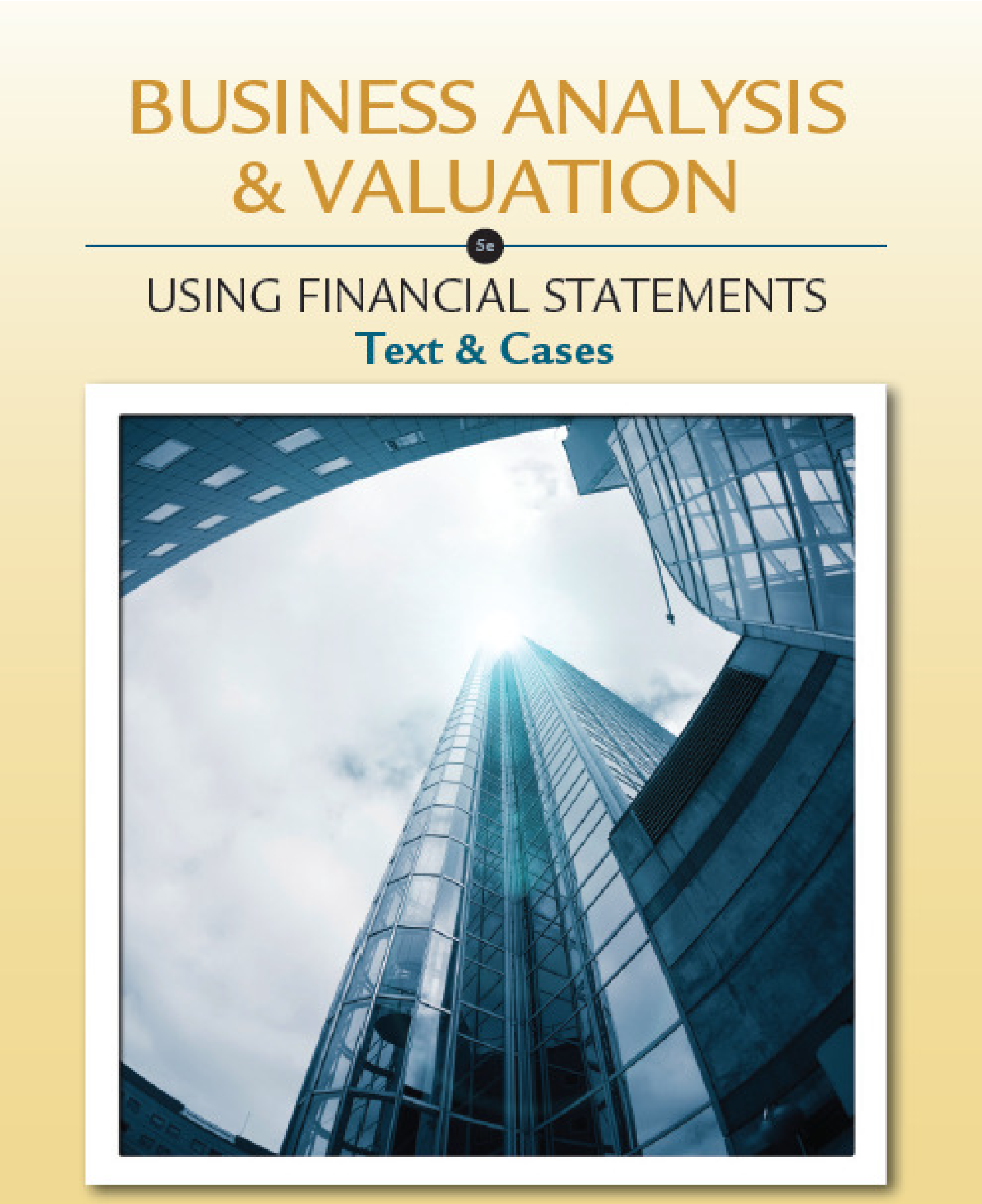


Chapter 12: Communication and Governance

Key Concepts in Chapter 12

- The perception that corporations lack transparency has made corporate governance an increasingly important issue.

