



Breaking the Short-Term Cycle

*Discussion and Recommendations on How Investors, Asset Managers, and
Corporate Executives Can Refocus on Long-Term Value*

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Cleveland

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The symposia participants framed the overall issue of short-termism as:

- An obsession with short-term results by investors, asset management firms, and corporate managers collectively...
...leads to unintended consequences of:
 - (1) destroying long-term value,
 - (2) decreasing market efficiency,
 - (3) reducing investment returns, and
 - (4) impeding efforts to strengthen corporate governance.
- The causes of this short-term fixation are multifaceted, which necessitates reforms that involve many stakeholders, including those that participated in the symposium – corporate issuers, analysts, asset managers, shareowners, institutional investors, regulators, and media representatives.

“Short-termism” is corporate and investment decision-making based on short-term earnings expectations versus long-term value creation for all stakeholders

2004

- Business Roundtable Institute for Corporate Ethics survey of Chief Executive Officers - “Effective company management in the context of investor expectations” labeled one of the most important ethics issue facing business.

2005

- January 2005 survey of 400+ executives found that 80% would decrease discretionary spending (R&D, maintenance, and hiring) in order to meet Short-term earnings targets.
- March 2005 NIRI survey on Earnings Guidance practices reveals decrease in number of companies providing only quarterly guidance; and increase in providing only annual guidance
- At May 2005 CFA Institute annual meeting, SEC Chairman William Donaldson cited “short-termism” as one of the primary issues facing the financial industry

November 2005

- **Held first symposia meeting on short-termism**
- U.S. Chamber of Commerce urges executives to stop issuing quarterly earnings guidance and focus on communicating longer-term indicators of their companies' health

“Short-termism” is corporate and investment decision-making based on short-term earnings expectations versus long-term value creation for all stakeholders (Continued)

2006

- **Held second and third symposia meeting on short-termism**
- A *Directors & Boards* eNewsletter survey of readers finds that nearly 75% favor giving up the practice of earnings guidance.
- *The McKinsey Quarterly* March 2006 survey reports “most executives continue to issue earnings guidance...in the absence of any clear consensus on its contribution to company value and largely at the insistence of brokerage house analysts.”
- Candice Browning, Head of Global Securities at Merrill Lynch & Company tells Congress that earnings guidance “creates an echo chamber that drowns out investor debate and distills what should be a complex message about a company’s operations and performance into a single number.” Merrill Lynch’s position is that “it would be in the best interests of investors if companies dropped quarterly earnings guidance.”

July 2006

- **Release of “Breaking the Short-Term Cycle”**

Symposia Series Objectives

The objectives of the series were to:

- Diagnose and frame the issue of short-termism
- Offer principles and practices for reshaping the current model into one that is more effective and value-additive for all participants.

Bringing together key representatives from a complete range of perspectives, namely corporate issuers, asset managers & analysts, investors, regulators, and the media, to create a blueprint for addressing and solving the behaviors of short-term reaction instead of long-term strategy

Summary Recommendations

The panel recommendations are that corporate leaders, asset managers, investors, and analysts should:

