EFFECTIVE CORPORATE COMMUNICATION

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INFORMATION ASSYMETRY

Defining the corporate activity of Investor Relations

This chapter will display the framework and the objective of this book, and will also display the definitions of terms, activities and market players who are involved in the corporate communication process and the main types of corporate disclosure.

With reference to the title of this book, it is also essential to define the terms "effective" and "voluntary" as they are used here. According to Webster's Encyclopaedic Dictionary (1988, Lexicon Publications, Inc.), "effective" is defined as *"causing or capable of causing a desired or decisive result"*. "Voluntary" is defined as *"acting, made or done freely, not under constraint or compulsion"*. In this book, the terms *"corporate* communication", "corporate financial communication", "communication of information", "corporate disclosure", and *"disclosure of information"* as well as *"investor relations"* refer approximately to the same idea and meaning and are used interchangeably.

The Cadbury report (1992, paragraph 3.2) describes corporate financial communication as *"…an open approach to the disclosure of information (which) contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinize companies more thoroughly"*.

A set of definitions, given by researchers, practitioners and authors over the years, and which try to grasp the multidisciplinary activity of investor relations, follows. Most people from the academic community as well as Investor Relations (IR) practitioners accept the well-defined descriptions of the Investor Relations function, given by the National (US) Investor Relations Institute (NIRI)[1]: *"a strategic management responsibility using the disciplines of finance, communication and marketing to manage the content and flow of company information to financial and other constituencies to maximise relative valuation"* and by the UK's Investor Relations Society (IRS)[2]: *"…as the means whereby listed companies maintain a dialogue with existing shareholders and potential investors. Its purpose is to present an accurate picture of corporate performance and prospects, thus allowing the investment community, through an informed market,*

[1] (http://www.niri.org)
[2] (http://www.ir-soc.org.uk)

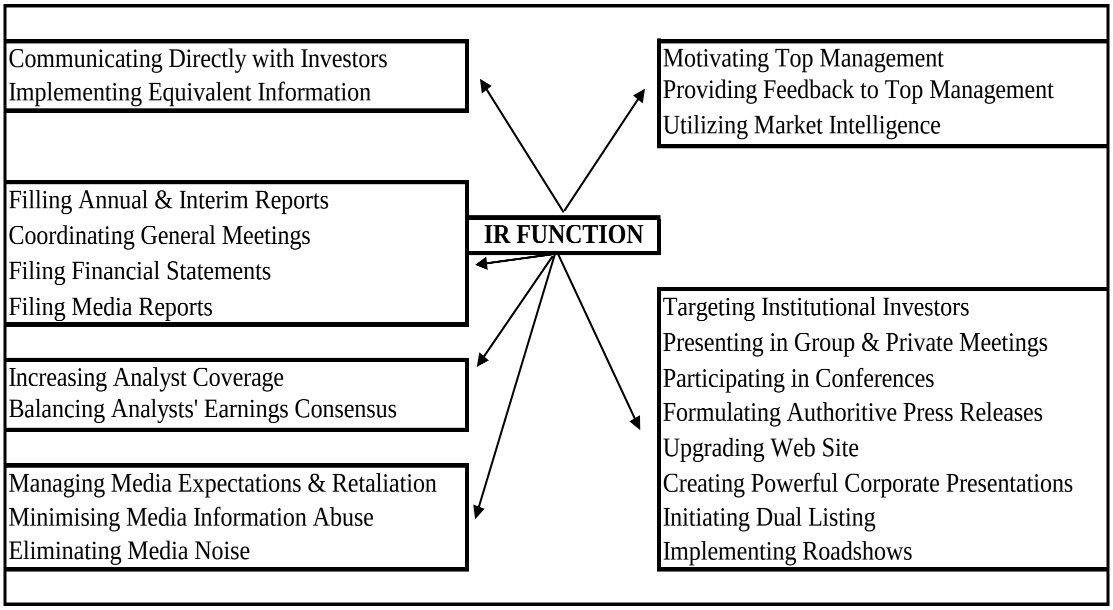
to determine a realistic share price. As a result, IR can have a positive impact on a company's market value and cost of capital relative to the industry sector and overall economic climate". The former stresses the strategic element of the IR, which shows that the Americans have grasped the essence of the activity. The latter identifies rightly the end result of the IR activities - that of the share price and evaluation.

