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DVFA Principles for Effective Financial Communication

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DVFA

Society of Investment Professionals in Germany

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On the origin of the Principles

The DVFA Principles for Effective Financial Communication were introduced to the German capital markets in May 2006, followed in September 2006 by introduction on the European stage, and were well received by investors, financial analysts and investor relations professionals. A survey by the Hamburg-based news agency *News Aktuell* in September 2006 showed that two out of three IR managers were familiar with the DVFA principles, and had a primarily positive opinion of them. This result can be attributed in large part to the work of the German Investor Relations Association (*Deutscher Investor Relations Verband* - DIRK e.V.), which not only participated in defining the principles, but also promoted awareness and acceptance of them among its membership.

The DVFA Principles for Effective Financial Communication have since established themselves as the industry standard for target group-specific financial communication. Furthermore, the DVFA has developed the 30 principles into a process for the concrete measurement of a company's IR performance ("DVFA Perception Profiles").

The DVFA Principles for Effective Financial Communication describe the expectations of institutional investors and financial analysts with respect to companies' financial communication, and explain how the failure to meet these expectations can be *interpreted* by the audience in some instances.

In this sense, the principles represent a recent economic theory – that of Behavioral Finance – which applies the precepts of Behavioral Psychology, Human Science and Systems Theory to the behavior of economic actors, in particular how cognitive and emotional motivations impact their supposed rationality. Behavioral Finance enabled transcendence of the *Homo Economicus* paradigm, which assumes solely rational and logical decision-making, e.g. for the appraisal of options or the formulation of opinions under extreme time pressure or in the chaos of conflicting information.

The DVFA Principles for Effective Financial Communication show how investors and financial analysts interpret company activity based on factors other than rationality, and how the credibility of financial communication is "construed" on the basis of heuristic, non-logical judgments. This is not to say that investors make irrational decisions. Rather, there is an interplay between analytical and metrics-based evaluation, influenced by emotional factors and subject to realities such as extreme time pressure, information overload and optimism bias, for which reason strictly linear, logical decision-making by investors is more the exception than the rule.

The principles are deliberately designed to be recommendations – not rules – for directors, IR managers and interested groups. They were created by the DVFA Committee on Effective Financial Communication, which brings together the expertise of investment professionals in various asset classes with that of IR managers and representatives of the professional associations DIRK and DPRG.

The recommendations contained in the principles are based on the examples provided by investment professionals of both successful and unsuccessful financial communication. Applying the "Critical Incidents" method derived from the field of market research, the illustrative examples were abstracted and systematically distilled by a broader group of investment professionals using a multi-phase process to produce recommendations.

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A. Credibility

Effective financial communication stems from the credibility of a company's management, and credibly communicated information.

Credibility is the result of experience on the part of capital market participants, especially that of investment professionals (institutional investors and financial analysts). If the recipient knows that a company's past statements and forecasts have been upheld, or that any deviations were communicated promptly, there will be confidence of the same conduct in the future. Credibility is like a loan made on future performance in the form of trust.

A company is considered trustworthy when there is a visible determination to earnestly and fairly provide information to investors concerning its targets, strategies and the state of operations. To this end, companies must develop scenarios and disclose their fundamental assumptions, as well as promptly and proactively communicate to the market any changes to these parameters. This ensures that capital market participants and management are working off of the same sheet of music.

Companies represent a complex union of strategies, plans, products, markets and segments, which can only be comprehended on the basis of accurate and credible communication, and not solely by looking at the company's income statement, balance sheet or cash flow statement. Since the investment expectations relate to the company's *future* performance and results, the establishment of credibility and the trust is a key objective of effective financial communication.

Only when investors and financial analysts consider the communication received from companies to credible, i.e. authentic and truthful, will investors make long-term investments in a company.

B. Financial Analysis

“Institutional investors” are capital market participants that invest on a professional basis on behalf of, e.g. banks, investment firms, insurers or pension funds.

Financial analysts are capital market participants that professionally analyze securities and issue (buy) recommendations based on their analyses. These include sell-side analysts, i.e. those who prepare analyses for brokers and securities firms dealing in both equities and bonds, as well as buy-side analysts, who analyze bonds and equities for their employers or directly for investors.

In this document, the term “investment professional” is used as a synonym and equivalent to “institutional investors and financial analysts”. Investment professionals, as defined by DVFA, are persons who evaluate and/or manage investments or credit risks in a professional capacity.

What follows is meant to be a short depiction of financial analysis, in order to clarify the context in which the Principles apply.

The basis for financial analysis, which is used as a central instrument for the evaluation of an investment along the entire process from analysis to investment decision, is a complete analysis model based on monetary and key financial analytical figures.

