Do the SEC’s Safe Harbor Provisions Encourage Forward-Looking Disclosures?

Douglas J. Skinner

Recent surveys indicate that CEOs are reluctant to make disclosures of forward-looking information because they believe these disclosures expose them and their firms to stockholder litigation. Partly as a result of these claims, the SEC has recently called for testimony on whether the current safe harbor provisions are effective in encouraging corporate managers to disclose voluntarily forward-looking information. Evidence from the voluntary disclosure literature suggests that legal liability concerns have important effects on managers’ voluntary disclosure choices and that these concerns often prevent managers from issuing earnings forecasts. By strengthening the safe harbor provisions to reduce the expected legal costs of disclosure, the SEC can increase the extent to which managers voluntarily disclose forward-looking information.

We’re afraid to talk about the upside. . . . We’re not making any projections because by their very nature we could be wrong. (Peter Behrendt, Chief Executive of Exabyte Corporation, quoted in “Shareholder Suits Beset More Small Companies,” Wall Street Journal, March 9, 1994.)

The SEC has recently called for testimony on whether current safe harbor provisions encourage voluntary disclosures of forward-looking information.1 Underlying this effort is the belief that safe harbor provisions do not adequately protect corporate managers who make voluntary disclosures about the future prospects of their corporations. For example, 79 percent of CEOs responding to a recent American Stock Exchange survey indicated that the risk of stockholder litigation influenced their decisions about whether to disclose forward-looking information to investors.2 If this belief is correct, strengthening safe harbor provisions could increase voluntary disclosures and so improve the efficiency of U.S. capital markets.

Voluntary disclosure research has at least three implications for the adequacy of the current safe harbor provisions. First, this research shows that voluntary disclosures of earnings-related information are rare. For example, firms on the NYSE, Amex, or Nasdaq average only one earnings forecast every other year, and many firms make no forecasts. This evidence suggests that disclosure costs, including litigation costs, are too high.

Second, research shows that disclosures convey information to capital market participants, thereby affecting stock prices. Thus, voluntary disclosures are beneficial (they communicate value-relevant information to investors) and credible.

Third, and perhaps most important, evidence indicates that corporate disclosure practices are affected by the threat of stockholder litigation, particularly “strike” suits filed under SEC Rule 10b-5.3 Specifically, managers are reluctant to issue earnings forecasts that may turn out to be overly optimistic, preempt large negative earnings surprises more often than other types of earnings news, and disclose good and bad news in different ways. All of these patterns can be explained by fear of stockholder litigation.

If the SEC could reduce the legal costs of disclosure by strengthening the safe harbor provisions, it could change managers’ disclosure practices. The SEC could improve disclosure practices in three ways. First, because most voluntary disclosures of forward-looking earnings information are made outside of formal SEC filings, safe harbor provisions should be extended beyond statements made in documents filed with the SEC. Second, limiting investors’ ability to sue because of overly high earnings per share forecasts would increase

Douglas J. Skinner is an associate professor of accounting at the University of Michigan Business School.
the dissemination of potentially informative “good-news” forecasts. Third, currently, much value-relevant information flows privately from managers to analysts. Analysts use this information to make investment recommendations to clients and/or to form earnings estimates, which are later publicly disseminated. Thus, information flows from managers to analysts (who process it) to the public. Lowering the costs of public disclosures of managers’ earnings expectations would increase the extent to which managers’ private information flows directly to investors.4

EARNINGS FORECAST RESEARCH
To provide evidence on the effectiveness of the current safe harbor rules, this section summarizes research on three aspects of managers’ voluntary disclosure practices: the frequency of their earnings disclosures, whether they disclose only “good news” about earnings, and whether securities offerings by their firms affect their disclosure practices.

How Often Do Managers Make Voluntary Disclosures?
Research on disclosure shows that management earnings forecasts are rare, implying that disclosure costs, including costs from the threat of stockholder litigation, are too high. For example, Grace Fownall, Charles Wasley, and Gregory Waymire recently collected all management forecasts of annual or quarterly earnings released over eight randomly chosen weeks during the 1980–87 period.5 Using the Dow Jones News Retrieval Service, they found 444 forecasts for the eight-week period, which translates into an average of about 2,912 forecasts a year. Given the number of firms listed on the NYSE, Amex, and Nasdaq during that period, these numbers indicate that, on average, one of every two of these firms discloses an interim or annual earnings forecast every year, a small number in absolute terms. Because fewer than one-third (136) of the 444 forecasts were point or range estimates (the rest were lower- or upper-bound forecasts), precise forecasts of EPS are even rarer.

