

# Financial disclosure and value creation : the role of financial communication

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## FINANCIAL DISCLOSURE AND VALUE CREATION: THE ROLE OF FINANCIAL COMMUNICATION

Communication processes aim to satisfy conflicting needs in the financial sector: it is necessary to inform the public promptly and accurately to enhance market efficiency. However complete disclosure would dissipate the value of the private knowledge that is at the root of the creation of value. These conflicting needs are object of regulations of ever-increasing complexity. The careful handling of communications is a necessary condition for corporate success.

*Keywords:* efficient capital markets, incomplete information, contracting.

The object of finance is the choice of investment opportunities, that is priorities to give to scarce capital resources. Firms, investors and governments are the interested actors of this allocation process that determines economic growth. Only few of the available projects are funded in capital markets. Therefore it is important that markets have the information to select wisely. For this reason it is desirable that market participants have access to information.

Modern finance practice has been greatly influenced by the 'Efficient Market Theory'. This theory states that market prices reflect all available information. Prices in efficient markets contain therefore all the information investors need to reach their best decisions. These decisions will be risky, because of the unresolved uncertainty stemming from the incomplete information available to investors.

Incomplete information relates either to future events, the occurrence of which is uncertain, or to private information. Private information is

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available only to some market participants, but not to the general public. Typically this information is disclosed over time through corporate announcements or the trading activities of informed investors. Although these activities may anticipate corporate announcements, they would be unreliable indicators in the absence of corporate disclosures, because they could lead to market manipulation. Corporate announcements therefore play a central role in providing information to investors, reducing uncertainty surrounding investment opportunities.

A reduction in uncertainty is typically welcome by investors, because it limits their risk. It would be easy to jump then to the conclusion that firms could please investors by disclosing as much as possible. Once all the private information was to be disclosed by the firm, there would be no useful function left for trading on private information. Corporate insiders and other informed investors could then be forbidden from trading ahead of corporate disclosures.

What is missing in the naive analysis above is the role of private information in the creation of value. Firms create value only by exploiting imperfectly competitive markets for their products. In markets that are perfectly competitive financial profits fall to zero and there is no advantage to invest.

Among the imperfections that make investments profitable the development of new knowledge plays an important part. New knowledge allows in fact for the development of successful innovations in products and services. Firms that introduce successful innovations enjoy competitive advantages. However these advantages are temporary in nature, disappearing when competitors catch up. It pays therefore that innovators try to delay the diffusion of innovative processes through patents, copyrights or lack of disclosure. Increases in value of financial securities associated with investment projects reflect the value of rents available to innovators during the transitory period before competitors close the gap.

Managers' wish to protect project rents from competitors conflicts with the need to inform investors about firms' activities. This need exists not only at the time new capital is sought, but every day. Disclosure is in fact necessary for the operation of secondary markets, where investors exchange securities. Poor disclosure drains liquidity, making it hard for investors to trade. Investors are then locked into their investments to some degree, often beyond their desired time to liquidate. The consequences of that are more onerous financial terms for firms seeking further financing.

The above conflict must be resolved primarily in financial markets. However its social relevance has attracted the attention of numerous

agencies and it is at the origin of a large amount of financial regulation. The regulatory process is still in evolution, disciplining ever more tightly the type and the means of information available to investors.

The increasing complexity of regulations leads to increasing compliance costs. They cannot be avoided because the cost of omissions or misleading statements is very high, especially in the more regulated North-American markets. More and more firms are subject to the regulations of those markets because of globalization pressures.

Firms need professional structures to manage their corporate communications, striking the optimal balance between disclosing and withholding information. This is especially true of multinational firms, operating in several markets and subject to regulations that are often contradictory. As important as regulations, the effectiveness of enforcement shapes the form of the optimal strategy for corporate communications.

More withholding of information exposes the firm to a higher cost of capital and to potential charges of insiders' manipulation. More disclosure may hurt the value of investments and increases the chance of errors.

Errors in corporate communications encompass material errors, misleading statements, confusion in communication strategy. Of these perhaps material errors are the easiest to rectify. The other ones damage the confidence of investors in the management team, often irreparably.

Corporate communications include accounting reports and public announcements.

Traditionally little more than quarterly accounting reports was required to keep investors abreast of corporate business developments. That was due to the relatively static nature of business, largely tied to illiquid corporate assets. Managers had few options to influence the course of business in the short run. Moreover investors largely understood those options. Public announcements were used mostly to announce acquisitions, major investments, changes in senior management and few other events of corporate life.

In recent years investors' sensitivity to corporate disclosures has been enhanced by the widespread use of derivatives in corporate management. Derivatives are financial securities having values dependent on the price of an other financial asset and time. Using derivatives it is possible to change substantially the exposure of corporations to different sources of risk. Therefore investors that ignore which derivatives corporations hold have a hard time trying to figure the effects of news on the values of corporate securities.

Derivatives are hard to classify as either assets or liabilities. For that reason they do not appear in the balance sheet, but they are secluded in the footnotes. Moreover their complexity is almost never apparent in the aggregate reports commonly used. The typical corporation limits its disclosure to meaningless aggregate figures on the face value of outstanding derivative contracts and a general policy statement on its proposed derivative strategy.

