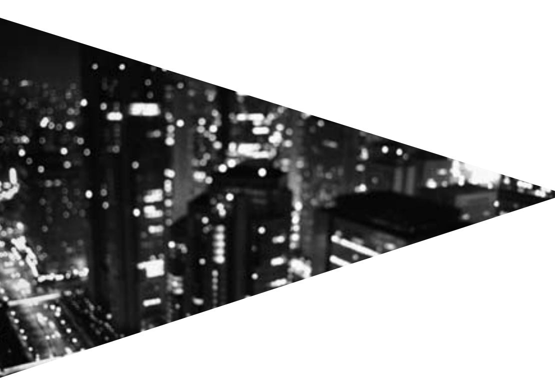
Issue 9: November 2009

InSights for European Audit Committee Members

The financial communication challenge



Executive summary

Throughout the last decade, companies have expanded considerably the depth, breadth and reach of their financial communications to the market in response to heightened investor and analyst demands and as a result of enhanced financial-reporting requirements. Management has sought to tell its "story", and analysts have sought to validate it and devise their own. Audit committees, for the most part, focus on one part of the story: the audited financials and earnings releases. Few review or provide input on other kinds of financial communications.

However, given the financial crisis has magnified market sensitivity to these communications — and many companies have increased their communications with investors and analysts — does the audit committee's limited review constitute a risk? To assess this question, Tapestry Networks interviewed representatives from a range of financial stakeholders, experts and accounting standards-setters (see appendix for a complete list of research participants).

Key takeaways include:

- **Financial stakeholders want a cohesive story about company performance**
  Companies provide a great deal of financial-performance information, yet stakeholders continue to find it difficult to get a clear story and are less trusting as a result of the financial crisis. (Page 3)
- **Audited financial statements are a core building block**
  Audited financial statements remain key to financial stakeholders and are a major focus for management, yet their usefulness is undermined by complexity and changes in accounting standards. (Pages 4-5)

Ernst & Young
Quality In Everything We Do

Executive summary *continued*

- **Other parts of the story are increasingly important**
  In forming their analyses, financial stakeholders are relying more heavily on management's forecasts and analysis of company performance, and data on key performance indicators (KPIs). (Pages 6-9)
- **Some elements of the story are not well told**
  Research participants want stronger communication and disclosures on enterprise risks — including how they are being mitigated — and on corporate governance factors (such as board directors' abilities). (Pages 10-11)
- **There is a debate about the role of the audit committee in reviewing the story**
  European audit committees typically see their oversight role as limited to reviewing the company's audited financial statements. However, some research participants feel the audit committee has a broader role to play. (Pages 12-13)
- **Conclusion: is it time to review the audit committee approach?**
  With the intensifying focus on management's story and the growing demands of financial stakeholders, audit committees should consider a broader review of financial communications. (Page 14)

About this document
InSights is produced by Tapestry Networks to provide assessments of key issues of interest to European audit committee members. Initially, *InSights* will be distributed to members of the European Audit Committee Leadership Network who, in turn, will share it with colleagues on audit committees and boards and their advisers. It will be distributed by Ernst & Young to the partners of its member firms. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the participants interviewed. They neither reflect the views nor constitute the advice of participants' companies, Ernst & Young or Tapestry Networks.

Financial stakeholders want a cohesive story about company performance

Research participants confirmed that there is a major demand not only for financial statements, but also for a broader story about future company performance. Unfortunately, some companies are better at telling a clear story than others. As one participant put it, *"Companies are putting out more and more information — more dots, if you will. But not all are good at helping us connect the dots."*

The information is communicated through many vehicles, including published financials, interim and annual reports, earnings releases, supplementary materials provided to analysts, and non-public information provided to credit rating agencies. Management — including the CEO and CFO — spends a great deal of time preparing this information for release, with support from various staff functions (notably investor relations, treasury, and corporate communications).

A research participant said, *"Across the board ... there is a focus [now] on what's behind the numbers and [a desire to know] what management didn't know before the crisis."* As company performance plummeted in the first half of 2009, sell-side and buy-side analysts sought to validate what management was telling them with additional sources of information, such as market data, competitors' performance and even the views of key suppliers and customers. A research participant said, *"When everything was going fine ... [analysts did not] spend as much time checking as in this difficult period."* They have also focused much more attention on the balance sheet, particularly the debt profile and maturity schedule.