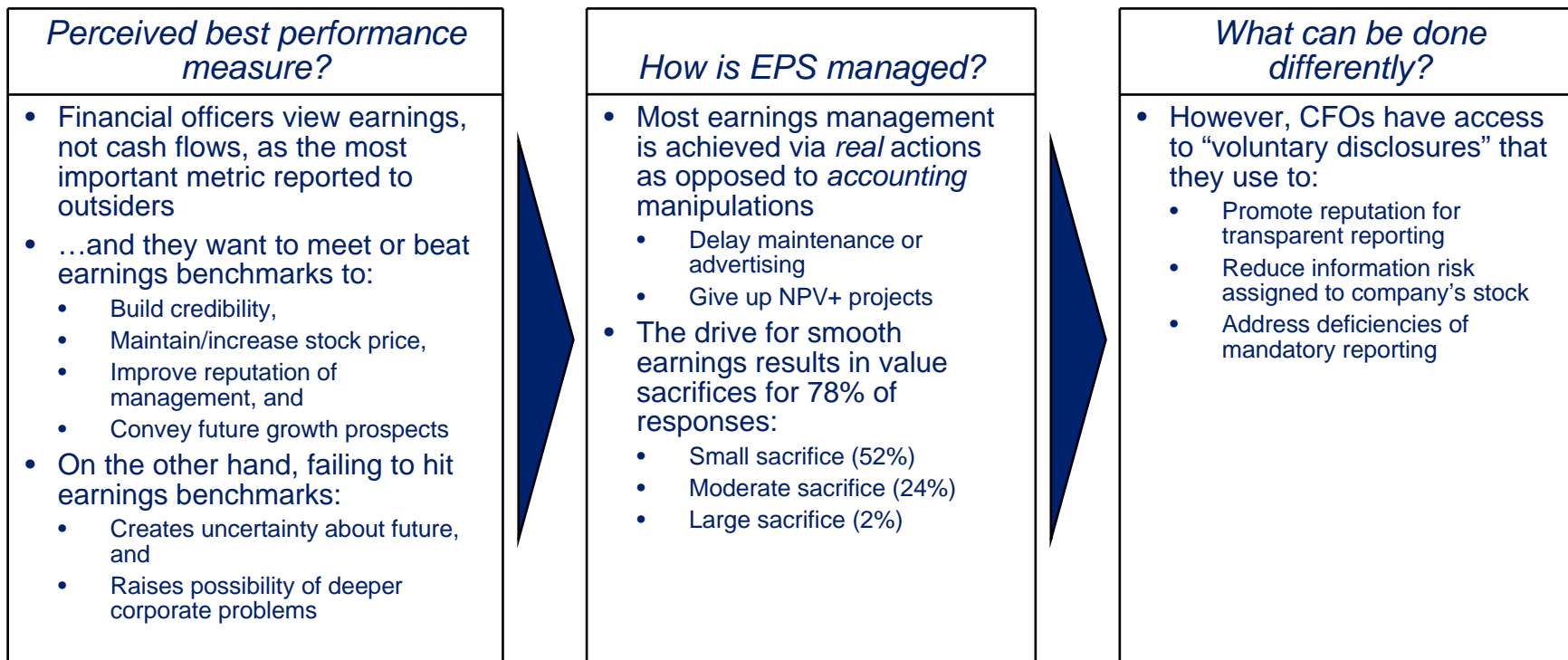
- 1) **Reform earnings guidance practices:** Companies need to reconsider the benefits and consequences of giving earnings guidance and make adjustments to their involvement in the “earnings guidance game” that best reflect shareowners’ interests.
- 2) **Develop long-term incentives across the board:** Compensation for corporate executives and asset managers should be structured to achieve long-term strategic and value-creation goals.
- 3) **Demonstrate leadership in shifting the focus to long-term value creation.**
- 4) **Improve communications and transparency:** More meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community’s dependence on earnings guidance.
- 5) **Promote broad education of all market participants about the benefits of long-term thinking and the costs of short-term thinking.**

Earnings Guidance

1. End the practice of providing quarterly earnings guidance.
2. However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.
3. Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.

Academic research finds “the majority of CFOs admit to sacrificing long-term economic value to hit a target or to smooth short-term earnings...[suggesting] a flaw in corporate governance practices.”

A survey of 401 financial executives reveals:

