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Title: A Model of Corporate Financial Communications

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Executive Summary

Background and Methods

This report seeks to understand how large UK companies manage their financial communications with analysts, fund managers and wider stock markets, and how their learning experience changes their behaviour in this regard .

The listed companies in this study operate in a world where they need to continuously communicate with fund managers and analysts in a competitive market for information both during the corporate reporting cycle, and as *ad hoc* events occur. They also face a world of change in their product markets and in their corporate value-creation processes. Holland (2004) examines how the content of corporate financial communications has been influenced by corporate perceptions of changes in their value-creation processes, as well as by major changes in financial markets. The same forces have come into play in influencing corporate financial communications behaviour. Demand-side and supply-side factors have been changing the nature of the information gap between companies and suppliers of risk capital, while these forces have also created a need on the part of companies to develop their financial communications capabilities.

Seven categories of value-relevant information (V1 to V7) were identified from the interviews with the companies:

- V1: information about the uncertain process of creating growth through strategic options (organic growth and takeover targets), over a long-term horizon.
- V2: information on how new sources of additional value are created by new strategic options exercisable in the short-term to medium-term.
- V3: information concerning new cash flows and earnings derived from the recent exercise of strategic options.
- V4: information about the value arising from current operations, current trading and immediate growth.
- V5: information regarding the way in which top management and the board, directly influence the level of expected cash flows and the risks in V1 to V4.
- V6: information on how top management and the board boost confidence in the company value-creation processes.
- V7: information about the quality of corporate disclosure and its role in creating confidence about the company value-creation process.

Elements V5 to V7 cover information about the ‘hierarchical’ (or board and top management) value-creation process, while V1 to V4 relate to information about ‘horizontal’ (or input, process, output) value creation, and ‘network’ (alliances *etc*) value-creation processes. These seven categories of information also provide a more structured approach to narrating the Corporate Story of value creation as outlined in Holland (2004).

The companies perceived that their disclosure activity altered attitudes amongst core fund managers and analysts and perceived that their financial communication about the value-creation information agenda changed fund managers' and analysts' 'understanding and confidence in the company', and these in turn impacted upon the stock market. There was a cumulative two-way learning process by the fund managers, analysts and company managers. Pressures from private meetings together with continuous and cumulative feedback from market prices influenced this process.

Corporate disclosure and the fund manager (and analyst) process of using objective and subjective evidence (company and external) to evaluate the company story, helped in building confidence in the companies' value-creation processes. This interaction between the companies and the fund managers and analysts spread information about a company's expected financial earnings and about value-creation stories from the core group of key fund managers and analysts to the market as a whole. However, this confidence was very vulnerable to company surprises and to changes in market sentiment. This 'fragility' was due in part to natural exposures to business risk, but also reflected poor corporate track records in every case. This fragility was also increased by high financial communications exposure if a company was always a focus of the public interest.

The companies perceived that fund managers and analysts played a critical role in intermediating company-specific information into stock prices, volatility, liquidity, bid-offer spreads and the cost of capital. The companies expended time and financial resources to probe and receive feedback on what information was in the market amongst fund managers and analysts and reflected in the stock price. Changes in the stock price were often the first observable feedback that problems or opportunities were being recognised by the market in the execution of corporate value-creation and/or with disclosure behaviour. As a result, the stock market reaction to specific corporate disclosure as well as general sector and stock market movements were closely monitored by the case companies on a continuous basis. Fund managers, analysts, and market traders further amplified this stock market feedback during their private interactions and dialogue with companies.

Stable high quality disclosure was expected to be reflected in the stock price and lead to a reduction in the cost of equity capital. This cost of capital 'information premium' was expected to remain stable relative to competitors with similar assets and market position, but which had a lower quality of disclosure and less interaction with the market. The market was thought to learn how to price company disclosure over time; the premium, therefore, included an expectation about future disclosure and information. Those companies with an 'information premium', that announced a negative surprise to the market were expected to experience a sudden drop in their stock price and an increase in the cost of capital. The companies, therefore, recognised that they had strong incentives to maintain high disclosure standards and to avoid surprises. Those companies without an 'information premium' were less exposed to such a shock because their more erratic disclosure behaviour was already built into their stock price. However, they faced a relatively higher cost of capital and this was perceived as representing a major competitive disadvantage.

A similar premium on the cost of equity capital was identified with the quality of the board and top management and was built into share prices as the market developed an expectation about the future quality of management. The companies, therefore, had to maintain high management and board standards and to avoid succession and resignation surprises.

The companies learned to respond to market change and developed *(i)* a high responsiveness to user demands and changing market conditions; *(ii)* a flexible disclosure policy in terms of public *vs* . private *vs.* secret information flows; and *(iii)* adaptable internal and external structures.

The companies decided on the nature of their financial communications policy as new information continuously arose within the company and its competitive environment that changed the corporate value-creation story and their benchmark measures. The previous relationship with the market played a key role in guiding new decisions about the timing of disclosure and through which channel to disclose information. This learning process and prior disclosure behaviour interacted with corporate perceptions of the business environment leading to changes in strategy and key intangibles. This changes the value-creation story, and so the iterative process continued.