The average number of forecasts per firm is deceptive, because firms vary tremendously in how often managers make earnings forecasts. Managers of some firms publicly disclose earnings forecasts at least once a year; others make no voluntary disclosures for years. I investigated the number of voluntary disclosures that managers of 93 Nasdaq National Market System firms made between 1981 and 1990.6 The firms were chosen to be representative of all exchange-listed and Nasdaq stocks (because National Market System stocks are the largest Nasdaq stocks, they tend to be smaller than most exchange-listed stocks but larger than other Nasdaq stocks). The number of voluntary disclosures per firm over that ten-year period, as reported in the Dow Jones News Retrieval Service, is shown in Figure 1. Seventeen firms made no voluntary disclosures during the ten-year period, and 16 firms made only one such disclosure. The majority of firms made fewer than five voluntary disclosures during the entire period. At the other extreme, 4 firms made 13 or more disclosures and 12 firms made 10 or more disclosures. These numbers suggest that the benefits and costs of disclosure vary widely across firms.

Figure 1. Frequency Distribution of Disclosures: 93 Nasdaq Stocks, 1981–90

Source: Skinner, “Why Firms Voluntarily Disclose Bad News.”

Do Managers Volunteer Only Good News?
Many people believe managers have a good-news bias; that is, they disclose forecasts when their firms are performing well but remain silent when they have neutral or bad news. Early research on disclosure supports this idea, although more recent evidence does not.

In an early study, James Patell documented that management earnings forecasts convey good news to the stock market.7 Analyzing annual EPS forecasts collected from the Wall Street Journal for 1963 through 1968, Patell found that the average stock price reaction to a sample of 336 forecasts was positive. When Patell looked at what managers said, he found further evidence of a good-news bias: 62 percent of earnings forecasts predicted an
increase in annual earnings, 30 percent predicted that earnings would be flat, and only 8 percent of forecasts predicted that earnings would decline.

Stephen Penman, who collected Wall Street Journal forecasts of annual EPS for the 1968–73 period, also reported that stock prices, on average, react positively to management earnings forecasts.\(^8\) In addition, Penman found that forecasting firms enjoyed positive stock price performance for three months on either side of the forecast date, suggesting that forecasting firms are performing abnormally well on the stock market.

Thus, research on management earnings forecasts from early time periods finds that forecasts convey good news to the stock market, consistent with the idea that managers attempt to skew investors’ perceptions by a policy of selective disclosure. Recent research, however, which focuses on broader samples and more recent time periods, suggests that management earnings forecasts convey information that represents neutral or even bad news. Maureen McNichols reported that the average stock price reaction to her sample of management earnings forecasts (from 1979 to 1983) was close to zero.\(^9\) Two recent studies based on samples from the 1980s provided evidence that voluntary earnings disclosures tend to convey bad news.\(^10\)

One interpretation of this evidence is that the legal environment changed from the early sample periods (the late 1960s and early 1970s) to more recent periods (the 1980s). For example, the “fraud-on-the-market” theory, which makes it easier for large classes of plaintiffs to demonstrate reliance in Rule 10b-5 cases, became increasingly accepted by the courts during the 1980s and was affirmed by the Supreme Court in 1988. Thus, the current legal environment makes filing and succeeding in Rule 10b-5 lawsuits easier for stockholder plaintiffs. As the evidence indicates, managers have become more reluctant to disclose good-news forecasts and more likely to voluntarily disclose bad news as the expected legal costs of revealing large, negative earnings surprises have increased.

Differences in studies suggest we should interpret disclosure findings carefully. Early papers (such as those by Patell and Penman) look only at point or range forecasts of annual EPS and restrict their samples to Wall Street Journal forecasts. In contrast, recent papers sample from the Dow Jones News Retrieval Service, which contains a much larger set of news articles. In addition, recent studies define earnings forecasts more broadly than just point or range forecasts of annual EPS. These studies include interim and annual forecasts, upper- and lower-bound estimates, and sometimes qualitative disclosures, as well as point and range estimates of EPS. These differences may be important, because managers disclose good and bad news in different ways. For example, I found that managers were more likely to release good news as point estimates of annual EPS, but bad-news forecasts were more likely to relate to quarterly earnings numbers. So, differences in the results of studies based on different time periods have two possible explanations: (1) The legal environment has changed considerably during the past three decades, which has had an effect on disclosure, and/or (2) differences in sampling methods across studies make assessing the extent to which managers’ disclosure policies have actually changed through time difficult.