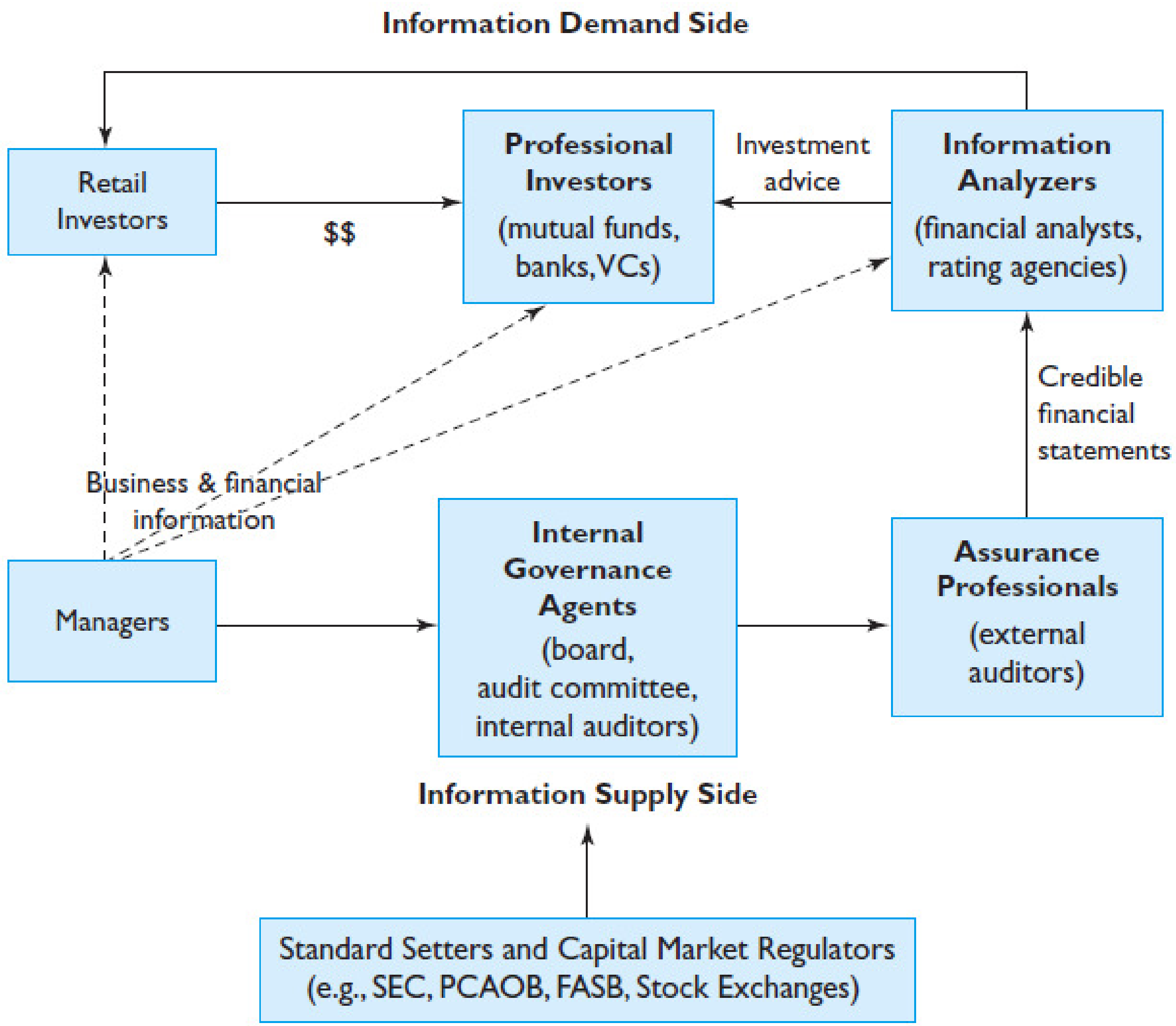
- Relatively new regulations such as the Sarbanes-Oxley Act have been enacted in an attempt to increase accountability.

- Understanding the management communication and governance processes is important to security analysts and investors.

Governance Overview

- Unchecked, management is likely to be overly optimistic in its disclosures of financial performance.
- Information intermediaries help to rein in management bias in reporting.
- An illustration of the role these intermediaries play in the financial markets can be seen in Figure 12-1.

