Interviewee											Total
	A	B	C	D	E	F	G	H	I	J	K	
Advisors		*	*	*	*	*	*	*			*	8
Variability of earnings		*		*	*		*	*		*	*	7
Board of directors				*		*	*	*		*		5
Economic conditions		*		*			*	*		*		5
Industry		*		*	*			*				4
News in the forecast		*		*			*	*				4
Forecasting systems		*		*	*		*					4
Whether bid contested		*	*				*					3
Management ownership				*	*			*				3
Other party to the bid		*		*								2
Market expectations		*								*		2
Size of company							*	*				2
Quality of management		*										1
Closeness to financial year end		*										1
<b>Total</b>		11	2	9	5	2	8	8		4	2	51



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