During the last decade, researchers have exposed other sides of the IR function. In particular, Marston (1996b, p. 477) defines IR *"as the management of the relationship between a company with publicly traded securities and the holders or potential holders of such securities".* She adds that *"the IR process must reflect the highest standards of integrity of its practitioners if it is to retain the trust it requires from both corporate management and the investment community"*. In other words, she stresses the human elements of the IR activity, such as management of the relationship, integrity of IR officers and even ethical boards of directors and the top executives.

Brown (1995, p. 44) defines Investor Relations as a *"strategic corporate marketing activity, combining the disciplines of finance and communication, which provides present and potential investors with an accurate portrayal of a company's performance and prospects"*. The issues of strategy and long range company prospects are stressed here, placing IR at the inner core of the top management of each listed corporation. Preis and Berbers (1990, p. 102) concluded that investor relations is *"the mechanism by which companies communicate those facts about themselves that lead to a judgment, by the capital markets, on their corporate operational ability"*. According to them, the IR function is a vital communication processor or mechanism that helps to make the right investment decisions.

According to the author's experience as an IR practitioner, investor relations is a strategic multidisciplinary function that combines principles, methods and tools from sciences and arts, such as finance, accounting, marketing, economics, game theory, public relations, psychology and military strategy. Moreover, investor relations and corporate communications are activities that are initiated, planned and executed by skilful people in an organization at the highest level, since they affect the company's evaluation and future prospects (Figure 1.1).

Figure 1.1: IR function.



In addition, these personnel are incorporated into the organizational chart according to the specific needs of the company and the top management, and interact and communicate information internally and externally. The leader of the corporate communication team has been named Investor Relations Officer (IRO) and since he/she is close to the upper management of any company and organization, is considered by market players to be a strategic operating officer. Therefore, the Investor Relations Officer (IRO) is the executive who is responsible for initiating, organising, planning and implementing the IR strategy, as well as consulting and directing the top management to the most effective communication path. The IRO can follow either formal or informal communication paths to convey the company's message to the market participants (Demos, 2005c).

The people internally with whom the IRO continuously interacts are mainly the Chairman of the Board of Directors, the Members of the Board, the Chief Executive Officer (CEO), the Chief Financial Officer (CFO) and to a lesser extent the marketing director, the chief accountant and the Chief Operating Officer (COO). The Chairman of the Board of Directors (BoD) is the independent and authoritative person who sets the Board agenda, ensures the Board obtains the highest quality information and facilitates communication both among Board members and between them and management. The Members of the Board are the operational administrators of the firm and the independent officials who guarantee and authorize the decisions, strategy and efficiency of the Board. The Chief Executive Officer (CEO) is the manager whose job is to run a major company successfully in an increasingly risky and hyper competitive global economy. The Chief Financial Officer (CFO) is the manager whose job is to oversee the financial matters of the firm.

Investor relations, is also highly interrelated with the rules and principles of corporate governance. This relationship is so important that it resembles the father-son relationship. The former likes to control and direct and the latter tries hard to act independently. IROs have lost many nights of sleep over the extension of corporate governance and regulation.

This is a concern for all IR people across the globe[3]. Every year, over the last nine years (1999-2007), in the annual global IR conferences[4], organised by the International Investor Relations Federation (IIRF), lengthy discussions have taken place and the main question has been whether regulation is counterproductive for the IROs and IR activity. But what is corporate governance? Corporate Governance (CG) is the set of rules and regulations that direct and prescribe the business conduct for accountability and performance (Milonas, 2002; Holland, 1995). Moreover, it tries hard to control and standardize the corporate dissemination of information in order to create an environment of equivalent information for all market players and the instantaneous share of information by others with the firm's insiders (i.e. Chairman of the BoD, CEO, CFO and others).