Credit rating agencies have shown that they are more willing to move their ratings. They have upgraded their own methodologies and analyses and are using these to ensure data is more comparable across companies, sectors and geographies. They are also now more likely to run their own scenario analyses or stress tests and to depend less on company management. One participant noted that credit analysts now need *"much greater skepticism."* Moreover, rating agencies and debt investors are now more sensitive to management's ability to achieve its stated performance targets and more willing to adjust their ratings or investments further and faster in reaction to incorrect or misleading information.

"Across the board ... there is a focus [now] on what's behind the numbers and [a desire to know] what management didn't know before the crisis."

Audited financial statements are a core building block

Audited financial statements are a critical component of the story and, as such, a major focus of management and the audit committee. Several participants remarked that the preparation, distribution and communication of the core published financials consumes *"80% of the investor relations team's time."*

For financial stakeholders, audited financials provide an objective benchmark of the company's health, albeit retrospectively. Analysts and investors use this information to build their own models for tracking business performance and highly value the fact that it is independently verified and generally consistent between periods and across companies. Some sell-side analysts observed, *"Our own quality-control process is requiring that we focus more attention on checking our numbers with the published financials."* Similarly, credit rating agencies have invested heavily in new systems that capture and adapt financial statements in a way that makes cross-company, cross-jurisdiction comparisons easier.

Convergence of accounting standards helps, but creates transition challenges for analysts

Financial stakeholders say that the quantity and comparability of financial statements has improved considerably. *"Financial statements are much better today than 10 to 15 years ago,"* noted one participant. In Europe, much of the change can be attributed to the adoption of International Financial Reporting Standards (IFRS) in 2005. As Charlie McCreevy, European Commissioner for Internal Market and Services, said recently, "In these difficult times, it is easy to overlook what we have achieved over the last few years. We remain committed to an international standard-setting system; falling back on national or regional solutions, even if sometimes tempting, is not the way forward."[1] Almost 120 countries are now using IFRS (or standards based on IFRS), with several more key countries in the process of converting, including Brazil, Canada, China, India, Japan and Russia.

There have also been material changes to IFRS and to US Generally Accepted Accounting Principles as part of an ongoing set of convergence projects designed to bring these standards closer together. As one participant noted, *"Not too long ago, there was no comparability at all. There were different standards in every country. Now there are really two major accounting standards, and those are very close."*

While convergence projects aim to increase comparability, the changes to the standards that convergence requires can make it difficult, in the short term, for users to compare data across companies or from one period to the next. One research participant said, *"I've been very frustrated by the degree of [accounting] changes my companies have undergone in their reporting recently."*

To deal with the change, this research participant calculates his own estimates to maintain consistency with past disclosures. Audit committee members recognize that this is a problem. The audit chair of a large-cap European company said recently, "We need more stability and simplicity in accounting. It is getting more and more difficult to understand accounting standards."[2]

"Not too long ago, there was no comparability at all. There were different standards in every country. Now there are really two major accounting standards,and those are very close."

[1] Charlie McCreevy, keynote address at the "Financial Reporting in a Changing World" conference, Brussels, 7 May 2009. Available at http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/223&format=DOC&aged=0&language=EN&guiLanguage=fr.

[2] Audit Committee Leadership Summit, "Current issues in financial reporting: a discussion with Bob Herz," *ViewPoints,* 4 August 2009, page 8. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View9_Jul09.pdf.

> "Financial statements are much more complex today because business transactions have become more complex."