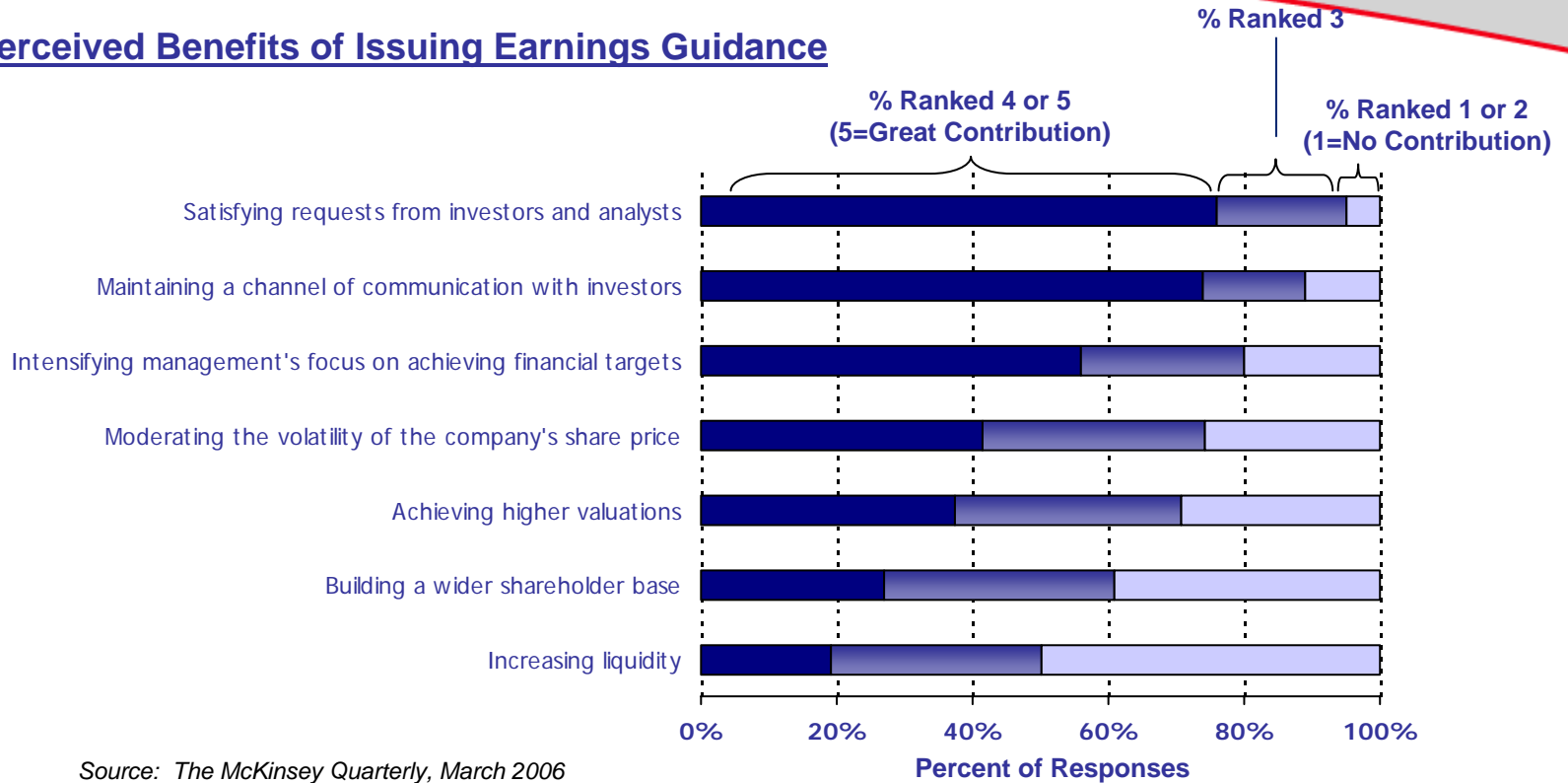


Over 75% of surveyed executives would give up economic value in exchange for smooth earnings

Source: “The Economic Implications of Corporate Financial Reporting.” by John R. Graham, Campbell R. Harvey, and Shiva Rajgopal. (2005).

