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# Public Company Communications with Equity Investors and Firm Value

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## Abstract

Corporate governance is essentially developed from the characteristics of a public company. In such a company, there is a strict division between entrepreneurship and ownership, which results with agency problem between management and stockholders in asymmetric information's conditions. Therefore, the communication of society is with the investor's public, which is one of the key areas of corporate governance. This is primarily related to existing and potential firm's stockholders, who use that information for the assessment of existing, or potential investment. There are many ways of communication. Periodically, the most comprehensive is by using financial reporting. Unfortunately, today's common financial reporting practice are not directed to existing and potential firm's stockholders. Reporting shows business value primary as firm's assets value and stockholders are observing assets as financial potential, and are primary interested in economic value based on expected cash flows and risk reward relationship. Because of that, there are big challenges for the improvement of financial reporting. Furthermore, there are many challenges to improve alternative ways of firm's communication in the areas of main risks exposure of firm's business operation, business strategies, fair approach to investors, etc. All these improvements have significant potential for better assessment of firm's value.

**Keywords:** corporate governance, communications with investors public, components of firm's value, assets value, economic value, risk, financial reporting

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## 1. Introduction

The separation of entrepreneurship from ownership in modern economy enabled the concentration of capital in the individual economic entities. This enabled the transformation of

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business activities from the universal owner-entrepreneurs to the well-educated and well-trained professionals who should perform all of their tasks in the best interests of the owners of such large and complex economic entities. This feature of contemporary economics has been made possible through the transparent and efficient financial market, particularly the capital or, more specific, the stock market. The stock market allowed the generalization of individual and personalized owner's goals and transformed them at a level of the company's long-term stock market values, and the stock market values became the owner's instrument for achieving greater wealth.

The separation of ownership and entrepreneurship raises the issue of additional mediation between people because of the entrepreneurship and property rights which were once contained in a single person (i.e., owner), now manifest through the action of the managers as the agents (the principal) working under conditions of information asymmetries. Therefore, one can conclude that the agency problem [1] exists not only in modern public corporations with the relation between the management and the owners, but also within owner interest groups, primarily between small and large shareholders, those who hold significant interests in the company. Agency theory [2] shows how the problem of agents in terms of conflict of interest can lead to specific securities' categories agency cost [3]. The problems of agents and associated information asymmetries have begun to interest the academics and the practitioners in the early twentieth century, especially after the Great Crisis [4] in a framework known as corporate governance.

It is possible to significantly reduce the agency problem in an environment that increases the information symmetry between agents and principals, managers, and owners (shareholders). Therefore, for a public company, the communication with public investors on financial markets is *conditio sine qua non* of existence as well as the privilege of the public company to obtain the largest amount of capital at the lowest costs [5]. This necessity is primarily related to communication with existing and potential shareholders. However, possible conflicts of interest between creditors and owners may also arise. Conflicts of interest are commonly brought up in the context of over indebtedness and deterioration of the company, unless one does not wish to expand the concept of a creditor on those who spontaneously lend to the company, such as, for example, the vendors.

The financial economy and the financial industry are considered to be important and extremely sensitive segments of the economy, which is why the financial markets, particularly the capital market, are highly regulated. Of course, this implies that the financial market regulation and financial supervision, have a significant impact on the public company communication with the overall investment public. Financial supervision is organized differently in different countries. Still, most often, it is decentralized, with demands that often impose supervision of banks focused primarily on banking business and the protection of creditors [6]. In a broader sense, public company communication with investors is affected also with other supervisory bodies in the economy. The globalization of the financial markets on public company's communication with investor's public is increasingly affected by the international financial supervision, where once again the supervision of banks dominates, along with different international bodies responsible for communication harmonization.

This chapter aims to initiate a professional and academic debate on improving public company communication with equity investors for the main purpose of enabling valuation of a company as close as possible to its real intrinsic value. This applies to all forms of communication and, in particular, to financial reporting. Although we are witnessing significant success in standardization and harmonization of financial reporting worldwide, there are still many problems in using financial statements in the valuation process. In this context, the initial assumption is that today's financial reporting is oriented to the lenders rather than the equity investors. Financial reporting does not explicitly contain descriptions of main operating and financial risk exposure of the firm. Furthermore, increasing use of fair market value principles for valuation financial statement position increases subjectivity and opens the possibility to prepare targeted financial statements.

## 2. Company value

Corporate governance is a complex concept which is differently understood, in part due to the broad understanding of the term "governance," as the job between the board and the reign. However, both the board and the reign have their legal basis, but with respect to those that are managed or governed, it can also be based on promises (paraphrase of [7]). Because of this, the communication with those who are governed, as well as with other stakeholders, is an integral part of corporate governance. Corporate governance encompasses processes, customs, laws, policies, regulations, and institutions that affect how a firm is managed and controlled. Although corporate governance refers to many stakeholders, it is mainly focused on the shareholders of the company.