Complexity is creating real analytical challenges

Participants also highlighted that financial statements have become increasingly voluminous and complex throughout the last decade. The reason for their complexity is clear: *"Financial statements are much more complex today because business transactions have become more complex. For example, a decade ago there was almost no securitization — and then it exploded. Those securitizations are complex — and almost all are unique — and because of that they are hard to compare."*

As accounting and reporting standards have sought to keep pace with business, those who rely on financial statements have become increasingly frustrated. *"The page count is enormous. It can be 200 to 300 pages, and I need to react in 15 to 20 minutes to give a first view,"* complained one analyst. *"We have 20 minutes to react to the earnings release and then less than 24 hours to read through the entire financial statements to check our analysis and look for inconsistencies,"* noted another. One participant noted that the sell side is particularly affected by *"an overload of information [from companies],"* because their ranks have thinned in recent years due to cutbacks in investment-banking research capacity. In addition to sheer length, several participants pointed to the complexity of issues such as fair value accounting, financial instruments, valuations and pensions accounting.

Some companies release additional financial data

In practice, financial stakeholders make numerous adjustments to published financials — such as including operating leases in calculating effective leverage — to better analyze a company's underlying performance. To make it easier for stakeholders, as one participant said, *"Large-cap companies will issue their own financial [data] — aside from the [official] published financials — that make adjustments they know will be done by analysts."* Demand for this type of financial data reflects the view that one participant summarized: *"The published financials are increasingly disconnected from the economic reality."*

Questions for audit committees: What steps has your company taken to ensure its reported financials are sufficiently comprehensible to investors? If your company publishes adjusted financials, how do you ensure they are accurate and appropriately represent the company's underlying financial performance and health?

Other parts of the story are increasingly important

Several participants pointed out that the changing nature of accounting standards and the complexity of financial reporting have accelerated a trend among investors and analysts toward reliance on other forms of financial communications. Chief among these are:

- Management's analysis of company performance
- Data on the key operational performance metrics
- Management's forecasts or guidance on future performance

One research participant remarked, *"I spend 15% or less of my time on accounting and financial information ... [I spend the remainder] on how the markets are developing, looking at non-accounting information such as [KPIs], which are very useful, and on [broader] changes which are driving [my] industry."*

These elements of the story are found in the quarterly earnings releases, which some audit chairs say their committees review in detail both for facts and tone. However, equally substantial and arguably more influential is management's communication through supplemental materials and verbally with analysts, credit rating agencies and other financial stakeholders. Face-to-face meetings with investors and buy-side analysts have become increasingly important as this audience *"wants to look management in the eye,"* noted one participant.

Management's analysis of company performance is a frame for the story

An executive at a major institutional investor said, "Numbers are the universal language ... but we also want a very good narrative to build on with that."[3] Management's commentary in earnings releases and in company annual reports is a key vehicle for this narrative. Management puts a great deal of effort into telling the story of the company's strategy, performance and expectations for future performance. As one participant put it, *"Companies have to get their equity story right ... [They say,] 'This is our strategy, and this is how we are going to do it.' This information is essential."*

Seasoned financial analysts and investors recognize that management's commentary is, in part, a sales pitch, and that it should be judged within the context of disclosed data in an independent and objective manner. One research participant said, *"Every CEO and CFO is competing within their sector, so it's normal to expect they will do a sales pitch. Some will be persuasive, but one has to be thick skinned. [We need to] make a value judgment."*

In those countries using IFRS, there are few standards and little guidance for presenting this information, making comparability a major challenge. Standards-setters recognize this concern, as shown by the IASB's June release of an exposure draft, detailing the Board's "proposals for a broad framework for the preparation and presentation of management commentary to accompany financial statements."[4] At that time, Sir David Tweedie, the IASB chairman, said, "Management commentary is one of the most useful sections of an annual report, yet many countries applying IFRSs do not have guidelines that cover how to prepare or present this important information. In today's uncertain financial climate, it is particularly important for entities to explain their financial performance relative to their expectations and their strategies."[5] (The exposure draft is out for public comment until March 2010.)

[3] International Corporate Governance Network, *Financial Reporting and Auditing: What do investors want?* (London: International Corporate Governance Network, 2007), page 24. Available to subscribers at http://www.icgn.org/publications/surveys-and-reports/-/page/567/.

[4] International Accounting Standards Board. *Management Commentary,* June 2009. Available at http://www.iasb.org/NR/rdonlyres/53DC9B3B-34A5-400F-B4B5-4F2FF24F231E/0/EDManagementCommentary.pdf.