An essential tool for the work of financial analysts and professional investors is a spread sheet that breaks down and models the company in financial analytical terms. The model generally includes:

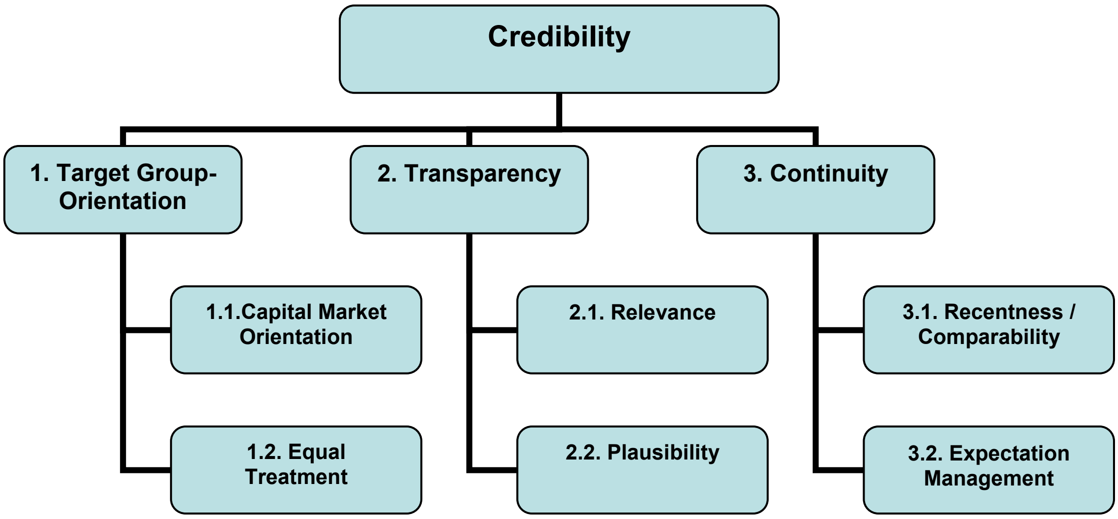
- The quarterly income statement, cash flow statement and balance sheet
- The annual income statement, cash flow statement and balance sheet
- A segment model (revenue, margins)
- A model of the business operations (volumes, prices, market model)
- Discount models (DDM, DCF)
- Peer group and multiples

Source: Markus Plümer West LB, Handout DVFA Workshop: Managing Expectations 2005

Company reporting data are laid out in spread sheets by financial analysts. Contrary to popular belief, the reported financial data and figures are not used merely for the purpose of computations. Rather, analysts compare “their” models with the results modeled on the basis of historical data to determine discrepancies between their assumptions and reported results. This makes clear why the modeling of company financial data and key figures cannot be amended with a few simple adjustments, and why investment professionals demand consistency and continuity in company reporting.

The mere recording of numbers is not sufficient as a basis for defining the parameters and premises for their forecasts. A continual dialogue with the company, in which the analysts’ assumptions are compared with those of the company, is crucial. This ongoing comparison of background for a fundamental data set is one of the key objectives of effective financial communication.

C. Structure of the Principles



The Principles are structured as follows:

- 3 dimensions for effective financial communication
- 6 models of conduct – 2 for each dimension
- 30 principles, including explanations, definitions and examples

1. TARGET GROUP ORIENTATION

1.1. Capital Market Orientation

Target group requirements with respect to effective financial communication are adequately addressed by top management. The company actively pursues dialogue with investors and analysts.

On the German capital market, statutes governing regular and ad hoc reporting dictate when and in which situations issuers are required to enter into dialogue with investors and other market participants.

Regular and ad hoc reporting as well as listing requirements, however, represent only a minimum of the measures that are necessary and possible. A company can successfully establish good relations with investors and financial analysts when it proactively provides the capital market with accurate information. The principles of capital market orientation presented here provide recommendations in this regard.

1.1.1. Senior management is available for discussion several times per year (one-on-ones, road shows, investor events).

It is standard practice that CEOs and/or CFOs regularly provide investment professionals with opportunities for dialogue beyond those offered as part of mandatory events (e.g. investor conferences in the context of a listing on Deutsche Börse's Prime Standard). One example are conference calls within the framework of interim reporting (cf. principle 1.2.5.).

The integration of the senior managers responsible for key company functions, e.g. R&D, product design, sales management etc, in important operative matters is also helpful. Financial analysts and investors are greatly interested in learning more about company locations, plants, production facilities, in order to gain direct insight into the company.

1.1.2. Senior managers have detailed information on company performance and are able to comment on figures immediately.

The member of upper management responsible for the capital market – usually the CEO and/or CFO – should have the ability to provide significant and broad based information. This shows that the executive "lives" the numbers. Close integration with the IR department ensures prompt, adequate supplementary information. Other members of the management board should refer to their limited right/ability to provide information and, if need be, avoid company presentations without the support of other colleagues. Where necessary, company experts should be on hand at investor conferences to answer detail questions.

1.1.3. Accurate and up-to-date information is provided by competent IR representatives.

IR management plays the important role of contact manager, as a go-between representing the needs of investment professionals and top management, and acting as a mediator in discussions.

In addition, IR management should address frequent questions posed by lower priority target groups independently and without high-level management presence.

1.1.4. An official language policy is in place to ensure uniformity of statements by management, IR and PR.

Language policies ensures that statements by the management, IR and PR do not contradict one another. Such official language is a good solution when a company intends to convey a value reference (guidance) to investors and analysts.

For instance, an official language policy can specify that changes, e.g. of strategic objectives or financial figures are only to be announced or commented upon by the CEO or CFO, whereas IR serves everyday informational needs, including status-quo continuity. In addition, uniform official language may serve to minimize interpretations by capital market participants and thus uncertainties in connection with sensitive subject matter. It can also provide legal protection.

Negative example: In an interview with a radio station covering the stock market, the new CEO of a small technology firm (his first job with a listed company) announces the growth guidance for the next two years, which had just been approved at a meeting of the supervisory board. This information was not known before the meeting, and actually contradicted the previously communicated guidance. Although the company had an IR representative, he was not made aware of the results from the supervisory board meeting, nor did he know of the radio interview. Consequently, he initially refuted the information when approached by analysts about the new growth guidance.