Information process and information asymmetry

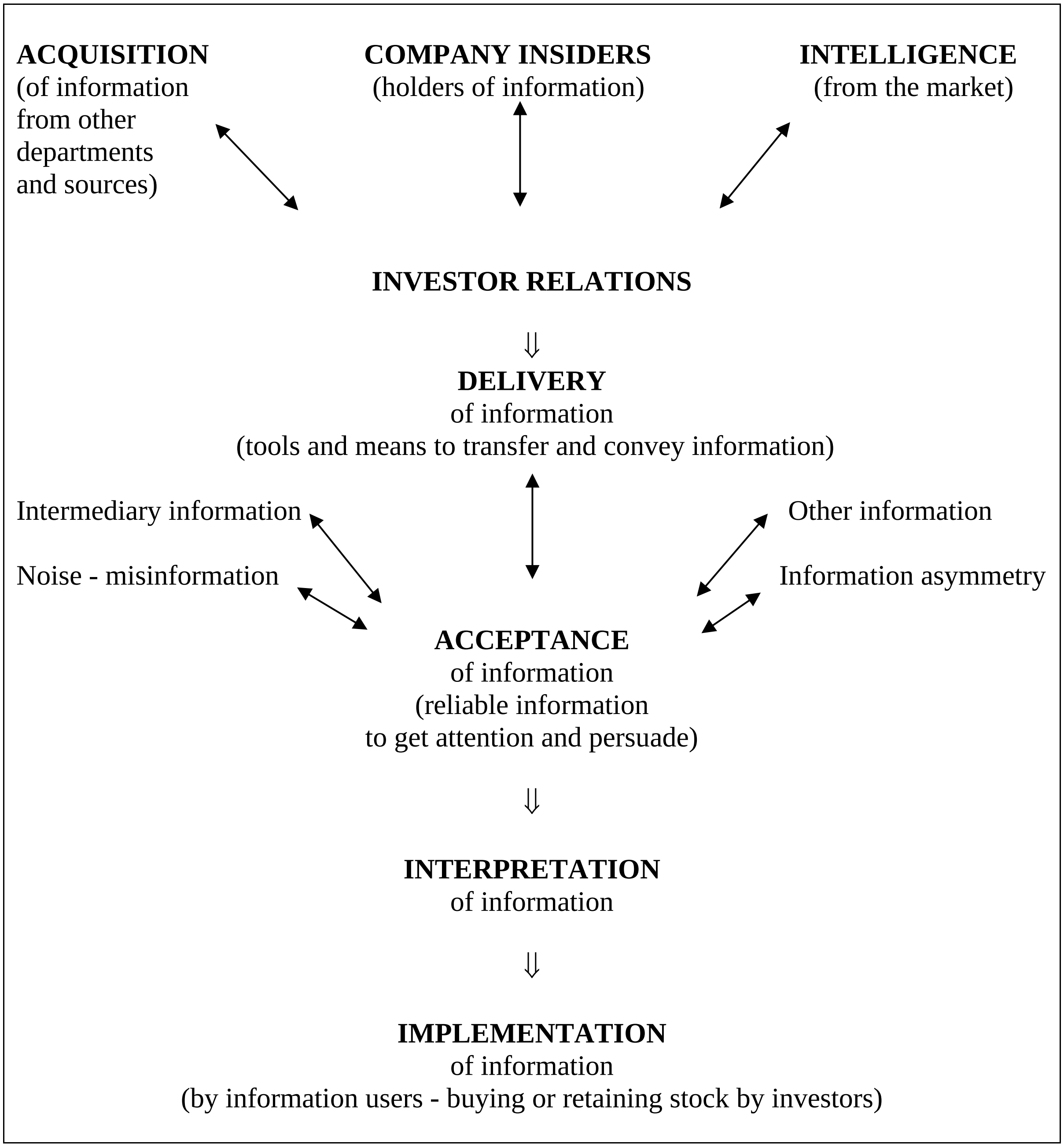
The information process is defined by the acquisition, interpretation and use of information (Figure 1.2).

When information delivery fails then information asymmetry issues arise that seriously affect decision making. Decision making is also affected by the proliferation and excessiveness of information and therefore the existence of noise. Information asymmetry and noise are problems in the corporate communication process and affect investment decisions.

[3] International Investor Relations Federation (IIRF) annual conferences' discussions, minutes and publications (www.iirf.org).

[4] IIRF Conferences, 2007, 2006, 2005, 2004, 2003, 2002, 2001, 2000, 1999.

Figure 1.2: Information process and information asymmetry.



Source: Demos, 2001a; Dixon, 1976.