Although it may appear useful to improve derivative disclosure in financial statements, it is not clear that benefits would outweigh costs. Derivatives are in fact much cheaper to trade than financial or real assets. Therefore accounting reports that disclose a firm's derivative position with a delay of a few months are not accurate descriptions of the firm's current position.

Because of the impossibility investors face in following fast-changing corporate decisions about the use of derivatives, investors are forced to rely on corporate policy statements. Their only indirect check of the success of corporations in following their stated policies is given by the reported financial results. Because of that short-term financial results are object of almost paranoid attention. Anything in them or other corporate announcements hinting at departures of management from stated policies has often devastating effects on stock prices.

Investors' attention to the implementation of corporate policies does not derive from a strong preference for a particular policy. In fact investors that are not comfortable with corporate choices can take individual actions that largely offset corporate decisions. To do so however they must be knowledgeable about corporate activities. If these activities are at odds with investors' expectations markets are thrown into disarray and managers lose investors' confidence. That is the reason for which departures from stated corporate policies are causes of market distress.

Inappropriate communication processes even under careful policy development and implementation may cause market distress. The fault of inappropriate communication may rest only partially with the firm, but investors bear the costs in any case. In some cases these costs may amount to billions of dollars. For this reason it is important that senior managers be involved in the definition of corporate information strategies.

In the course of financial communication processes it is important to listen as well as to speak. In particular, neglected requests of clarification by market regulators or investment analysts have occasionally extreme consequences.



The demise of a large agricultural concern, the Ferruzzi Group, may be traced back to its inability to explain satisfactorily the hedging nature of a large position held in the soybean futures markets. The regulators, having not received satisfactory answers, offered the group the opportunity of winding down its position quietly. This opportunity was spurned, leading the regulators to the choice of forcing the liquidation of the soybean futures contracts with large financial losses.

More recently, failure by Amazon.com to illustrate its strategy to financial analysts satisfactorily has led to widespread perceptions that the company was well on its way to insolvency, contributing to the substantial decline of the company stock. This decline extended to other firms in the industry and it is still bottoming out in spite of the announcement of very good Christmas sales.

Perhaps the sectors that encounter the most difficulties today in their financial communications are technology and genetics. Their difficulties are due to investors' difficulties in understanding the feasibility of the proposed investment projects and even more importantly, the lack of hard data to rank the chances of commercial success of proposals against alternatives that aim to satisfy similar needs.

Markets have been reacting to the lack of hard data on technology and genetics with irrational exuberance, followed lately by ever-increasing disappointment. These phases may seem to be of marginal importance because of their transitory nature. Once harder information becomes available appropriate market valuations may follow. Unfortunately many young firms will find financing hard to come by in the current market environment and will not reach the phase where harder information becomes available.

Difficulties in communication may lead therefore to permanent underinvestment, with negative consequences on economic growth. Contract theory and financial engineering attempt to mitigate this problem on a theoretical or a more applied level. Unfortunately these tools do not resolve communication difficulties completely. Indeed they often introduce new complexities in the framework of reference, contributing to the misunderstandings that plague financial decision processes.

The process typically begins with a mandate to a consultant to solve a financial problem of the firm. The problem is often only partially determined. The consultant therefore has to complete the definition of the problem, including the objective function and the constraints, which may reflect imperfectly the actual problem the firm faces.

Once a consultant identifies an innovative solution to the financial problem it is necessary to persuade management to accept it. To do so it is tempting to simplify the analysis, glossing over elements that do not appear of immediate relevance. Managers' acceptance is therefore based on partial or misleading information.

An example of the above can be found in the proceedings of the case 'Procter & Gamble vs. Bankers' Trust'. Bankers' Trust had proposed an innovative interest-rate swap<sup>1</sup> to the plaintiff without fully illustrating the potential results under some set of circumstances that was deemed to be extremely unlikely. Once those circumstances materialized, the large losses Procter & Gamble faced led to legal action. The judicial decision came in favor of Procter & Gamble, drawing a tighter boundary for North American financial consultants' behavior in the future.

The final difficulty in the communication process the firm faces is the communication of its new strategy to the market place. A well-known case of that is the experience of Banc One, a large American bank, in the early nineties. Banc One had implemented a very extensive hedging program that included the values of some intangible elements of its business. A very negative reaction by investors to the disclosure of this hedging program led to its abandonment.

In the last example it may be argued that the communication failure was more remote, concerning the firm's failure to understand what investors wanted rather than a failure in communicating the hedging plan implementation properly. In either case better communications would have prevented an expensive experiment.

In conclusion, there is plenty of evidence that the financial industry devotes large amount of resources to market and customer communications. The emergence of the new elements discussed above ensures that this trend will continue in future. More resources will be devoted to enhance the quality of the communication process.

It becomes therefore important to develop new training programs that provide personnel with the skills necessary for the effective management of financial communications. The Università della Svizzera Italiana is currently considering how to structure these programs. We hope that this first article will foster a debate among the readers of 'Studies in Communication Sciences'.

<sup>1</sup> An interest rate swap is an exchange of cash flows at future times. The amounts exchanged depend on the levels of interest rates at each time of exchange.

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