[5] International Accounting Standards Board, "IASB proposes guidance for the preparation and presentation of management commentary," press release, 23 June 2009. Available at http://www.iasb.org/News/Press+Releases/IASB+proposes+guidance+for+the+preparation+and+presentation+of+management+commentary.htm.

> "During the financial crisis, many companies have prioritized their buy-side communications over the sell side."

The most influential financial stakeholders:

- **Sell-side analysts:** These have long been one of the highest priority audiences for public company financial reporting and a major focus for investor relations. While their influence has decreased during the past five to six years, research participants agreed that sell-side analysts are critical: *"The sell side remains very important … They are the public voice of the analyst community."* They are able to broadcast their views to a wide range of market stakeholders, and buy-side analysts and the financial press in other markets or geographies still rely on sell-side analyst views as a key source of input to their own analyses.
- **Buy-side analysts:** The influence of buy-side analysts has increased throughout the past decade. Large investment institutions have improved their research capabilities so they don't have to depend so heavily on sell-side analysis. During the financial crisis, many companies have prioritized their buy-side communications over the sell side due to the buy side's direct influence over investment decisions. One participant said, *"Companies are asking, 'Are we going to meet with analysts or investors?' Now they are going to meet with investors."* Another said that companies *"went to the buy side and did more road shows. [They recognized] you have to talk to those who have the money. This is something [that] definitely changed."* A challenge for companies is determining whether to meet the institutional money managers or the underlying owners, such as pension funds. The latter are becoming more influential in terms of pressing for enhanced disclosures and improved governance standards.
- **Debt investors and credit rating agencies:** Over the past decade, increased borrowing and financial leverage have elevated the influence of debt investors and credit rating agencies. Senior management now dedicates more time to this financial stakeholder group.
- **Financial media:** Research participants tended not to view the financial media as having direct influence over investment decisions, but *"depending upon the investor — and the confidence they have in their own research — they may use [information provided by the financial press] to confirm and reaffirm their views."* Participants believe the financial media has most influence on investor views during significant events, such as during a merger or acquisition. They have also been influential in their coverage of issues related to corporate governance.
- **New media sources:** Research participants view blogs and tweets as the least influential. A participant said, *"They might have some influence to smaller investors and day traders, but institutional investors, less so … perhaps retail investors would use the information [there] as background."* See "A glimpse of the future: it's online" on page 13.
- **Debt investors and credit rating agencies:** Over the past decade, increased borrowing and financial leverage have elevated the influence of debt investors and credit rating agencies. Senior management now dedicates more time to this financial stakeholder group.

Other parts of the story are increasingly important *continued*

Operational performance metrics are critical
Research participants emphasized the importance of operational metrics — such as average revenue per user or customer acquisition cost — to their analyses. *"The share price can go up or down with this [kind of] information,"* noted one participant.

Participants highlighted two ways to use operational metrics successfully:

- **Pick metrics that drive long-term value creation**
  Both the companies providing operational metrics and those relying on that information often worry about which metrics to use. Some executives fear that providing the market with certain KPIs may reveal commercially sensitive data that could benefit competitors. One participant said, *"When you report operational performance, you have to decide how to guide the market on key performance indicators. [Executives] and audit committees are always confronted with this. They need to understand what is key to investors."* Analysts and investors agree that companies should choose what to disclose based on what drives value in the business. They suggest that operational performance metrics that management uses to make strategic decisions are the metrics that interest investors.[6]
- **Be consistent about the metrics used**
  One research participant said, *"I frequently hear companies are trying to change those [metrics]. Consistency is a best practice ... It's best to use a few consistent metrics for a long period of time."* Several participants noted that when companies keep changing their metrics, it creates concern that management either is trying to manage the message too much or is struggling to execute their strategy.

Forecasts and guidance have a major influence
Users of financial statements have one thing in common: they are trying to predict the future. In drawing materials together to aid their efforts, they pay a great deal of attention to actual or implied guidance from the company's management. One research participant defined management guidance: *"Guidance is taking together all things management knows and put[ting] it out there. I'm in favor of that."*

Participants pointed out that management's guidance and forecasts are useful because they provide a benchmark against which analysts can test their own models, allowing them to validate their inputs and results. The quality of the guidance and forecasts are also indicators of management's credibility: poor-quality guidance or an inability to meet their own targets speaks poorly of management.