A McKinsey & Co. survey indicates that companies provide earnings guidance primarily due to pressure from investors and analysts

Perceived Benefits of Issuing Earnings Guidance

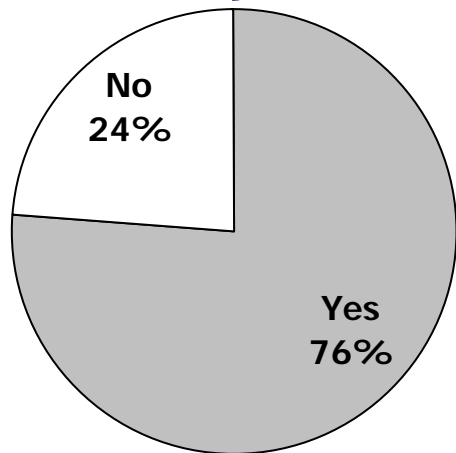


Source: *The McKinsey Quarterly*, March 2006

The panel believes that these benefits can still be achieved through a model without earnings guidance

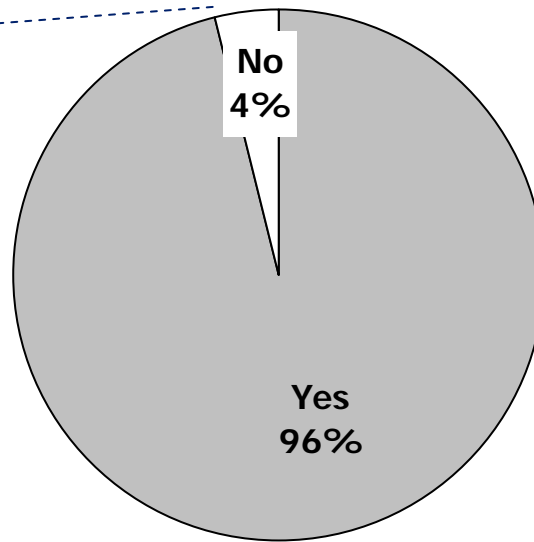
In a CFA Institute survey – representing the views of a large number of analysts and asset managers – respondents indicated a strong preference for discontinuing focused, quarterly earnings guidance

Should companies move away from focused quarterly earnings guidance?



2,686 CFA members answered

If you answered "Yes," should companies provide additional information on the fundamental, longer-term drivers of the business?

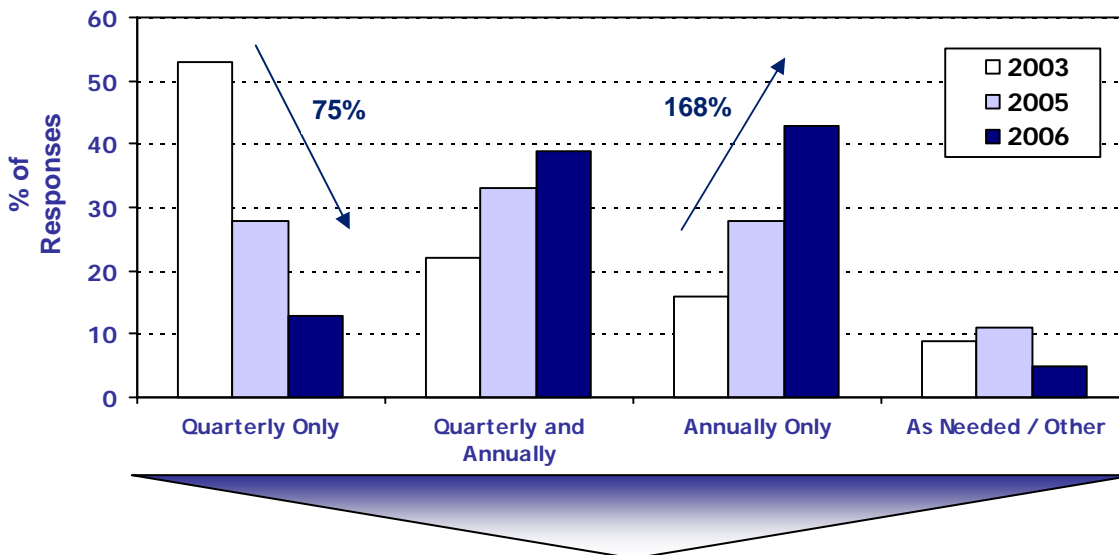


2,106 CFA members answered

Source: CFA Institute (March 2006)

More companies are decreasing earnings guidance, while at the same time, increasing communication of market and company-specific operating information

How often do you provide earnings guidance?