1.1.5. News – even negative news – is proactively communicated by the company.

On the German capital market, statutes governing regular and ad hoc reporting dictate when and in which situations issuers are required to actively report important occurrences. These requirements are based on the Securities Trading Act (Wertpapier-handelsgesetz – WpHG), last amended by way of the Act on the Improvement of Investor Protection (Anlegerschutzverbesserungsgesetz – AnSVG), for which the BaFin issuer guideline are a valuable interpretive tool.

But there is also a range of other information that, although not statutorily required as part of ad hoc publicity, is important for the development of expectations among investment professionals, without having any substantial direct influence on market price. Continual communication of such information, even in the event that the trends represented are not exclusively positive in nature, is especially important in the building of trust between company and capital market.

Whereas prior to the coming into force of the Act on the Improvement of Investor Protection (AnSVG) issuers were required to disclose information that could potentially affect their assets or financial position or general trading position, or impact their business activities, the AnSVG now requires ad hoc reporting of specific information concerning:

- circumstances which are not public knowledge,
- relating to one or more issuers of insider securities,
- which, if it became publicly known, would likely have a significant effect on the stock exchange or market price of the insider security.

Some standard examples of circumstances subject to the ad hoc reporting requirement are:

- Disposal, discontinuation or commencement of core business areas,
- Acquisition or disposals of qualified participating interests,

- Replacements of key personnel in the management or supervisory boards,
- Initiation/resolution of significant litigation,
- Reductions in lines of credit by banks,
- Defaults by significant debtors,
- Important inventions,
- Receipt or loss of key patents, as well as important (active/passive) licenses awarded,
- Significant product liability or environmental cases.

Source: DIRK Deutscher Investor Relations Verband, 2006.
Further information: BaFin Issuer Guideline.

Moreover, there are numerous day-to-day events and episodes at companies, beyond those subject to ad hoc publicity requirements, that facilitate the evaluation of risks and opportunities and are thus important for investment professionals to know. This not only applies to positive developments, but also and especially to negative ones, such as the discontinuation of development for a new product line (which would generally lead to an ad hoc disclosure for a growth company), as well as plans and projects in important geographical regions that do not succeed.

Another example of negative news that should be communicated directly to investment professionals would be price deterioration in fixed-line business for telecommunications companies.

It is also important to bear in mind that, even if a company is required to issue an ad hoc announcement relating to a particular circumstance, this does not necessarily mean that investment professionals have received and disseminated this corporate news. In the face of the chronic deluge of information on the markets, and the problem of differing time zones, companies should not settle for simply announcing the news of important circumstances. In critical situations, it is recommended that companies make use of a conference call in which investment professionals have the opportunity to discuss the matter directly with management.

Negative examples:
A technology provider – against expectations - fails to receive a contract from the Ministry of Defense – thus missing out on a budget worth approx. 20% of total projected sales. 7 days elapse between the announcement of the decision by the Ministry of Defense and the communiqué from the company.

In the previous financial year, a medical technology company executes a major change of strategy, which is characterized at an investor event as completed and successful. The management also referred to the positive performance of the company. Two months later, the strategic shift is blamed for a dramatic reduction in earnings.

1.1.6. The company acknowledges input from investment professionals with respect to strategic issues, and takes this into consideration for decision making.

Company decisions that deviate from the expectations of capital market participants as investors or intermediaries usually result in price reactions, and often to declines. In order to proactively counter such reactions where possible, it makes sense to weigh the suggestions and sensibilities of market participants when making decisions that impact business, and to work towards elimination of the expectation gap through communicative measures.

At issue here are circumstances and management decisions that are controversial among investment professionals, and result in a desire for background and rationales, which could lead to opposition from investors against the company's management if left unaddressed.

This includes, e.g. mergers and acquisitions, capital increases, the amounts of board remuneration or the handling of litigations. Investment professionals not only want prompt information but expect corporates to continuously aligning decisions with their strategy as it has been communicated: simply put, decisions must fit the story. The best way for this to be accomplished is for issuers to uphold ongoing, consultative dialogue with capital market participants.

Fundamental topics that require persistent strategic dialogue with investment professionals include:
- The issue of growth through acquisitions, as well as returns on and financing of such investments
- Investment vs. distribution of cash flows
- Dividend policy (distribution ratio vs. dividend continuity)
- Total debt and any changes to capital structure
- Entry into new areas of business or regional markets
- Strategic diversification vs. focus on current core businesses
- Earnings guidance

1.2. Equal treatment

Capital market participants receive equal treatment with respect to information. There is no "reward" or "penalty" in the form of selective provision of information in reaction to positive or negative commentary.

Most capital markets have legislation in force for ad-hoc disclosure and general disclosure obligations for corporates. Regulation Fair Disclosure (RegFD) in the US implemented rules for the US capital market that had long been law in some markets e.g. in the German capital markets.

1.2.1. All capital market participants are equally provided with information of the same value.

By law, 'significant' information must be provided to all market participants at the same time. The form of presentation and depth of detail may vary, provided there is no 'distortion' of the information. There is no requirement in either US or German law that 'insignificant' information be equivalently communicated.

Example: One of the 10 subsidiaries of a particular group loses its ISO certification, but this does not greatly impact the group's business. In such a case, there is no reason (at least legally) that the company may not communicate the information selectively.