Corporate opportunism was also observed in the companies disclosure policies. The learning and feedback process acted as an important market pressure to counteract corporate preferences for secrecy over private disclosure and private disclosure over public disclosure. Concern about managerial and company reputation and how these interacted with executive job tenure, job succession, personal marketability, and pay schemes, were important disclosure constraints.

Performance promises, targets and forecasts also acted as key constraints on companies to respond to growing shareholder wealth maximisation pressures. In particular, private and public shareholder wealth maximisation pressure set the boundaries on public and private disclosure and focused disclosure on shareholder wealth maximisation issues. Shareholder wealth pressures also stimulated the release of value-relevant information and the development of value-relevant information systems.

Chapters three to six develop ideas of good practice and show how managers can jointly agree their communication practices with their core fund managers and most influential analysts over time. Companies should recognise that they need to earn this 'agreement' with 'market forces' through a continuing quality dialogue with active fund managers and by being able to interpret immediate feedback from the stock market. Private disclosure, knowledge-intensive intangibles, benchmarking and many other elements in the financial communications model can be interpreted as a rational corporate attempt to satisfy such 'market forces' in a period when conventional financial reporting channels are facing problems of declining informativeness (Francis and Schipper, 1999; Lev and Zarowin, 1999).

Policy implications - at regulatory levels

The financial communication behaviour described in this report can be seen as a regulatory success, a regulatory failure and a regulatory opportunity. It is a regulatory success in the sense that the companies avoid the private release of 'price-sensitive information' which could immediately affect prices in material or significant ways. It is, however, also a regulatory failure in that it highlighted the deficiencies in the information content of conventional disclosure mechanisms, such as the financial report and its Operating and Financial Review (OFR) section, as well as those in public announcements made *via* the Stock Exchange. This provides a regulatory opportunity and the model of financial communications in this report could form the basis of Financial Services Authority (FSA)-designed guidance.

The insights from corporate financial communication practice might be of use in designing new disclosure guidance. Policy makers could require companies to disclose their 'business model' or value-creation story in the OFR using the three value-creation processes identified in this research and by Holland (2004). First, qualitative or narrative disclosure could focus on how top management and the board play a role in creating and protecting value in the value-creation process (hierarchical). Secondly, qualitative or narrative disclosure might usefully focus on how business operations (horizontal) and network alliances create value. The story or narrative concerning horizontal and network value-creation could be further structured around the status of strategic options. UK regulators have sought to improve the OFR during the 1998-2002 UK Company Law Review and in the Companies Act 1985 (Operating and Financial Review and Directors' Report etc.) Regulations 2005. However the requirement for quoted companies to produce a statutory OFR was repealed on 12 January 2006 . However, this has been very much an *ad hoc* 'muddling through' approach to reform. The above proposal is more structured and would facilitate a common approach across many companies.

Company announcements of price-sensitive information to the stock exchange could also be rationalised using the insights of this research report. The UK Listing rules indicate many specific events that have to be announced to the market because they represent price-sensitive information. Holland and Stoner (1996) also identify other corporate price-sensitive information event categories from a study of UK companies including, *inter alia* , the launch of a new product, new investment, new research and development expenditure. Many of these price-sensitive information events can be placed within two major categories identified in this research . Firstly, they could be classified as actions and events associated with the hierarchical, or top management and board value-creation process. Alternatively, they could be categorised as actions and events associated with the horizontal and network value-creation process. Company announcements of price-sensitive information to the stock exchange concerning horizontal and network value creation could be further structured around the status of strategic options and the four categories of value-relevant information identified in chapter four. These would include many of the price-sensitive information categories identified by Holland and Stoner (1996) and would also relate to the release of information about substantial changes in the corporate story, or changes in the relative ranking or effectiveness of benchmarked value-creation intangibles, as well as changes in the risks faced by the company, and alterations to the status of strategic options.

Private interactions and disclosure can also be regulated in the same way. Fund managers and analysts could be asked to disclose information about their private question and answer sessions with companies, with the structure of disclosure based on the value-creation process. Regulators could ask companies to reveal which of their internal intangible quantitative benchmark indicators were of most interest to these fund manager and analyst users, and which external indicators were published by other information specialists but were not generally available in the public domain. Regulators might also ask companies how they assessed the extent to which their disclosures had a positive effect on the information market's understanding and confidence, and what measures or proxies they employed to understand this. Companies might also be required to disclose their policies on public *versus* private disclosure and their communications policy.

Many of the above ideas are consistent with the prior UK development of guidance on how to disclose effectively to the stock market (price-sensitive information guidance) and how to develop good financial communications practice with fund managers. For example the Myners Report (1995) advocated that private company and institutional meetings, and associated communications, should be improved in the interest of national competitiveness; it placed particular stress on improving corporate investor relations and improving business awareness on the part of fund managers. This could be extended to include analysts as well as fund managers, and should explore how corporate disclosure can be developed to improve perceptions and understanding by all information parties.

Disclosure guidance developed from this model may play a positive role in improving allocative efficiency in capital markets and in improving intermediation effectiveness. The model also provides a key context for other studies of disclosure and suggests many new testable hypotheses. These are discussed in chapter seven and appendix five to the report .

Finally, the model captures information flows of relevance to many corporate finance decisions. Such a model may potentially be combined with an investment-financing cash flow model (Brealey and Myers, 2003) to add a novel and dynamic information dimension to conventional corporate finance.

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