The major shareholders or owners of a listed company, but mostly the top executives who run it and can evaluate better the business entity, are the information insiders (agents) who select the type and time of delivery of information and the disclosure pattern (Fishman and Hagerty, 2003; Hong and Huang, 2003; Del Guercio, 1999; Hilton, 1993). Consequently, there might be an information gap between the acceptance and interpretation of the company's information, and its proper use and implementation by the market players (agency information paradigm).

The investor relations literature is based mostly on the agency economic theory and selected themes from accounting, finance and marketing. In other words, there are several academic disciplines involved in the study of investor relations (Bushee, Matsumoto and Miller, 2003; Hong and Huang, 2003; Brennan and Tamarowski, 2000). Verrechia (2001, pp. 98-99) states that *"disclosure literature could be probably characterized as an eclectic commingling of highly idiosyncratic (and highly stylized), economics-based models",* and, furthermore, suggests *that "eclecticism is exacerbated by the fact that disclosure, as a topic, spans three literatures, accounting, finance, and economics, and thus inevitably takes on features of those literatures"*.

Marston (2004, p.7) argues that *"there is no specific theory that can explain IR practised by companies"*. She evaluates IR as part of the financial reporting process but also suggests that IR can be viewed from different angles, not merely as an information providing function. She also stated (1996) that the purpose of IR is to provide information to the financial community, such as analysts, media, institutional and retail investors and public investors, in order to evaluate a listed company optimally. Since the recent stock market bubble in 2000, the subsequent collapse of investors' confidence and the proliferation of mandatory rules and corporate governance regulations by the US and other SECs, formal corporate communication has become synonymous with regulated disclosure (Witt, 2004; Stilponos, 2004; Mulligan, 2001).

In other words, all formal channels of company information could be regulated and controlled by the authorities. The annual, semi-annual and quarterly reports, the official press releases, the agenda and minutes of the general assembly, the financial statements and the footnotes, and the fillings were and are part of the formal or regulated corporate communication. Corporate disclosure and IR activity were examined either as formal or as informal corporate communication functions (Holland, 1998b; Marston, 1999). Informal corporate communications and activities can be classified as public and private (Brennan and Kelly 2000; Marston, 1999; Holland, 1998a). Public disclosure includes press releases, web site and web casting communication of information. Private communications consist of mailing information to market participants, answering queries, providing feedback on analysts' reports, email information, group and/or one-to-one meetings, etc. Disclosure is a firm's voluntary and discretionary delivery of information to the investors and the market, and disclosure effectiveness refers to the use of information, so savers/investors are able to make informed investment judgments (Pae, 2002; Palmiter, 1999; Holland, 1998a).

IR theoretical foundations

This subchapter provides a literature overview on the subject of corporate communication and investor relations. It describes the theoretical foundations that may be applied to corporate disclosure and investor relations, such as the agency theory and the efficient market hypothesis model.

Later, it exposes the research findings in the area of corporate communications according to corporate governance (CG), disclosure via intermediaries and in discretionary mode. By doing so, it gives an overview of the theoretical and empirical development of the corporate disclosure and investor relations research.

Again, corporate communication, investor relations and corporate disclosure are used interchangeably, since it is accepted here that they are in essence similar in function and activity.

Agency theory foundations

Investor relations have been examined from an agency theory perspective. The traditional agency theory was introduced by Coase (1937), and later expanded by Jensen and Meckling (1976), and Fama (1980) observed that the role of financial information was to supervise the behaviour of top management in order to reduce the agency cost. Dye (2001, p. 184) suggested that *"there is a theory of voluntary disclosure and (this theory) is a special case of game theory with the following central premise: any entity contemplating making a disclosure will disclose information that is favourable to the entity, and will not disclose information unfavourable to the entity".* Investor Relations and voluntary disclosure decisions *"involve balancing conflicting incentives associated with different audiences"* (Chen, Conover and Kensinger, 2005, p. 1). Investor relations (IR) play a vital role in the *"information process and information asymmetries"* (Yoshikawa and Linton, 2000, p. 3).

The IR is accepted by top management (company information insiders) as an information filter, official company communication voice and even a buffer and protection zone for the executives. As Rao and Sivakumar report, *"top managers found it rational to hire personnel to buffer themselves from external scrutiny"* (1999, p. 30).