Below is an example of less than optimum communication within the context of the recommendation: Slides are presented at the analysts' conference of a company in London, which are not shown to the professionals present at the same event in Germany. The justification used is that Anglo-American investors expect more detailed information than continental Europeans.

1.2.2. Information is not provided selectively in response to positive/negative recommendations or prior criticisms.

Among the duties of CFOs and IR officers requiring a high measure of fairness is the job of dealing with investment professionals, for instance, if they are skeptical of the strategy presented by the company, or are critical of individual decisions made by the management and ultimately – despite great efforts – cannot be convinced to issue a "buy" or make an investment.

Financial analysts in particular know the finesse with which companies disadvantage critical investment professionals, e.g. through the amount of time that management spends in discussion with them or by providing very little detail when information is requested, short of an out-and-out boycott.

The recommended course of action is – similar to dealing with unsatisfied clients – that companies pursue intensive, constructive dialogue with critical analysts. They should enquire directly as to whether there is an information deficit problem and find out which facts are unsatisfactory, so that these may be addressed in a targeted manner. Such cases are ultimately the result of managements' inability to convince the analysts of the company's own forecasts. Therefore, an informational blockade would lead to the permanent loss of an analyst who can help the corporate sustain visibility in the capital market.

An example of disregard for this rule of conduct: A automotive firm invites six financial analysts who are positive on the company to its testing center, where the brand chief and head of design are on hand to answer questions and both prototypes and pre-production models are available for test drive. No other participants are invited.

1.2.3. Material information is not disseminated solely through selective channels.

Information relevant for investment professionals is disseminated not only through selective media, but at least concurrently also made available via the major informational channels of this target group and the company's website.

Some examples of selective media are newspaper interviews by board members covering important strategic topics, or articles in specialized industry journals.

This in no way means that senior management should refuse such interviews. However, we consider it prudent that such selective interviews be simultaneously published on the company's website. Additionally, the major news services should be actively informed of the interviews.

The assessment as to which press articles are potentially of significant relevance to investment professionals is one of the main central responsibilities of the IR department, in close cooperation with the company's PR.

Negative examples:
In an interview with a real estate industry journal, a senior manager discusses the

prospects for acquisition of several property portfolios.

A CEO gives an interview to a large national daily, in which he states his position on upcoming restructuring talks.

A new production process that has the potential to lower the company's production costs by 10% is introduced in an industry journal.

1.2.4. In order to deal with circulating rumors, there are rules of communication in place that set forth the circumstances under which the company issues statements.

Rumors, as long as they are rumors, cannot be refuted logically – it is fundamentally impossible to determine how much truth is behind them. It is only because rumors generally contain some amount of information, brought into the context of proven events or facts, that they spread. Between the believable portions and the non-specific, non-provable information, there is a mutual amplification, a circular process.[1]

Since information is asymmetrically distributed on the capital markets, new information has the potential to induce price movements.

The risk for companies comes from neglect in the handling of rumors, which can lead to unexpected price movements. For the validation of rumors, investment professionals have to rely on whether and how a company responds.

Past conduct displayed in connection with rumors often determines how investment professionals assess their truth or falsity. For instance, if a company regularly denies rumors, but does not do so in one instance, market participants could assume that the one rumor is true.

Sustainable, consistent, open and transparent financial communication is the best way to meet interventions in an environment of circulating rumors.

[1] Dunant, Jeffrey. (2002). "Rumors in financial communication", in: Bentele et al. Communication Management.

1.2.5. All capital market participants are offered conference calls and push e-mail service.

Conference calls in the context of analyst/investor conferences or for important announcements are already the standard for many companies. Conference calls offer investment professionals logistical benefits in the way of reduced travel times/costs, and in reporting season, allows them to attend a greater number of conferences.
In addition to minimizing travel, conference calls offer financial analysts clear time advantages. They take part in a conference call, and simultaneously integrate the results communicated by the company into their work, i.e. their models. Immediately following conclusion of the call, they are able to take advantage of the time advantage by directly providing their institutional clients with analyses and results.

A conference call must include at least:

a) A controlled access point (operator), with the possibility to pose questions;
b) An accompanying presentation *before* the conference call begins, or in the case of a conference call held during an in-person event, provision of an identical presentation;
c) Access to the presentation and transcript of the conference call for at least 12 months via the Internet.

The increasing concentration of IR events during the short reporting periods means that investors and financial analysts may be able to participate in neither the in-person events nor the conference calls of some companies, and are thus grateful for the ability to retrieve conference calls and presentation slides for later viewing.
An attractive additional element is the availability of a conference call transcript, which enables participants to reference and include statements by the management, such as quotes, responses to questions etc., in their reports ("copy and paste").

If a conference call is offered, the presentation should be made available via the Internet or as an e-mail attachment at least 30 minutes prior to the start. All of the presentations posted on the website should be equivalent in terms of scope, detail and accuracy to the presentation made at the conference.

Negative example: A company holds two conference calls at different times, one for German-speaking participants in the morning, and one a few hours later for English speakers, who thus receive the information late.

2.1. Relevance

Information is communicated based on relevance for the recipients and meets the expectations of investors and financial analysts with respect to scope, detail, frequency and completeness.

2.1.1. Corporate news is relevant, plausible and understandable.

Relevant in this sense refers to materiality and urgency with regard to company management, similar to the principle of "materiality" in the context of internal auditing, which says that reporting should primarily cover areas of risk and processes essential to the company mission.

The plausibility of a text is determined by the speed with which the reader can comprehend its meaning. Results are reasonable and can be mathematically corroborated. As well, company-specific terminology for standard figures (e.g. earnings figures) is avoided.