FIGURE 12-1 The Intermediation Chain Between Managers and Investors



Source: © Cengage Learning

Management Communication with Investors

- There are many reasons for managers to have a positive bias, including:
  - Favorable rates for new equity issues
  - The need to sell the company to employees, customers, suppliers, and investors
  - Their personal performance is tied to firm value

- Example: communication issues for Jeffries
  - The stock price declined 56% in Nov. 2010, due to concerns about its exposure to European sovereign debt..
  - The decline occurred even though management reported little exposure to MF Global and European sovereign debt.

Communication Through Financial Reporting

- Management communication through accounting and financial reporting
  - Accounting reports encompass both past performance and expectations for the future.
  - The Sarbanes-Oxley Act requires the CEO and CFO to certify:
    - That the financial statements fairly represent financial performance of the company.
    - That the company's internal controls are adequate to support those financial statements.

Communication Through Financial Reporting, Continued

- Factors that increase accounting communication credibility
  - Accounting standards and auditing
    - GAAP and external auditors help to assure that financial statements fairly represent firm performance.
  - Monitoring by financial analysts
    - Analysts with specialized knowledge evaluate the quality of management's reported results and forecasts.
  - Management reputation
    - The credibility of a manager is a key element to their being able to communicate effectively with investors and analysts in the future.

Limitations of Financial Reporting for Investor Communication

- Accounting rule limitations
  - GAAP is not able to fully disclose all aspects of a firm's performance.
- Auditor and analyst limitations
  - Auditors and analysts do not have the depth of company knowledge possessed by managers.
- Management credibility problems
  - Information from managers with credibility problems will likely be viewed with skepticism.

Communication Through Financial Policies

- Dividend payout policies
  - Dividend policies convey management’s expectation of current and future earnings.
- Stock repurchases
  - A way for management to communicate to the market that it believes the firm is undervalued.
  - Stock repurchases are costly because of fees and price premiums involved.

Communication Through Financial Policies, Continued

- Financing choices
  - Terms of new financing arrangements or the credibility of new investors or lenders provides information to the market.
- Hedging
  - Management can reduce certain unexpected changes in earnings through hedging.
- Example: Jeffries
  - Jeffries repurchased 5m shares & largest stockholder and insiders purchased additional shares. But did not arrest stock slide

Alternate Forms of Investor Communication

- Analyst meetings
  - Regular meetings with analysts releases information to these intermediaries.
  - Material information released to analysts must also be publicly disclosed.
- Voluntary disclosure
  - Management has the discretion to voluntarily disclose information, though there are constraints on this type of disclosure.
- Example: Jeffries disclosure
  - Provided new information to disprove allegations

The Role of the Auditor

- U.S. external auditors provide investors of publicly traded companies assurance that financial statements are prepared in accordance with GAAP, or state why they are not.
- Audit results are presented in the audit report that accompanies financial statements issued to the public.
- Procedures essential to the audit are:
  - Understanding the key risks associate with the firm audited
  - Evaluating the firm's internal control system
  - Performing procedures to identify unusual transactions or events
  - Gathering evidence on controls, transactions, and account balances to support the auditor's opinion

The Role of the Auditor

- Challenges facing the audit industry
  - Maintaining audit quality in a competitive environment
  - Legal liability
- Financial analysis tools in auditing
  - Strategy, accounting, financial, and prospective analyses are used to identify company risks and evaluate the reasonableness of discretionary accounting treatments.
- Example: auditing Jeffries
  - Most questions the auditor should have focused on disclosure of off-balance sheet risks.

The Role of the Audit Committee

The audit committee has become increasingly important as a part of the corporate governance system.

- The requirements for the audit committee have been expanded and formalized.
  - SEC, 1999, Sarbanes-Oxley Act
- The audit committee:
  - Is required to be comprised of independent board of directors with no conflicts of interest with management.
  - Is responsible for appointing, overseeing, and negotiating fees with external auditors.

Concluding Comments

- Effective communication by management to investors is important to efficient capital markets.
- Typically, communication to investors is made through financial reports, but management also uses other means of communication.
- External auditors and audit committees play a direct role in effective governance of the firm.