IR is also accepted by the analysts (information intermediaries) and the investors (company information users) as a reliable source of company information (Holland, 1997; Marston, 1997a). IR relate directly to two major agents in the corporate setting: the top executives and the owners. *"Managers must provide owners with accurate, timely, and complete disclosure of the company's positions",* and systems, codes and governance have been developing in order to resolve *"conflicts of interest between owners who lack the specific information (or the background knowledge to utilize it) and the managers who act as their agents"* (Chen, Conover and Kensinger, 2005, abstract).

Lev (1992, p. 17) pointed out that *"economic theory has recognized that without active disclosure the truth never comes out and consequently a permanent information gap generally exists between insiders and outsiders".* Gelb (2002) argued that the separation of ownership and control leads to agency problems and the diffusion of ownership leads to governance problems. The economic theory of the agency paradigm also addresses the information asymmetry and communication gap between management and shareholders.

Research by Glosten and Milgrom (1985), Lang and Lundholm (1996, 1993), Welker (1995) and others in this field indicated that corporate disclosure is positively related to information asymmetry between investors and managers. Agency theory and investor relations are also closely related through the relationship and/or distinction between existing shareholders and prospective investors. As Miller Lee Richard (1988, p. 128) noted, *"in most companies, the Investor Relations function devotes a very large proportion of its efforts to the outsiders (prospective investors – if and when some of them purchase the securities of the firm), and only a limited part to the shareholders (the actual investors). This is probably because the Public Relations function has traditionally been the "parent" of the Investor Relations".* Watts and Zimmerman (1978) argued that the companies should increase discretionary disclosure in order to minimize pressure from government and stakeholders' and unnecessary compulsory regulation.

In conclusion, a large portion of the academic research and literature on disclosure and investor relations draw heavily from the agency theory.

Efficient Market Hypothesis (EMH) foundations

Investor relations have been examined from an efficient market hypothesis (EMH) perspective. The market is efficient if information is included in the market price. IR also plays a vital role in the timing of the corporate disclosure and information efficiency (Holland, 1998b). As Rogers (2002, p. 22) reports, *"companies derive significant benefits from voluntary reporting, including using vehicles like the CEO presentation which allows management some interpretive licence".* To handle such, IR must be integrated at the topmost levels of the firm. The use of the means that convey the company's information (i.e. letters, telephones, press releases, web sites, email, meetings, etc.) to the investment community and the equal access to this information by the information users and other market players (analysts, media, regulators, authorities, institutional, individual investors, etc.) are major concerns in the IR function, and as such, investor relations have been examined from an efficient market hypothesis perspective. Deller, Stubenrath and Weber (1999), found that by disclosing more to interested parties and to the market, a company could influence the market participants.

Marston (1997a, p. 266) argues: *"In practice there will always be information asymmetry".* It is not possible to convey to the market all the information about a company. If this were possible the market would exhibit strong form efficiency, which has been reported on by Keane (1983, p.10) as follows *"The market is efficient in the strong sense if share prices fully reflect not only published information but all relevant information including data not yet publicly available. If the markets were strongly efficient, therefore, even an insider would not be able to profit from his privileged position".* Bromwich (1980, p. 68) connects information asymmetry with insiders and, most important, financial analysts with inside information, and suggests that the holders of esoteric company intelligence partially help the market efficiency.

In particular, he argues that, *"given the relatively small numbers of individuals who have access to such non-public information",* these individuals first of all may contribute to economic efficiency, since they have access to superior company knowledge, as they claim, and, secondly, they exercise a kind of monopolistic information power and, therefore, *"will not provide the information to all those willing to pay the incremental cost of their demands".*

In conclusion, since investor relations play an important role in the information process, information asymmetry and information efficiency, they can be analysed from the efficient market hypothesis framework.

