When should companies issue profit warnings?

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A firm should release a profit warning if it has material information which is likely to have a material effect on the price or value of its securities, or which may create a false market.

A profit warning is a declaration issued by a listed company to investors through a stock exchange, advising shareholders and the public that the company's earnings results will likely not meet expectations.

A company generally issues a profit warning prior to the public announcement of its official earnings results.

Disclosure-based regime

From around 2002, Singapore regulators made a shift towards a disclosure-based regime to ensure investors have accurate and timely information.

Previously regulators sought to pre-judge the risks of investments and attempted to protect investors by barring what they viewed as risky products. It recognises that regulators are not able to spot all the risks on behalf of investors.

The Singapore Exchange (SGX) Listing Rule 703 now requires the issuer to disclose information concerning it or any of its subsidiaries or associated companies that would be likely to have a material effect on its price or the value of its securities.

This is to avoid the establishment of a false market in the securities of the company, where erroneous or incomplete information can be used to manipulate and affect prices.

Appendix 7.1 of the Listing Rules sets out a list of events which are likely to require immediate disclosure. It's not a complete list, but includes "firm evidence of significant improvement or deterioration in near-term earnings prospects".

To disclose or not to disclose

While the principles of disclosure appear clear, there is no specific Listing Rule which expressly states when companies should issue profit warnings.

There is however a requirement under Appendix 7.2 of the Listing Rules to disclose "where a forecast or a prospect statement has been previously disclosed to shareholders, any variance between it and the actual results".

Against the severe penalties for failing to make prompt disclosures and a highly volatile business and trade environment, companies should consider carefully their duty to provide profit warnings.

This requirement was included by SGX after a series of reprimands to companies which had announced results substantially different from their prior guidance.

In general, the company should issue a profit warning if it has material information which is likely to have a material effect on the price or value of its securities, or which may create a false market. This would apply in the following situations.

First, if the company has provided guidance to the market about its business, operations, financial position and/or prospects in the prior financial quarter or period, and it transpires that the period to be reported will turn out to be materially different. Companies should, in particular, make an SGX disclosure to update the market if the results are likely to be materially adverse.

Second, if the company has not provided previous guidance, but there are significant external conditions which the board judges will result in significant deterioration in near-term earnings prospects, the company should consider if such factors have been previously disclosed. In which case, the company should consider making such a disclosure and its implications on the performance of the company.

Third, if the company is aware that the public expects the company to be profitable (for example based on analyst or media reports), but the company has a preliminary view that the financial period or financial year may turn out to be a loss or materially less profitable than expected, the company should consider issuing a profit warning at the appropriate time.

Timing of disclosure

If the company decides to issue a profit warning, the next question is when to make the announcement.

Generally, listed companies will close their books to prepare the financial statements for the financial quarter or year just ended. Where there has been significant deterioration in the financial results compared to the guidance to or expectation by the market, it should issue a profit warning to the market immediately after the end of the financial period but before the date of the SGX announcement of the financial results.

If it is apparent to the company even before the end of the financial period that there will be significant deterioration in the results, then it would be advisable for the profit warning to be made as soon as reliance can be placed on the estimates.

This will avoid a situation where investors are trading in the market without knowledge that the eventual results will be vastly different from what they were previously guided on or had expected.

As always, listed companies loath the fact that profit warnings will most likely cause their share price to fall. The usual question is how bad should results be before such a profit warning should be made.

Given the potential impact on investors and the market that trades on false expectations, it would be best to be prudent in issuing the profit guidance rather than not.

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