Leading types of non-earnings guidance provided to assist analysts in arriving at their estimates:

- Qualitative statements about market conditions
- Trend information that may impact the business of the company
- Industry-specific information
- Qualitative information on business measures and/or assumptions
- Quantitative information on business measures and / or assumptions

Source: National Investor Relations Institute

Incentives and Compensation

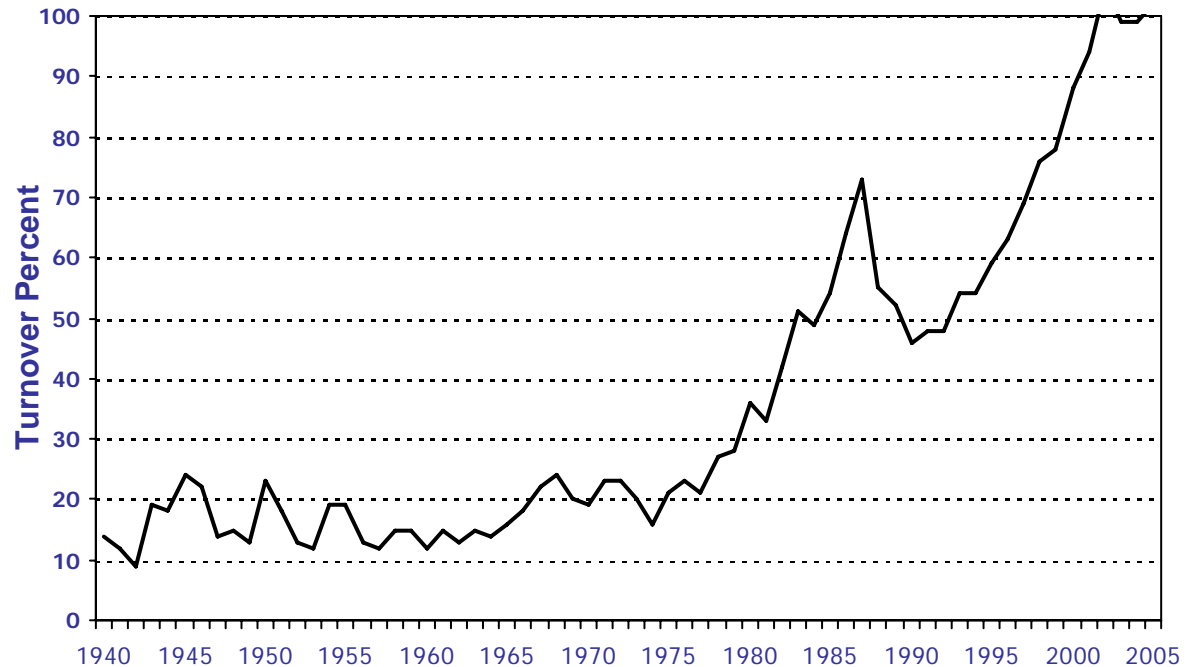
1. Align corporate executive compensation with long-term goals and strategies and with long-term shareowner interests. Compensation should be structured to achieve long-term strategic and value-creation goals.
2. Align asset manager compensation with long-term performance and with long-term client interests.
3. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.
4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies they invest in use effective, long-term, pay-for-performance criteria in determining executive compensation.

Leadership

1. Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.
2. Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions.
3. Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.

Leadership from multiple groups is necessary to counter a short-term mindset from a more transient investor base

- The annual turnover (“churn rate”) for shares of New York Stock Exchange listed companies has increased dramatically from a range of 10 percent to 30 percent during the 1940–80 period to more than 100 percent in 2005.
 - Such a churn rate imparts a cost on companies and their investors, including higher transaction fees and possible internal company trade-offs against long-term strategic investments.
- In contrast, a group of the Fortune most admired corporations for “Long-Term Investment” had an average turnover rate of approximately 60 percent in 2005.



Source: New York Stock Exchange Fact Book. 2006

Communications and Transparency

1. Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company's operations.
2. Encourage greater use of *plain language* communications instead of the current communications characterized by accounting and legal language.
3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company's operating model.
4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.
5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.