**How Do Securities Offerings Affect Managers’ Voluntary Disclosures?**

Many commentators have argued that firms can lower their cost of capital by increasing the amount of information they disclose to outsiders.\(^11\) If this idea is true, we would expect firms that go to the capital markets on a regular basis also to be those that disclose the most information to investors. To examine this notion, Richard Frankel, Maureen McNichols, and G. Peter Wilson looked for a relation between the extent to which firms rely on external financing and how often managers of these firms issue earnings forecasts.\(^12\) They found that, in general, firms that access capital markets frequently also issue the most earnings forecasts, suggesting that the benefits of disclosure are larger when firms are trying to sell securities to the public. Even though these firms generally disclose more often than other firms, however, they do not disclose more in the period just before public securities offerings. The reason is that in the period immediately before public offerings, the risk of stockholder litigation increases because firms making public offerings are subject to more-stringent disclosure requirements than other firms. Overall, the evidence suggests that disclosure has benefits related to the cost of capital but that these benefits are more than offset by increased legal costs of disclosure in the period just before public securities offerings.

If managers are careful to time their voluntary disclosures according to when they are issuing securities to the public, they may also time securities offerings according to their schedule of manda-
tory disclosures. Some evidence suggests that managers do engage in this practice. In a recent study, Robert Korajczyk, Deborah Lucas, and Robert McDonald found that a large number of equity offerings occur in the period just after mandatory quarterly earnings announcements (when most of the manager’s private information about earnings is in the public domain) and that the number of offerings declines steadily through the period just before the next earnings announcement (when the manager’s informational advantage is likely to be largest). Thus, managers avoid selling securities when their informational advantage over investors is largest and their legal duty to disclose most pressing. Although not directly related to earnings forecasts, this evidence suggests that managers time their equity sales (as well as their voluntary earnings disclosures) to minimize the expected legal costs of issuing securities.

HOW DOES FEAR OF LITIGATION AFFECT MANAGERS’ VOLUNTARY DISCLOSURES?
Under current law, managers who wait to disclose large negative earnings surprises on quarterly earnings announcement days are issuing an open invitation to stockholder lawsuits. Earnings announcements are mandatory disclosures that typically occur several weeks after the end of the fiscal quarter. As a result, it is difficult for managers to argue that earnings announcements are timely disclosures. If a large stock price decline occurs at the time of an earnings announcement, stockholders can bring suit under Rule 10b-5, alleging that managers failed to disclose material information on a timely basis, and have a reasonably strong prima facie case. To reduce the chances that such lawsuits will occur, managers can “voluntarily” disclose the bad news before the announcement date. Early disclosure reduces the expected costs of stockholder litigation because (1) it reduces the credibility of plaintiffs’ arguments that disclosure did not occur on a timely basis and (2) it reduces the length of the class period, the number of potential stockholder plaintiffs in the class, and so the total dollar damages that plaintiffs can claim.

Consistent with this argument, I found that managers preempt large negative earnings surprises on quarterly earnings announcement dates more often than they preempt other types of earnings news. I collected data on the magnitude of earnings surprises for all quarters with data available for the 93 Nasdaq firms described earlier. The final sample comprised 2,647 firm-quarters of earnings news from 1981 to 1990. I then analyzed whether managers were more likely to preempt bad earnings news with voluntary earnings disclosures, as we would expect if they were concerned about lawsuits.

The evidence is presented in Figure 2. The horizontal axis shows the magnitude of the earnings surprise: Firm-quarters in Decile 1 are those with the worst earnings news, those in Decile 2 are those with the next-to-worst news, and so on. The vertical axis shows, for each earnings decile, how often the earnings news was preempted by a voluntary disclosure. The nature of the earnings news is strongly related to the extent to which it is preempted. The worst earnings news is preempted most often (20–25 percent of the time), followed by the next-to-worst news (15–20 percent of the time), and then by the Decile 3 news (10–15 percent of the time). After these three bad-news deciles are removed, no pattern is clear; earnings news is preempted less than 10 percent of the time for the other earnings news deciles. This pattern is exactly what we would expect if the legal liability story is important: Managers disclose most often when the news is bad (and more often when the news is worse), but if the news is not bad, earnings news does not affect managers’ disclosures.