It is advisable to provide supplementary contextual information relating to individual news releases, so as to provide a basis for comparison and an idea of underlying trends.

To the extent possible, data should be

- Presented using identical structure and format, to facilitate comparison and express trends;
- Oriented to the needs of investors and analysts, i.e. short and concise, point-by-point rather than in prose;
- Located within news releases in order of priority;
- Oriented on accepted formats and Principles, sufficiently suited to the company's business models. It is recommended that companies base the structure, format and frequency of such releases on the practice of their foreign and domestic peers.

Negative example: German drug developers tend to embellish when presenting negative clinical data, making the results appear more positive than the study would actually allow. Additionally, the companies are seldom successful when it comes to wording complex clinical data in a way that is understandable in an ad hoc release. On company in particular has a talent for making news seem quite "urgent" for private investors, where an expert recognizes the same report as devoid of content.

2.1.2. Companies present financial statements and interim reports in a well-structured, comprehensible form, with content prioritized so that important information can be readily seen.

This recommendation applies not only to annual and interim reporting, but to all documents published by a company, e.g. ad hoc disclosures, corporate news, press releases, analyst/investor presentations, newsletters etc.

A target group-specific reporting structure is one that is oriented on the reading and utilization habits of the audience. For cultural reasons, a very different structure is favored in English-speaking regions as compared to that used in German-speaking countries. Since financial and capital markets are dominated by an Anglo-American influence, it is advisable to heed significant features of English usage and style:

1. Documents have a "top-down" structure. Their structure allows a cursory reading, as the content is summarized at the beginning of the document; detailed information is located in the later pages or in separate appendices.

USA	UK	Germany
♦ Humor	♦ Humor	♦ Solid product, company
♦ Wit/Spirit	♦ Good story	♦ Technical data
♦ Modern flair	♦ Good product	♦ Beginning - middle - ending
♦ Slogans	♦ Price/Performance	♦ Sufficient documentation (paper)
♦ Sales drive	♦ Quality	♦ Serious-mindedness
		♦ Price/Performance
		♦ Quality
Attention span: 30 min.	Attention span: 30-45 min.	Attention span: 1 hour +

Source: R. Frank Handout "Managing Expectations" workshop; Richard D. Lewis, When Cultures Collide"

2. Longer documents contain an “Executive Summary”, as a preface to the report. This presents important information, for instance, in the form of bullet points, spanning no more than one and a half pages; contents may include significant results, amended key data and projections, noteworthy changes in market conditions, products or management, as well as reasons and background. Key figures are also summarized concisely in a table. The Executive Summary contains page number references pointing the reader to more detailed information within the report.
3. For longer reports written in long form, it is advisable to include an opening paragraph – similar to an Executive Summary – which summarizes the ensuing passages.

2.1.3. Investor and analyst requests for additional detailed market and product information are addressed and promptly filled.

Capital market participants often have a need of information, beyond that provided in standard reporting, in connection with their analysis needs. This information is made available by companies on request. Since the development of markets and products has a substantial impact on future company performance, these are often the focus of such requests. To the extent available and compatible with the principles of equal provision of significant information as described in standard 1.2.1., investment professionals place a high value on information concerning subjects such as competitors, market developments, market shares (of competitors as well) or studies dealing with market developments, to name a few.

Positive example: A German automotive supplier publishes an annual fact book, describing the development of numerous important industry figures and market shares. The fact book is updated each year and the items of data included remains more-or-less the same.

2.1.4. Risks are explained specifically and in detail; the use of empty phrases and abstract descriptions is avoided.

The ability to realistically and specifically assess the risks faced by a company is of crucial importance for investment professionals. Risk has a decisive impact on volatility in the modeling of the company.

The use of empty standard language or incomprehensible descriptions bears the hazard of damage to management credibility, since investment professionals are forced to work on the basis of a worst-case scenario in the absence of specific details on company risks.

Negative example: After the devastating hurricanes in the fall of 2005, a reinsurance company reports on projected maximum losses. But the published documentation does not make clear that the figure did not relate to all areas of the company’s business. The wording “maximum loss” suggests that the losses will not rise further, thus soothing the nerves of capital market participants. The actual losses later disclosed are substantially higher than the reported projection, leading to a fall off in the company's share price and decline in the credibility of its financial communication.

2.1.5. The company reports on non-financials, intangibles and 'soft-factors' in a structured manner conducive to comparison.

With respect to non-financials, only aspects relevant to the business of the company, which are utilized by it in the context of performance measurement and which can be substantiated by the auditor using clear criteria, should be reported.
Reports and facts concerning non-financials and 'soft factors' assist investment professionals in gleaning the most realistic possible impression of the exogenous and endogenous factors that impact the company.
The Value Reporting Framework is recommended as an example in this case. [2]

Area	***Balanced Score-card Perspective***	**Description**	**Examples**
non financial	Management	Information concerning company strategy and its implementation	• Strategic options • Goals • Success factors • Investments in intangibles
	Client	Information relating to marketing and sales activities	• Market shares • Data on client loyalty and satisfaction • Brand equity • Marketing investments
	Processes	Representation of internal processes and value chains	• Data on product and process quality • Number of patents • Investments in research and development
	Development	Company Infrastructure details (employees, IT systems)	• Figures on employee satisfaction and loyalty • Employee productivity • Investment in databases and other information technologies

[2] Labhart, Peter (1999). Value Reporting: Informational demands of the capital market and value creation through reporting. Zurich

2.2. Plausibility

Company reports should be consistent and plausible. Financial information should be quantified and sufficiently documented.