Many senior finance executives have noted that the financial crisis and market volatility have made providing guidance to the market especially difficult,[7] a fact that led several prominent companies in Europe — including Unilever and GlaxoSmithKline[8] — to decide not to provide short-term earnings guidance. Other companies have ceased giving annual guidance, but continue to provide quarterly guidance. Still, some 63% of Western European companies surveyed last year offer guidance,[9] and that does not appear to show any signs of declining significantly.

"When you report operational performance, you have to decide how to guide the market on key performance indicators."

[6] Robert N. Palter and Werner Rehm, "Opening up to investors," *McKinsey Quarterly,* January 2009. Available at http://www.mckinseyquarterly.com/Opening_up_to_investors_2246.

[7] Jason Karaian, "Top Ten Concerns of CFOs," *CFO Europe,* 2 February 2009. Available at http://www.cfo.com/article.cfm/13046594/c_13047759?f=insidecfoeurope.

[8] See GlaxoSmithKline, "GSK delivers EPS of 104.7p before major restructuring; Dividend increased 8% to 57p," press release, 5 February 2009, page 2 (available at http://www.gsk.com/investors/reports/q42008/q42008.pdf), and Sarah Johnson, "CFOs Put Away Their Crystal Balls," *CFO.com*, 21 April 2009 (available at http://www.cfo.com/article.cfm/13524003/c_13522915?f=todayinfinance_next).

[9] The Bank of New York Mellon, *Global Trends in Investor Relations — Fifth Edition: A Survey Analysis of IR Practices Worldwide* (New York: Bank of New York Mellon, 2009), page 31. Available at http://pdf.edocr.com/e4ddbd9cc50b65c08ff26115a70368b2d8b4595c.pdf.

> "Guidance is taking together all things management knows and put[ting] it out there. I'm in favor of that."

Forward-looking information of this type presents real challenges for audit committees:

- **It includes a disparate array of data**
  It can include guidance particular to the company, such as performance against specific metrics (e.g., earnings per share) or management forecasts of performance, such as future cash flows, but it can also be broader predictions on the state and growth of the sector, which have implications for the company's future performance.
- **It is communicated in many different ways**
  It is included in earnings releases, in public supplemental information shared with analysts and investors, in non-public materials shared with rating agencies, and explicitly or implicitly in verbal communications between management and financial stakeholders (in one-to-one meetings as well as at conferences or analyst days).
- **It can promote short-termism**
  Guidance has long been criticized because it causes short-termism in the marketplace and can lead to fraudulent earnings management. Recent research in the United States questions this view.[10]

As one participant put it, *"Even if management doesn't issue guidance, they pay attention to analysts' predictions and focus significant attention on consensus numbers."*

Questions for audit committees: At the board level, who oversees management's communication of company performance to financial stakeholders? Is there sufficient oversight of this? How has your company's investor relations' strategy changed in light of the financial crisis?

[10] Gregory Miller, "Should Managers Provide Forecasts of Earnings?" (Cambridge, MA: Committee on Capital Markets Regulation, 2009). Available at http://www.capmktsreg.org/pdfs/09-Sept-15_CCMR-Miller_Study_on_Earnings_Guidance.pdf.

Some elements of the story are not well told

In today's economic environment, transparency — and full disclosure — are more valued than ever. "*Gone is the time for managing the message. Instead, full disclosure is a better approach,*" asserted one participant. Many companies have stepped up their disclosure efforts, particularly on funding and balance-sheet (and off-balance-sheet) items. One research participant said, "*I used to see basic data on liquidity in annual reports. Now I can find this information in quarterly reports and public presentations. I am discovering new information in quarterly reports that was not available before.*"

However, research participants highlighted two areas in need of significant improvement: the risk side of the story and corporate governance factors.

The risk side of the story

Risk disclosures are at the top of financial stakeholders' list of disclosure demands. "*We need more information on the risks,*" asserted one participant. Most participants acknowledge that management has little incentive to talk about "*the risk side of the equation,*" but stakeholders crave a robust, prioritized list of key risks to help them in their investment or analytical decision-making.