I also found differences in the ways managers disclose good and bad news. Specifically, bad-news disclosures are more likely to be qualitative statements about quarterly EPS, and good-news disclosures tend to be point or range forecasts of annual EPS. For example, in predicting disappointing quarterly results, ADAC Laboratories said revenue for the first quarter ended Dec.
31 is expected to be well below analysts’ expectations. A company spokesman said . . . the company was not making any forecast on whether the revenue figure would exceed the $22,455,000 reported in the year-ago quarter” (Dow Jones News Wire, January 4, 1990, emphasis added). Conversely, in predicting upcoming good news, AEL Industries announced that it “expects fiscal 1988 earnings to match the prior year’s net income of $3.3 million, or 74 cents a share . . . and that earnings for fiscal 1989, which begins next March 1, will exceed this year’s results by more than 30pc, indicating net income in the range of $4.3 million” (Dow Jones News Wire, November 16, 1987).

The relation between the forecast horizon (annual versus quarterly) and the sign of earnings news (good versus bad) is strong. For a sample of 266 voluntary disclosures that related to either (but not both) annual or quarterly EPS, I found that 70 percent of the annual disclosures conveyed good news about future earnings and 67 percent of disclosures about quarterly earnings provided bad news about future earnings. Put differently, although most (57 percent) good-news disclosures related to annual earnings, more than three-quarters of bad-news disclosures were forecasts about quarterly earnings. This relation suggests that bad-news disclosures are more likely to be designed to preempt quarterly earnings surprises (and the resulting stock price reaction) and so reduce the chances of stockholder litigation.

I also calculated the stock price reaction to this set of voluntary earnings disclosures. The stock price reaction to bad-news disclosures is substantially larger, in absolute value, than the stock price reaction to good-news disclosures. The stock price reaction to the bad-news disclosures averages −6 percent compared with 2.5 percent for the good-news disclosures. Like the evidence on forecast horizon, this result suggests that bad-news disclosures are designed to reduce the chances of large stock price declines on earnings announcement days, thereby reducing the chances of stockholder litigation.

In addition to being sued for failing to disclose material information, managers can be sued for disclosing false or misleading information. For example, managers who knowingly issue biased earnings forecasts can be sued under the provisions of Rule 10b-5. Some evidence indicates that fear of such lawsuits prevents managers from issuing earnings forecasts, even when those forecasts are made in good faith. Specifically, Gregory Waymire found that firms that issue point or range forecasts of EPS have less-volatile earnings series than “nonrepeat forecasters” (firms that issue forecasts relatively infrequently). Because their firms’ earnings are more volatile than those of repeat forecasters, managers of the nonrepeat forecast firms are less certain forecasts will be realized. As a result, more of these firms’ forecasts are likely, ex post, to be overly optimistic and to result in lawsuits, which is why managers of these firms are reluctant to make forecasts. This interpretation is consistent with survey evidence from a Conference Board study by Francis Lees. Lees found that “Some companies . . . cite volatility of bottom-line results as a reason for not going public with their net income predictions. In these companies, a small difference in revenues can have a material effect on net income because fixed costs are high” (p. 19).

Waymire also found that the managers of the nonrepeat forecasters issue forecasts in years when their firms experience less-severe earnings “shocks” and issue their forecasts relatively late in the fiscal year. Once again, these facts suggest that managers make earnings forecasts only when they are reasonably sure the forecasts will be realized, reducing the risk of stockholder litigation.

If managers are concerned about the risk of stockholder litigation following forecast disclosures, they should be more concerned about forecasts that turn out to be too high (and so cause stock price declines) than with forecasts that are too conservative. As a result, the legal liability story predicts a larger number of downward forecast revisions than upward revisions. The evidence supports this prediction. For a small sample of earnings forecast revisions, I found that managers are more likely to make downward forecast revisions than upward revisions: Of the 24 revisions in my sample of voluntary disclosures, 19 were downward revisions. For a larger sample of 366 forecast revisions, 264 (72.5 percent) were downward revisions, where the sign of the forecast news was measured using Value Line analyst forecast data as a benchmark (i.e., bad news occurs when the new management forecast of EPS is smaller than the outstanding Value Line forecast). These findings suggest that managers believe the law imposes a type of “strict liability” for forecasts; that is, they face stockholder lawsuits if their forecasts turn out to be wrong, even when those forecasts are made in an unbiased way with the best information available. Consequently, because most managers are not clairvoyant, they are reluctant to issue good-news forecasts, because
those forecasts could be wrong, resulting in stock price declines and stockholder lawsuits. Whether the law actually distinguishes managers who act in good faith but suffer bad outcomes from those who engage in fraud is a controversial and unresolved issue in the law and economics literature. The important point is that managers *act* as if the law operates to discourage voluntary disclosures, especially disclosures of good news. One explanation for such beliefs on the part of managers may be the "litigation explosion" that has recently received a large amount of attention in the media and in Congress.