2.2.1. Communicated targets are plausible, quantified and sufficiently related to financial figures.

Because modeling is based on quantifiable factors and set in correlation to monetary figures, it is plausible that only quantifiable aspects are integrated into a model. Intangibles or soft factors must be translated into performance indicators (cf. standard 2.1.5.).

2.2.2. The method used for calculation of reported figures is disclosed.

For figures that deviate from financial analysis Principles, there should be an explicit explanation of how the number was derived, e.g. sample calculation or formula.

Standard financial analysis figures in this context refers to the "common" indicators and ratios. E.g. the German regulator BaFin has listed under IV.2.2.10. of the Issuer Guideline the following indicators:

- Revenue (sales)
- Earnings per share (EPS)
- Net profit
- Cash flow
- Earning before interest and taxes (EBIT)
- Earning before taxes (EBT)
- Dividends per share
- Earning before interest, taxes, depreciation and amortization (EBITDA)
- Profit margin (as percentage of revenue)
- Equity ratio
- Result from ordinary activities
- Operating result
- Operating result excluding special effects

Source: Federal Financial Supervisory Authority (BaFin) Issuer Guideline as at 15 July 2005

2.2.3. Segment reporting adequately represents the company, its lines of business and geographical distribution. The level of depth of financial statements in interim reports is sufficient to make detailed forecasts.

It is indispensable that a company's accounts contain separate and consistent information and figures relating to segments and geographical regions.

IAS 14 (segment reporting) defines in detail the informational requirements for business segments and regions. The key elements of the rule are as follows:

- The identification of geographical segments is currently not subject to any requirements: it can be based on the location of production facilities, the location where services are rendered or the location of markets and clients (IAS 14.13);
- The basis for external segment reporting should be the management approach, i.e. it is recommended that internal reporting serve as the basis for external segment reporting (IAS 14.14);
- The income of a segment includes all income directly attributable to it and relevant portions of company income that can reasonably be attributed to a segment. This can be from external or intersegment revenues (cf. IAS 31);
- The expenses of a segment include both direct and indirect expenses for both external and intersegment revenues. Segment expenses do not include, e.g.:
- Losses on investments accounted for by the equity method,
- Income taxes,
- Head office expenses. [3]

2.2.4. The structure of reports as well as the content and scope of data included is only changed in justified cases. Changes in accounting and in results are explained and accompanied by reconciliation statements.

The statement made above concerning the modeling of companies by financial analysts becomes clear in this context: Every change of reporting structures and accounting changes, especially the aggregation of reported figures, result in changes to the model. Because the changes made by the company, for instance in accounting, may not be understandable to onlookers, or are only clear in connection with related commentary from the company, reporting formats and structures should only be changed in extraordinary circumstances, or in the event of fundamental changes such as those arising from the transition to IFRS, should be accompanied by a detailed briefing for analysts and investors.

Positive examples:
Well in advance of the required transition to IFRS, two companies belonging to the chemical industry held comprehensive analyst workshops, at which the expected impact of the

[3] For further reading: Born, Karl (2005). Rechnungslegung international. IAS/IFRS im Vergleich mit HGB und US-GAAP. Schäffer Poeschel

change on reporting figures was covered in detail. This allowed a timely discussion of the distortions in reporting. In this way, the companies were able to guide the focus of capital market participants on the initial reporting date to the content of their reports. Discussions with respect to the presentation and new data material remained secondary.

The accounting transition from HGB to IFRS is accompanied by a conference held by the company; a financial services provider holds a live event to inform investment professionals about the changes in accounting with respect to the factoring of life insurance provisions.

3.1. Continuity and recentness

Information made available is always recent; communicated fragments and content are continually updated to reflect current developments. There are no contextual gaps in company reports. Abrupt, precipitous changes are avoided.

As explained above, companies are modeled analytically, and future results are extrapolated based on historical data and projections made by the company. Any change to the structure of reported figures, as well as any changes to the scope of data included, segments, composites and aggreations/disaggregations will always entail a change to the financial analysis model. This expense can be potentially harmful, especially if the company is inadequately covered. Historical data should always be offered for the new structure, so that the model can be “retro” calculated, allowing an extrapolation to be made at least on this basis.

3.1.1. Time series are consistent over time. In case of changes in definitions historic pro forma figures are provided. Financial targets are consistent over time and always followed up.

A continuity of information, in terms of both content and presentation, is key. Necessary changes should be additive rather than substitutive, in order to maintain a basis for comparison. Items must be defined, i.e. all key figures and items are sufficiently defined; any changes are indicated at a suitable point within the relevant context.

Accounting policy measures and legal changes should be communicated in advance (following board approval), rather than after implementation has begun. The communication is presented upfront, in the form of a sufficiently detailed synopsis, and not cursorily after the fact.

3.1.2. Changes to already defined segments are only made in justified exceptional cases.

Segment reporting clearly states which areas of business are attributable to which segments. For instance, the areas covered by the segments are unambiguously separated from Corporate. However, care must be taken to avoid attributing a disproportionate number of financial statement items to Corporate, as this clearly skews segment reporting to show the relevant results missing from the segments.

Example: A German integrated financial group has been reporting for years in accordance with IFRS, and recognizes four different areas in segment reporting. The property and casualty insurance segment, however, also reports income and expenses from the holding business, producing a massive distortion of results. This practice is carried on for seven years before holding business is accounted for separately.

