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Discussion of 'Motives for disclosure and non-disclosure: a review of the evidence'

Ken Lever*

1. Basic thrust of Professor Lundholm's paper

The argument put forward by Professor Lundholm is that the primary purpose of voluntary disclosures emanating from a firm is to minimise the adverse selection caused by investors who, absent such disclosures, are sceptical about the firm's future prospects.

It is suggested that full disclosure breaks down when frictions enter the picture. Frictions are categorised as arising when: management does not know; when management cannot tell and when management does not care.

1.1. Management does not know

This can arise where managers do not know anything more than what is required in mandatory disclosures or where something is known with such great uncertainty that legal worries or accounting principles prevent them from providing the disclosures.

1.2. Management cannot tell

This can arise where it costs money to create and disseminate a credible disclosure and it is suspected that other parties privy to the disclosure use the information to the detriment of the company making the disclosure.

1.3. Management does not care

This can arise where managers are not trying to maximise the current share price. It may also be that the level of concern for the current price varies across managers and time periods.

Chronicling how the costs and benefits change as frictions are introduced into the basic story is the purpose of the paper.

The conclusion of the paper is that empirical evidence shows that firms and the capital market seem to respond to their environment in a way that is broadly consistent with a basic full disclosure model and attendant frictions that alter the model's full disclosure prediction.

2. A company perspective in practice

The following comments are based on the experience of Tomkins plc and general observations about other companies, and are not based on any empirical studies.

2.1. Minimising adverse selection

Tomkins stated objective is to achieve sustainable growth in economic value through growth in after-tax cash flow. The focus is on cash flow rather than earnings. It is also recognised that over time the objective of management is to create value in the business ('intrinsic value') and through the communication process to endeavour to ensure this value is reflected in the external ('perceived value') of the company.

Within Tomkins, intrinsic value is monitored against perceived value and it would be normal for a value gap to exist. Typically, this gap will exist either due to management optimism leading to overstated intrinsic value or it may be that the market is not in possession of important information - either because it cannot be disclosed for legal or competitive reasons or management is not aware that the information may impact value.

2.2. Management does not care

As a general statement, it is unusual that managers do not care about the share price. The degree to which managers' interests are aligned to the shareholders will vary but a significant number of managers will have incentive schemes in some way linked to the performance of the share price or will have direct ownership of shares.

At Tomkins there is close alignment through annual bonus schemes based on creation of economic value and long-term incentive plans, linked to total shareholder returns.

2.3. Management does not know

It may be that management does not know any more than the financial market in certain areas. For example, management may forecast the likely trends in its markets, but ultimately management may be shown to be incorrect due to factors beyond its control. Management may then be penalised by the financial markets even though it was

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trying to be helpful. While forward-looking information of this type may be helpful to the financial markets, there is a reluctance on the part of management to give such information if it is seen as a stick to beat management subsequently.

2.4. Management cannot tell

Management may in certain situations seek to suggest that information cannot be disclosed due to commercial sensitivity. These situations should generally be unusual and management should be able to articulate information about market attractiveness and competitive position without giving away too many details of the strategy. Ultimately, the success of a business is driven by execution of its strategy. Seldom will disclosures affect execution.

The categorisation of the frictions may be oversimplistic and does not take into account the motives and drivers of different groups of shareholders. For example, hedge funds like to promote imperfections in the market to provide opportunities short the shares. Short-term share price volatility has frequently driven trading by the hedge funds, while long-only funds retain investments in the shares.

3. Our information strategy

At Tomkins, a balanced approach to information communication is used to ensure perceived and intrinsic value are aligned as closely as possible and so that investors and potential investors are well informed about the prospects of the business. While the bias of voluntary disclosures tends to present the picture in a favourable light, with the effect that adverse selection is minimised, it is recognised that if communication is seen as spin then investors are likely to penalise the valuation of the business due to the impact on management credibility.

Information used by management is communicated externally where possible so that the performance and prospects of the business can be seen 'through the eyes of management'.

In addition to required mandatory disclosures strategic position, market attractiveness and competitive position are discussed.

Considerable importance is attached to non-financial and narrative information to supplement and complement financial disclosures. Wherever possible, management tries to give a forward-looking orientation but recognises that the absence of safe harbour protection in the UK limits ability to make such disclosures extensive.

Overall, the focus is on understandable information, relevance, supportable, comparability over time and transparency.

3.1. Means of communication

The principal means of communications are analysts' briefings, investor meetings, capital markets conferences, the annual report, the operating and financial review and the management discussion and analysis in the US. Use is made of the website, live web-casts and printed documents.

3.2. Effect

Tomkins has a reputation for transparency, extensive disclosure and quality of management. Over a six-year period the share price has more than doubled despite having disposed of over one third of the activities.

4. Complexity of financial reporting

Concerns exist that the complexity of the financial reporting model is an impediment to communication. The move towards a balance sheet concept of income and the more extensive use of fair values is leading to less transparency.

An overly complex reporting environment can lead to information being misunderstood and may provide imperfections in the market which could lead to short-term trading by hedge funds and volatility in the share price.

The users require more information on the strategic position of the business and extent to which this will generate sustainable growth in after tax operating cash flow over time. This type of information is better presented through narrative and qualitative disclosures that would typically be included in an operating and financial review. The future development of narrative information will be important to a better understanding by the market of the factors that influence value.

5. Conclusion

Management's role is to create economic value in the business and to effectively communicate with the market.

Communication with the market should ensure the market over the long-term properly assesses the intrinsic (economic) value of the business and applies a fair valuation and eliminate the value gap. It should not be driven solely by the desire to avoid adverse selection.

The suggestion that an investor relations' function takes a sophisticated approach to the assessment of the type and timing of the release of information to the market is somewhat misplaced. Generally, there are tried and tested ways of communication that tend to be applied in a fairly routine way by most public corporations.

There is little to be gained by hyping the market in the long-term due to its impact on credibility. Ultimately, the market discovers this and will adjust the valuation of the equity.