**SUMMARY AND CONCLUSIONS**

Evidence on managers' voluntary disclosures was used to address the effectiveness of the SEC's current safe harbor provisions in encouraging voluntary disclosures of forward-looking information. The most important empirical results, along with their implications, are as follows:

- Voluntary disclosures of earnings-related information by corporate managers are rare. This finding is *prima facie* evidence that the costs of disclosure, including the expected costs of stockholder lawsuits, are too high.
- Those disclosures that do occur affect stock prices, suggesting that managers' disclosures provide investors with credible, value-relevant information.
- Consistent with the idea that increased disclosure helps firms lower their cost of capital, managers of firms seeking to raise capital through public offerings issue more earnings forecasts than other firms. Those managers, however, do *not* issue more forecasts in the period just before public offerings, when the threat of disclosure-related stockholder litigation is high.
- Managers' voluntary disclosure practices are likely influenced by the threat of stockholder litigation. Managers preempt large, negative earnings surprises more often than other types of earnings news and disclose good and bad earnings news in different ways. This practice suggests that managers try to prevent large stock price declines at the time of earnings releases to avoid stockholder lawsuits.
- Firms that make point or range forecasts of annual EPS have less-volatile (more-predictable) earnings, suggesting that managers are reluctant to make specific earnings forecasts unless they are reasonably sure that these forecasts will be realized. In addition, when managers revise their earnings forecasts, most revisions are downward. This pattern implies that managers are more concerned about outstanding forecasts that are too optimistic than they are about forecasts that are too conservative. Together, these regularities suggest that managers are concerned about the possibility of large, negative earnings surprises and the likelihood of costly stockholder litigation that often follows.

Overall, the evidence suggests that managers are reluctant to make voluntary earnings disclosures, especially of good news, because such disclosures increase the chances of stockholder litigation. Consequently, the SEC could increase the frequency of voluntary disclosures of earnings news, and thus improve the functioning of U.S. capital markets, by strengthening safe harbor provisions to reduce the legal costs of disclosure.

**FOOTNOTES**

1. U.S. Securities and Exchange Commission, *Safe Harbor for Forward Looking Statements*, Concept Release and Notice of Hearing, October 13, 1994 (release number 33-7101). The safe harbor provisions are set forth in Rule 175 under the Securities Act of 1933 and Rule 3b-6 under the Securities Exchange Act of 1934. Briefly, these provisions offer a safe harbor (protection from legal liability) for specified forward-looking statements that are made, or appear, in documents filed with the SEC. The safe harbor operates by requiring plaintiffs to show that the forward-looking statements lacked a reasonable basis in fact and were not made in good faith.


3. "Strike" suits are stockholder lawsuits filed immediately after large stock price declines at the time of information releases such as earnings announcements. Some observers argue that these suits are generated automatically when stock prices fall by a prespecified percentage.

4. Managers also have reason to be cautious about their private communications with analysts, because these communications can be characterized as unlawful "tipping" under the securities laws (see the recent *National Law Journal* articles by John C. Coffee, Jr., February 1, 1993, and by Harvey L. Pitt and Karl A. Groskaufmanis, April 18, 1994). To the extent that private communications between managers and analysts are constrained by this legal risk,
lowering the costs of public disclosure would increase the amount of information available to all capital market participants.


6. I originally chose a random sample of 100 firms from the population of firms listed on the Nasdaq National Market System at the beginning of 1981 but lost seven firms as a result of data requirements.


16. This set of disclosures is for the sample of 93 Nasdaq firms described previously.


19. I am grateful to Grace Pownall for providing these numbers to me. They are based on the sample of disclosures in G. Pownall, C. Wasley, and G. Waymire, “The Stock Price Effects.”


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