3.1.3. The website offers complete access to all historical data and reports, as well as current information. The degree of speed is good. The website is well-structured and convenient. General information on the internet is always up to date and new statements are immediately available on the internet. Interim reports and presentations are without delay available on the internet.

A clear sitemap is essential. All typical and relevant issues for investment professionals can be directly found and accessed in the IR section. This also includes, e.g. supplementary data concerning sales, manufacturing and technology markets.

A separate area, with a title such as “Current News”, is available in the IR section of the website to post, e.g. ad hoc releases, corporate news or financial reports at the same time that these are released to the press. Presentations on the occasion of investor and analyst meetings are posted on the website in advance or concurrently.

3.1.4. Companies communicate a precise IR calendar with firm dates.

The “corporate calendar” is must be continually kept up to date, and posted on the homepage. With the beginning of the financial year at the latest, all the dates should be set and the calendar published; in the event of changes, additions and closer scheduling, all important addressees should be promptly and proactively informed, e.g. via e-mail.

Negative example: A German real estate financier has only two events scheduled for the current financial year in the financial calendar on its website. One of them is already over, the other is the date of the annual general meeting.

3.1.5. The company’s capital market story is continually updated. The company creates awareness for any changes in their capital market story.

It is suggested that the capital market story be given a modular structure. The strategy and operating facts are supplemented by a section covering historical and current key financials. Depending on the size of the company, this is also advisable for individual segments. It is helpful at the beginning of each section to mention any changes made, in order to give investors who are less familiar with the company a clear picture of its development.

Example: The websites of two companies from the chemical industry contain detailed company presentations, fact books and information about the equity story. All of this is updated regularly (monthly in some cases). In this way, any analyst can catch up on the latest documentation at any time. In this way, personal contact with the IR representatives can be based on the presentations, saving both sides time.

3.2. Expectation management

Intelligent expectation management aims to give investment professionals as much orientation as legally possible. This increases forecastability and thus assurance with respect to the investment.

3.2.1. The company sets quantitative, long-term goals and communicates projections for company performance over the course of the year.

“Goal” refers to the desired outcome of a process. The goal often marks the success of a project, or a more-or-less involved undertaking. In general, the word “goal" is not used if the future state, although desired, envisioned or foretold, is not achievable through the company’s actions or if the ongoing process cannot be *influenced*. It is also generally required that the company has consciously selected the desired future state, in order for it to be considered a goal.[4]

Goals in the context of the capital market are of a long-term and fundamental nature. For instance, many companies set goals for return on equity (RoE) return on capital employed (ROCE) or market share. Growth goals are also common (e.g. increase in revenue of 30% over the following three years; sales of €2 billion by 200x). Whereas a goal is very precisely worded, the means of achieving the goal are often not set forth in detail. The communicated quantitative goals are often stated as indicative values, subject to economic conditions. The changing of goals sends strong signals to the capital market, and is met with great interest on the part of participants.

The significance of the goals should be made known explicitly, as should the issue of whether and what validity they have for the company. The basis for the formulation of the goals, and the deadline for the achievement of each should be named as specifically as possible. In this context, it is particularly important that the goals appear viable in relation to current figures.

Management forecasts, unlike goals, are shorter-term and are seen by the capital market as more binding. Forecasts are often issued for a period of 12 months, i.e. the current financial year. Thus, they are closely linked to real sales and revenue planning, and take account of sector-specific leading indicators as well as the general performance of the economy. In

[4] http://en.wikipedia.org/wiki/Goal_setting as at 3 June 2006

contrast to company planning, which is often completed as part of the budget process, forecasts are adjusted during the year. Whereas forecasts are mainly used in external communication, planning is principally an instrument for internal management and communication.

Forecasts often describe the development of the path towards achievement of the goals. In phases of economic boom, forecasts can actually far surpass communicated goals, without changing the value of the goal.

The meeting or timely adjustment of forecasts sends an important signal to capital markets about the ability of management to actively steer operations, and react to deficiencies. Adjustment of forecasts during the financial year is a normal process, but one that is watched closely by the market.

For an assessment of forecast quality, it is crucial that the key data underlying the expectation accompany the publication. Some examples here are: economic performance, exchange rates, interest rates, new product launches, targeted acquisitions, capital demand.

We recommend that the primary forecast figures not be expressed as single numbers, but rather as ranges of figures:

	Not	Ranges
Revenue	~~€ 185 mil.~~	€ 175 – 195 mil.
EBITDA	~~€ 20 mil.~~	€ 20 – 23 mil.
EBIT	~~€ 14 mil.~~	€ 12 – 15 mil.
Investments	~~€ 20 mil.~~	€ 18 – 23 mil.
Operating Cash Flow	~~€ 16 mil.~~	€ 15 – 18 mil.
Market Share Target Product A	~~12 %~~	10 – 13 %

The ranges represent an expectation corridor as the start of the financial year, and are continuously updated/corrected in the course of interim reporting. The use of ranges is due to forecasting uncertainties. Broad ranges signal a low level of certainty, while narrow ranges signal a high level of certainty among management.

A particular advantage to the use of ranges is that signals can be sent to the capital markets via the way in which they are adjusted.

