However, financial reports are not always able to convey the type of forward-looking information that investors need. Accounting standards often do not permit firms to capitalize outlays, such as R&D, that provide significant future benefits to the firm.

A second way that management can communicate with investors is through nonaccounting means. We discussed several such mechanisms, including using financial policies (such as stock repurchases, dividend increases, and hedging) to help signal management's optimism about the firm's future performance; meeting with financial analysts to explain the firm's strategy, current performance, and outlook; and disclosing additional information, both quantitative and qualitative, to provide investors with information similar to that of management.

In this chapter we have stressed the importance of communicating effectively with investors. But firms also have to communicate with other stakeholders, including employees, customers, suppliers, and regulatory bodies. Many of the same principles discussed here can also be applied to management communication with these other stakeholders.

Finally, we examined the capital market role of governance agents, such as external auditors and audit committees. Both have faced considerable public scrutiny following a series of financial reporting meltdowns in the United States. Much has been done to improve the governance and independence of these intermediaries. We focus on how the financial analysis tools developed in the book can be used to improve the quality of audit and audit committee work. The tools of strategy analysis, accounting analysis, financial analysis, and prospective analysis can help auditors and audit committee members to identify the key issues in the financial statements to focus on and provide common sense ways of assessing whether there are potential reporting problems that merit additional testing and analysis.

DISCUSSION QUESTIONS

1. Amazon's inventory increased from $3.2 billion on December 31, 2010, to $5.0 billion one year later. In addition, sales for the fourth quarter of those years increased from $12.9 billion in 2010 to $17.4 billion in 2011. What is the implied annualized inventory turnover for Amazon for these years? What different interpretations about future performance could a financial analyst infer from this change? What information could Amazon's management provide to investors to clarify the change in inventory turnover? What are the costs and benefits to Amazon from disclosing this information? What issues does this change raise for the auditor? What additional tests would you want to conduct as Amazon's auditor?
2. a. What are likely to be the long-term critical success factors for the following types of firms?
   - a high technology company such as Microsoft
   - a large low-cost retailer such as Wal-Mart

   b. How useful is financial accounting data for evaluating how well these two companies are managing their critical success factors? What other types of information would be useful in your evaluation? What are the costs and benefits to these companies from disclosing this type of information to investors?
3. Management frequently objects to disclosing additional information on the grounds that it is proprietary. For instance, when the FASB proposed to expand disclosures on (a) accounting for stock-based employee compensation (issued in December 2002) and (b) business segment performance (issued in June 1997), many corporate managers expressed strong opposition to both proposals. What are the potential proprietary costs from expanded disclosures in each of these areas? If you conclude

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that proprietary costs are relatively low for either, what alternative explanations do you have for management's opposition?

4. In contrast to U.S. GAAP, IFRS permits management to reverse impairment on fixed assets that have increased in value since the time of their impairment. Revaluations are typically based on estimates of realizable value made by management or independent valuers. Do you expect that these accounting standards will make earnings and book values more or less useful to investors? Explain why or why not. How can management make these types of disclosures more credible?
5. Under a management buyout, the top management of a firm offers to buy the company from its stockholders, usually at a premium over its current stock price. The management team puts up its own capital to finance the acquisition, with additional financing typically coming from a private buyout firm and private debt. If management is interested in making such an offer for its firm in the near future, what are its financial reporting incentives? How do these differ from the incentives of management that are not interested in a buyout? How would you respond to a proposed management buyout if you were the firm's auditor? What about if you were a member of the audit committee?
6. You are approached by the management of a small start-up company that is planning to go public. The founders are unsure about how aggressive they should be in their accounting decisions as they come to the market. John Smith, the CEO, asserts, "We might as well take full advantage of any discretion offered by accounting rules, since the market will be expecting us to do so." What are the pros and cons of this strategy? As the partner of a major audit firm, what type of analysis would you perform before deciding to take on a startup that is planning to go public?
7. Two years after a successful public offering, the CEO of a biotechnology company is concerned about stock market uncertainty surrounding the potential of new drugs in the development pipeline. In his discussion with you, the CEO notes that even though they have recently made significant progress in their internal R&D efforts, the stock has performed poorly. What options does he have to help convince investors of the value of the new products? Which of these alternatives are likely to be feasible?
8. Why might the CEO of the biotechnology firm discussed in Question 7 be concerned about the firm being undervalued? Would the CEO be equally concerned if the stock were overvalued? Do you believe that the CEO would attempt to correct the market's perception in this overvaluation case? How would you react to company concern about market under- or overvaluation if you were the firm's auditor? Or if you were a member of the audit committee?
9. When companies decide to shift from private to public financing by making an initial public offering for their stock, they are likely to face increased costs of investor communications. Given this additional cost, why would firms opt to go public?
10. German firms are traditionally financed by banks, which have representatives on the companies' boards. How would communication challenges differ for these firms relative to U.S. firms, which rely more on public financing?

NOTES

1. M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure," *Journal of Financial Economics* 3 (October 1976): 305–360, analyzes agency problems between managers and outside investors. Subsequent work by Bengt Holmstrom and others examines how contracts between managers and outside investors could mitigate the agency problem.

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