Participants interviewed for this research bemoaned the quality of current risk disclosures. One said, "*You have the American style of [disclosing] risks, [which can be] 20 pages or more, [which is too much] ... And then you have those that should list more [risks] because they are material.*" Another complained, "*Management is supposed to be prioritizing [the risks], but you have to do it yourself.*" One research participant summarized the situation well: "*A description of risks in writing is completely useless ... [it results in] a list that says all catastrophes are possible ... It is much better to address risks verbally [in management presentations].*"

Another research participant noted, "*Risk disclosures get longer each time something bad happens. Companies really cannot predict the future. [This is] part of the reason that face-to-face meetings are so important — to see how management thinks and responds when questions come up.*" In this context, a positive trend for analysts and investors has been the increased willingness of some financial institutions to include their chief risk officers or chief underwriters in analyst calls or meetings. But direct access to executives who oversee key risks remains rare, particularly outside of financial services.

Corporate governance factors

With perceived failures in corporate governance on the mind of many financial stakeholders, disclosures on board governance practices and executive compensation have become increasingly important. One participant noted that the financial crisis has caused more portfolio managers to focus on corporate governance factors. The leading financial media devote considerable attention to governance matters, and long-term investors and buy-side analysts are also attuned to these issues.

However, disclosure on governance is in its infancy in many European countries, and significant differences exist across borders. Still, one research participant said, "*Corporate governance [information] should be disclosed. It has to be done in a way that gives qualitative information, such as about topics discussed in meetings and the ability of the board members to address the risks.*"

Several participants noted that there are few opportunities for investors or analysts to meet directly with outside board members to compensate for weak governance disclosures. As one participant put it, in Europe, "*[access to non-executive directors] is very rare. But it is a great idea.*"

Questions for audit committees: Does the audit committee assess the quality of the company's risk disclosures? How well does management prioritize risks for investors? Does the story being communicated to the market offer a balanced discussion of risks and returns? How has the audit committee pushed for improvements to risk or governance disclosures? Should investors or analysts have greater access to non-executive board members?

The buy side typically prioritizes longer-term company fundamentals and places greater emphasis on the balance sheet.

What do the financial stakeholder groups focus on most?

- **Sell-side analysts:** Noted one participant, *"[Sell-side analysts] are interested in the short-term news flow or certain themes [such as regulatory reform]."* Another noted that, as large institutions have relied less on the sell side, the sell side has narrowed its focus to the concerns of *"event-driven, short-term or activist investors,"* making these analysts highly sensitive to any issues that could be *"short-term triggers affecting the share price."*
- **Buy-side analysts:** Participants noted the buy side typically prioritizes longer-term company fundamentals and places greater emphasis on the balance sheet, the risks facing the business, and the stability of the company and its sector over the medium term. This perspective reflects the fact that, as one participant put it, *"They have to eat the soup they cook."* The buy side — particularly pension funds — focuses more on governance factors: *"One of the things the sell side is slow on is issues of corporate governance. The buy side has been strong there; they have been much quicker."* The buy side also uses in-person meetings to assess management. Noted one participant, *"They want to know, 'What is management focused on? What does management view as the key value drivers? What is management's view on the quality of their profits?'"*
- **Debt investors, rating agencies:** This group takes the longest-term view of the company's performance and focuses heavily on the fundamental business drivers. This puts this group in closer alignment with the longer-term perspectives boards want to see management emphasize. Moreover, this group is least affected by short-term news in the market, whether positive or negative, which means it is least likely to be distracted by short-term minutiae.
- **Financial media:** Its focus is broad, covering reported financials, routine corporate news and major events, including corporate governance matters. The financial media are distinct in their focus on investigative matters. Gregory Miller, a professor of accounting at the University of Michigan, notes, "The press is important in uncovering [accounting misconduct]."[11]

[11] Martha Lagace, "The Business Press is a Watchdog that Bites," HBS Working Knowledge, 29 January 2007. Available at http://hbswk.hbs.edu/item/5591.html.