- A narrowing of the range towards the middle during the year is a sign of increasing forecast certainty.
- A broadening, on the other hand, signals increased uncertainty.
- A raising of only the lower end indicates a more-or-less unchanged, but somewhat more optimistic outlook.
- A lowering of only the upper end indicates a more-or-less unchanged, but somewhat less optimistic outlook.
- A raising of only the upper end is a sign of growing optimism accompanied by increased uncertainty.
- A lowering of only the lower end signals increased pessimism and uncertainty.
- A parallel shift of both ends indicates a major adjustment as compared to the original forecast.

3.2.2. Communicated financial targets are persistently pursued and always referred to the previous year.

The validity of the goals and forecasts, as well as changes and modifications should be addressed proactively. The review should include a report on the viability of the goals and an analysis of what has already been achieved. In the event of adjustments to guidance over the course of the year, reference should be made to the latest valid forecast, as well as the original forecast. If figures are released during the year, these should agree with the final numbers.

3.2.3. The company takes a realistic but conservative stance when it comes to forecasts, and avoids patently overcautious statements as well as those that are too upbeat.

“Conservatism” in management and communication is documented and verified through the transparency of planning parameters. “Soft”, i.e. vague, abstract, non-specific plans and forecasts are in and of themselves unhelpful, because they result in a knee-jerk reaction by the capital market. Depending on the business model, quite specific goals can be set, even during the course of the year. An example that is not conducive to success is pessimistic interim reporting (goals will not be easily reached, markets tight, competitors aggressive etc.) followed by end-of-the-year reporting that paints a glowing picture of the company’s success.

Realistic-conservative in this sense refers to the fundamental position that it is better to err on the side of caution in forecasting and adjust upwards as the year progresses. This does not mean that a company should purposely set unambitious goals that are easily achieved.

Our recommendation is based on the observation that investment professionals prefer to receive a mildly positive surprise than one that is slightly negative. The ability of the management to meet or somewhat exceed forecasts generates credibility and thus faith in the forecasts.

In the context of expressing a realistic-conservative stance, the interplay of planning and forecasting is of particular importance. If, for instance, a company budgets in revenue of €2 billion, a realistic-conservative stance may be expressed by targeting a range of €1.8 – 2.1 billion in the current financial year.
Another way to convey a realistic-conservative stance could be the use of more cautious economic parameters for the forecast, thus increasing the probability that results will be met.

Negative example: A German financial services provider regularly issues conservative full-year forecasts at the beginning of the year, based on business that is certain up to that point. Over the course of the year, the forecast must be adjusted upwards several times. This conservative method is seen by the provider itself as a measure of the quality of its forecasts. This is explained by its belief that it is important to regularly provide capital market participants with pleasant surprises.

3.2.4. The premises of the forecast, as well as the associated risks, are explicitly stated; speculative elements are highlighted.

Meant here is information that would be necessary for a scenario analysis, such as key drivers, specific risks and market conditions. The main issue is: What influences the strategy; which factors carry risk; and how do changes impact results? Which scenarios possible, both positive and negative?
In this context, the issue of potential extraordinary factors is significant: e.g. restructuring measures in excess of what can be expected; significant innovations intended for generating revenue in the planning or forecast period, should be described as specifically as possible (prices, volumes etc.).

3.2.5. Changes to earnings forecasts are explained in detail.

In addition to the statutory requirements set forth under standard 1.1.2. above, adjustments to forecasts should be accompanied by adequate explanations, whether negative (profit warnings) or positive. General references to good/poor economic conditions are not sufficient in this context.

The planning parameters and their bases are adequately explained and understandable for those outside the company, even without detailed background on the story. Details are provided for assumptions about market performance, market share, timeframes for product development etc. as well as their impact in results. It would also make sense to set forth the circumstances and deviation thresholds as of which the company will change its projections. Ideally, the company will make known the communicative measures that it will take when the thresholds are crossed (e.g. teleconference for investors).

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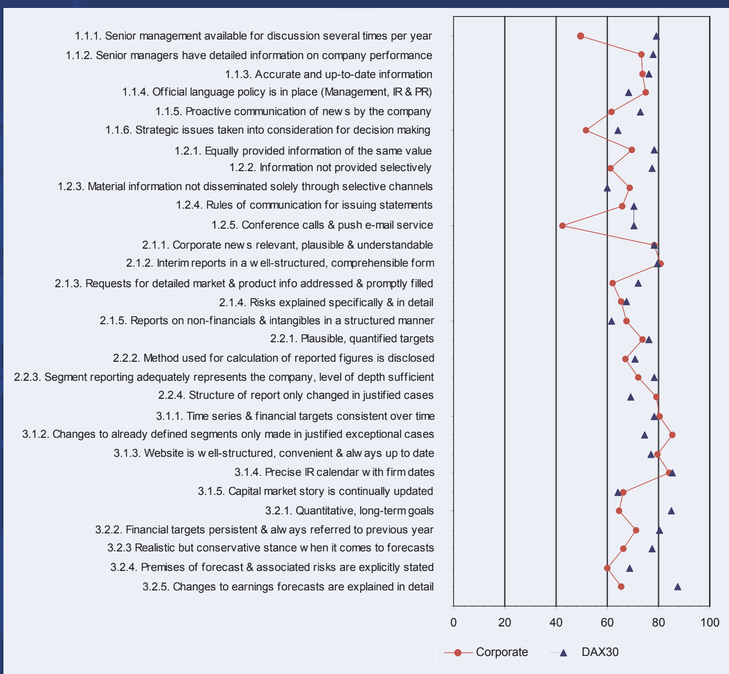

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