Direct and indirect corporate communication

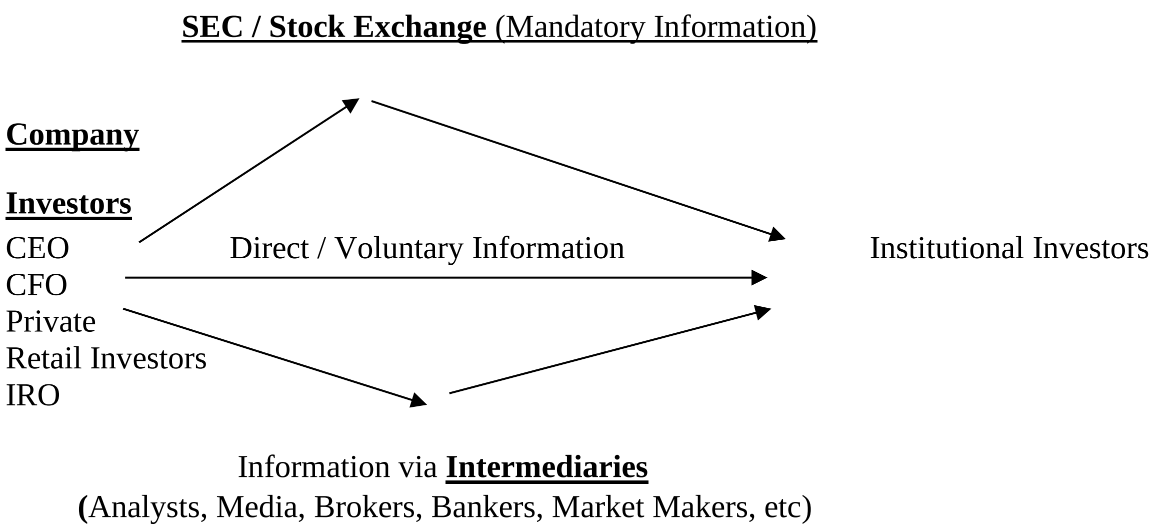
Historically, the IR function and industry came to existence, first in the USA, as a demand-driven activity and a necessity for both the top managers (as they were taking control away from the founder's family) and the investors (as they were becoming more and more institutionalized) (Marston, 1996b; Brown, 1995; Preis and Berbers, 1990). Later on it was demanded in the UK and the commonwealth countries and during the 1990s proliferated to Europe, Asia and the Rest of the World (RoW). Many researchers and practitioners accept that the IR function does help the information flow between the listed companies and their audience (Marcus and Wallace, 1998; Marston, 1996a; Derriman, 1969).

As mentioned, according to the Agency Theory, in which managers run the listed firms, they also plan and implement the strategic and marketing plans and consequently control all vital company information (Healy and Palepu, 2001; Bushman, Piotroski and Smith, 2001; Marston, 1997a; Holland, 1997). On the other hand, all shareholders and stakeholders (i.e. suppliers, bankers, customers, etc.) have little or no information on the company's activities and performance. Thus this information asymmetry between the two groups creates the need for an information processor such as the IR function, and the IR adventure begins, since as information processor, the communication flows constantly in all directions, in and out of the company.

Previous research found that the IR is not a simple function. It is a complex and multi-disciplinary executive practice, which combines knowledge of economics, finance, accounting, marketing, psychology and organizational behaviour with managerial skills such as effectiveness, persistence, strategic inclination and other personal attributes of the people who implement it.

The basic aim of the Investor Relations (IR) department is: a) the creation and cultivation of relations of trust with the investors; b) the direct, correct, valid and timely disclosure of company activities to the market (analysts, institutional investors, brokers, bankers, etc.); and c) the strategic planning and programming of IR activities, which have as their ultimate goal to optimize the company's share price (Demos, 2000a). It emerges as the basic need of communicating the company's information to the market, and, as a platform of information, it can be used by the different interested parties such as analysts, brokers, institutional investors, bankers, etc., to their benefits. The regulators appear precisely in order to control and direct the communication channel to the mutual benefit of all market participants (Figure 1.3).

Figure 1.3: Direct and indirect information to investors



Some believe that the IR should operate in the compulsory mandatory environment and others should be left to the voluntary mechanisms (Preis and Berbers, 1990; Marston, 1999; Holland, 1997; Nichols, 1989; Kopel, 1982).

Summary

The definitions, the background, the IR foundations were presented in order to outline the context and goal of the book. The book concentrates on the aspects of the three expressions of corporate disclosure (regulated, via intermediaries and voluntary). During the last decade in particular, many changes in the legal and regulatory disclosure framework were witnessed which consequently affected the companies' ability, flexibility and willingness to inform the markets and the market players. There has been inadequate research on all of these (three) fronts of corporate disclosure, especially for the non-English speaking markets. I hope this book adds some new insights, provokes further research and promotes the IR (idea and) practice.