There is a debate about the role of the audit committee in reviewing the story

The audit committee is responsible for reviewing the company's financial statements, and this oversight responsibility has been broadened in recent years by the passage of new EU and US regulations.[12] However, when a cross-industry group of European public company audit committee chairs met in April 2009 to discuss their role in financial communications, it was clear their approaches were highly variable. Most reviewed financial reports and, to a lesser extent, earnings releases. Yet, significant differences in the approach and level of scrutiny exist based on national practice, board structure (unitary or two-tier) and the historical practice of individual companies.[13]

Areas where more engagement may be merited

Some research participants feel the audit committee needs to increase its review of financial communications, and several concurred with the participant who said, *"Audit committees should pay attention to the management report and the key financial communications. In fact, that is where non-executive directors can really add value — they can focus on the picture management is painting and assess [whether] it matches their understanding of the business. They can read the CEO and management materials to see if they are setting the right tone and see that they are not being too optimistic or pessimistic."*

> "Audit committees should pay attention to the management report and the key financial communications."

Two areas that participants suggested might benefit from more engagement are KPIs and earnings guidance:

- **KPIs**
  Participants differed over the audit committee's role in reviewing and discussing their company's use of KPIs. One participant said, *"Audit committees should decide with management what are the few key performance indicators that talk to the long-term value of the company, and they should see how management communicates them to the market. For me, that includes reading the supplementary materials given to analysts and the presentations given the rating agencies."* Another participant thought the audit committee should limit itself to quantitative performance indicators: "*The temptation is to say that audit committees should look at KPIs. If the KPIs are very quantitative ... perhaps the audit committee [needs to be involved].*"
- **Earnings guidance**
  Several participants felt that the audit committee should advise the company on the provision of earnings guidance. If the company is considering eliminating guidance, audit committees should push management to provide more information in the form of metrics the company uses to gauge performance so that analysts and investors can develop their own models and forecasts.[14] For example, GlaxoSmithKline's decision to stop providing numerical earnings guidance in February 2009 was accompanied by a commitment by the CEO to communicate progress against the company's strategic priorities on a regular basis.[15]

[12] A discussion of the noteworthy US and European regulations can be found in European Audit Committee Leadership Network, *ViewPoints,* "The audit committee role in financial communication," 8 May 2009. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May09_View20.pdf.

[13] Ibid.

[14] Ibid., page 9.

[15] GlaxoSmithKline, "GSK delivers EPS of 104.7p before major restructuring; Dividend increased 8% to 57p," page 2.

"Audit committees should decide with management what are the few key performance indicators that talk to the long-term value of the company."

A glimpse of the future: it's online

- Few investor relations teams devote much attention to the financial press, leaving it instead to their corporate communications colleagues. Still fewer pay attention to online financial bloggers and tweeters. Yet, several participants believe that the financial press, broadly speaking, coupled with other online financial commentators, will become increasingly important in shaping a company's financial reputation.
- One research participant noted, *"A growing volume of commentary [about a company] is online, and companies cannot contain it anymore ... Reputation is run online."* Another stated, *"Companies can no longer ignore the online financial commentators."* This includes the mainstream financial media, *"which gets its reports online faster than anyone."*
- One participant noted that investor relations are waking up to this trend, *"but it is still early on in the development — they are still trying to figure out which blogs and commentators are potentially most influential with investors."* Moreover, investor relation executives *"remain overly cautious about journalists, focusing too much on their desire to find a story, rather than on the fact that their readership is the very same investors who companies want to influence."*

The external auditor can support the audit committee's review
Several research participants felt the audit committee should not be involved in financial communications more broadly. One research participant said, *"Beyond earnings releases and financial statements, it's the job of management."* Another said, *"A problem is they only have six to eight meetings per year, and there is a lot to be done. They don't want to be in a position of just ticking boxes. Perhaps they should do fewer things and do them better."*

Some participants highlighted that the external auditor may be a key resource to limit the audit committee's hands-on role:

- **By checking financial communications for red flags**
  A research participant noted, *"Share price movement takes place based on what's provided in the analyst pack, and today it is providing more information ... External auditors should have a look at this to make sure there is consistency and that they are comfortable. Once it's out there, people are making decisions on it."* Some external auditors attend rehearsals for earnings calls or listen to earnings calls (either live or after the fact). Here again, they look for consistency in messaging, because inconsistency in tone at the top of the company would be a signal of potential trouble.
- **By highlighting constraints in reporting systems**
  External auditors can push management to ensure information systems are sufficiently updated to gather the data needed for new disclosures. A research participant said, *"Many companies are realizing that their legacy systems are not able to collate information properly."*

Conclusion: is it time to review the audit committee approach?