Other Voices Add to the Debate

1. The Conference Board – *Revisiting Stock Market Short-Termism, 2006*
2. Marathon Club – *Guidance Note for Long-Term Investing, 2007*
3. Committee for Economic Development – *Built to Last: Focusing Corporations on Long-Term Performance, 2007*
4. The Aspen Institute – *Long-Term Value Creation: Guiding Principles for Corporations and Investors, 2007*

The Conference Board – *Revisiting Stock Market Short-Termism, 2006*

Corporate Link

- Enhance transparency on intangible assets
- Enhanced research on intangibles and extra-financial measures
- Widespread adoption of enterprise risk management

Investor Link

- Pension funds should develop LT internal governance practices
- Engagement (not antagonism) concerning LT issues
- Legal research into fiduciary duties and LT investing
- Investigate motivations of all investors (hedge funds)

Analyst Link

- Identify viable sell-side research models
- Reinforce development of LT and extra-financial analysis
- ERM frameworks should better communicate extra-financial info.

Marathon Club – *Guidance Note for Long-Term Investing, 2007*

Components of Long-Term Mandate

- Trustees Investment beliefs (Must align with:)
- Leadership and Governance
- Objectives
- Manager Selection
- Financial Alignment
- Relationship With Manager

Committee for Economic Development – *Built to Last: Focusing Corporations on Long-Term Performance, 2007*

Targeted to Corporate Boards

- Supports corporate strategic plans with LT focus
- Structure incentive compensation so sufficient portion is LT
- Restructure corporate reporting to include non-financial reporting
- Eliminate quarterly earnings guidance
- Promote succession plans to emphasize internal development of successors.

The Aspen Institute – *Long-Term Value Creation: Guiding Principles for Corporations and Investors, 2007*

- 1. Determine Metrics of Long-Term Value Creation**
- 2. Focus Corporate-Investor Communication Around Long-Term Metrics**
- 3. Align Company and Investor Compensation Policies with Long-Term Metrics**

The Cost of Short-Termism?

Dell - 2007

In August 2004, Dell acknowledged it would need to restate results because an internal investigation, “identified evidence that certain adjustments appear to have been motivated by the objective of attaining financial targets.” These activities typically occurred at the close of a quarter to meet the quarterly performance numbers.

- First quarter 2003 - Beat expectations by \$.01
- Second quarter 2004 - Met expectations
- Second quarter 2005 - Met expectations
- Fourth quarter 2005 - Beat expectations by \$.01
- Third quarter 2006 - Beat expectations by \$.06
- Fourth quarter 2006 - Beat expectations by \$.02
- First quarter 2007 - Met expectations

The Cost of Short-Termism?

Dell - 2007

1. Cost so far of \$59M associated with the Audit Committee's investigation into certain accounting and financial reporting matters.
2. Company expects to take total charge of \$150M from the scandal.
3. Dell plans to announce its restated results in early November.
4. The Securities and Exchange Commission is continuing a two-year probe of the company. The Justice Department also is investigating.

Next Steps – CFA Centre Model Earnings Release

April 2007, CFAI Centre and BRTI Published “Apples to Apples: A Template for Reporting Quarterly Earnings”

- **Stop quarterly earnings guidance**
- **Includes a GAAP income statement that starts at the revenue line and proceeds to net income:**
- **Positions GAAP reconciliation tables in immediate proximity to the non-GAAP financial measures they are meant to illuminate:**
- **Includes a consolidated balance sheet and statements of cash flows:**

Next Steps – CFA Centre Model Earnings Release

Analysis of recent quarterly releases from the S&P 1500 found:

- For companies presenting non-GAAP information and thus, required by Reg. G to reconcile to GAAP, 2/3 of large-cap companies presented the reconciliation in close proximity to the income statement; however, only 1/3 of mid-cap and small-cap company releases have their non-GAAP reconciliation tables nearby.
- Significantly, all companies analyzed present GAAP income statements and balance sheets, however, complete cash flow statements are provided by approximately 60% of large-cap companies, and approximately 1/3 of mid-cap and small-cap companies.



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