Companies have significantly ramped up their financial communications to the market over the course of this decade. Evolving accounting and reporting requirements have necessitated more complex and detailed financial statements. Meanwhile, investors and analysts continue to demand more and faster information, and companies have responded with a broadening range of media.

The financial crisis has made investors and analysts even more vocal in their demands, while elevating their skepticism about management's story. Increasingly, they are testing the story against other information sources and creating their own stories.

Audit committees have traditionally sought to limit their role in financial communications to the financial statements, and, to some degree, earnings releases, given their close connection to the financials. Many continue to take that position: as one participant noted, *"It is management's job to communicate to the markets."*

However, the increasing focus of financial stakeholders on the non-audited elements of the financial story begs the question as to whether this is still sufficient. And, as the role of non-executive directors continues to come under scrutiny as a result of the financial crisis, it is a topic audit committees may wish to address in the very near term.

Questions for audit committees: How involved does the audit committee get in discussing with management the full story communicated to key financial stakeholders? How much rigor does the committee apply to ensuring management's characterization of the company's performance accords with their understanding of the business? Should the committee spend time on agreeing the KPIs and reviewing how these are communicated to the market? Does the audit committee review management's forecasts or guidance, particularly that shared with analysts and rating agencies?

Appendix: Research participants

All the research participants spoke in their own capacity — representing their own views — and not those of their organizations. Subject-matter experts interviewed for this research include:

- Nick Andrews, Senior Vice President and Partner, Fleishman-Hillard
- Carla Antunes da Silva, Managing Director, JPMorgan Chase
- Jean-Baptiste Bellon, Equity Analyst, Cheuvreux
- Kate Burgess, Investment Correspondent, FT.com
- Uneke Dekkers, Executive Director, Citigate First Financial
- Patrick Finnegan, Member, International Accounting Standards Board
- Jacques de Greling, Equity Analyst-Telecoms Operators, Natixis Securities
- Fabien el-Haik, Equity Sell-Side Analyst, Exane BNP Paribas
- Natasha Landall-Mills, Analyst, Responsible Investment, Universities Superannuation Scheme Ltd
- Alain Laurin, Regional Credit Officer-Banking, Moody's Investors Service
- Frédéric Lemoine, Chairman of the Executive Board, Wendel
- Karl Maher, Head of Investor Relations, Roche Holding
- Patricia McConnell, Member, International Accounting Standards Board
- Gregory Miller, Associate Professor of Accounting, Stephen M. Ross School of Business, University of Michigan
- Gerbrand Nijman, Senior Vice President for Investor Relations, Aegon
- Anders Nyrén, President and CEO, AB Industrivärden
- Sunil Sodha, Member, CFA Institute Corporate Disclosure Policy Council
- Johannes Wassenberg, Managing Director-Banking, Moody's Investor Service
- Allister Wilson, Leader, Ernst & Young
- Richard Wilson, Leader, Ernst & Young

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve potential.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

The Ernst & Young organization is divided into five geographic areas and firms may be members of the following entities: Ernst & Young Americas LLC, Ernst & Young EMEIA Limited, Ernst & Young Far East Area Limited and Ernst & Young Oceania Limited. These entities do not provide services to clients.

About Ernst & Young's Assurance Services
Strong independent assurance provides a timely and constructive challenge to management, a robust and clear perspective to audit committees and critical information for investors and other stakeholders. The quality of our audit starts with our 60,000 assurance professionals, who have the experience of auditing many of the world's leading companies. We provide a consistent worldwide audit by assembling the right multidisciplinary team to address the most complex issues, using a proven global methodology and deploying the latest, high-quality auditing tools. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

© 2009 EYGM Limited.
All Rights Reserved.

EYG no. AU0390

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

www.ey.com