Corporate governance is an internal system which comprises policies, processes, and people that serve the needs of shareholders and other stakeholders, by directing and controlling management activities according to sound business practice, company goals, responsibilities, and integrity. Proper corporate governance is evaluated by obligations made to the external market and legislation, as well as by healthy governance that protects policies and processes [8]. It is aimed at maintaining the balance between economic and social goals and likewise between individual and common goals. The aim is to align the interests of individuals, corporations, and society as nearly as possible [9]. Corporate governance could also be considered as an economic discipline focused on incentive mechanisms for motivating the management of a corporation, such as contracts, organizational schemes, and legislation. It is often limited to issues of improving financial performance of the company [10].

Corporate governance is primarily focused on the principal-agent problem and asymmetry of information in creating value for shareholders. Valuation under corporate governance is also connected with the transaction cost theory introduced by Ronald Coase [11]. Principals are shareholders, and the principal-agent problem is often observed between shareholders, government, and executive management. The role of government is to protect the interests of shareholders, or to direct the business according to shareholders' interests. Essential aspect of effective corporate governance with lowest possible agency costs is whether the government

will assume the role of managing operations (executive management) or will it be protecting the interests of shareholders. Furthermore, agency problem can be observed inside interest groups with key potential conflicts among shareholders, primarily between large and small stockholders. The great, as a rule, appears as a part of the Administration, and to some extent directs the company according to their partial interests.

The principal-agent problem under asymmetry of information incites communication between the firm and its shareholders. In this sense, financial reporting is, along with other publications and announcements for the investment community, subject to corporate governance. While investors seek to influence the practice of financial reporting and communication of publicly traded companies with their financial environment (primarily through associations of financial analysts), the fact is that financial reporting is strongly influenced by financial supervision and is primarily concerned with protecting creditors and preserving the stability of financial institutions and the financial system in general. This argument is further enforced with practices of earnings management. This is significantly under the influence of financial market regulation, several corporate governance standards, and is, to a great extent, under the influence of the financial market's strength to force corporate administration to established dividend policy in the interests of the small shareholders [12].

Regardless of the interests of other stakeholders, corporate governance is always focused on satisfying the interests of the owners of the corporation. Their interest can be viewed through a consensually accepted goal of the firm in the context of financial analysis—long-term increase in stock value, which is always the subject to the interdependence of risk and reward [13]. According Peterson [14], the value of all businesses, large or small, is based on these three components:

- what a business owns;
- what a business earns; and
- what makes the business unique.

A business owns specific assets. Total assets represent the specific financial potential available for making money. This implicates that a business may hold assets which might prove unnecessary for operations and could be questionable to profitable holding. Assets can be found in the business's balance sheet, which is thus a starting point for firm's asset evaluation and a useful indicator of business value.

Every business earns through its business operation. This can be viewed as profits or incomes or as cash flows. Firm's profits are determined with accounting convention based on both commodity and cash flows, while firm's cash flows, as earnings results, are determined on cash flows. Realized profits in near or distant past can be found in profits and losses (or income) statements. This makes aforementioned statements a starting point for forecasting firm's earnings [15]. Earnings analysis is the first step for analyzing the earnings power as well as analyzing and forecasting the expected cash flows as usable economics incomes unlike profits as accounting or accrual income.



Every business is a specific, distinctive operating unit, which, to a degree, makes every firm unique. On one hand, this uniqueness determines the risk of investments, but on the other hand, it determines the desirability of investment in its business. Business' uniqueness impacts both risk and desirability of investments, as well as the value of assets and earnings. In short, it reflects firm's earnings power value. Expected earnings must be evaluated with opportunity costs, founded on risk-reward trade-off. Opportunity costs can be quantified with risk adjusted discount rate for determining earnings present value. This refers to the net present concept of business cash flows which quantitatively depends on discount technique.

Each of the aforementioned components of business value has a specific influence on its value. They can be combined in various ways with a, sometimes, surprising result. For example, a firm which owns respectable assets can produce goods unacceptable by the market and in turn loses money in operations. For a normal investor, the value of this firm is poor. However, for an only competitor, this firm may have a high acquisition value to obtain monopolistic extra profits, or to acquire assets below replacement costs for additional outputs. In contrast, a firm with poor assets can produce high profits and generate significant cash flows, if its location allows monopolistic position. However, with the construction of new roads, the location of this firm can become bad and disable future high profitability.

If the observed value of a company from the buyer's or investor's standpoint is in the equity, then it is certainly the case of buying earning power of the expected cash flows. Such an investor plays the role of external analysts who observe the component of earning power more easily in the financial potential of the assets, because the fine procedures of using that potential in the realized and expected profits and cash flows, which can be easily detected by an internal analyst, are hidden from him. This, of course, does not mean that an external analyst will avoid exploring deeply the component values of the analyzed companies.

If the company's assets are its earning potential, then the value of a company can be viewed as the total value of the assets and as the value of the expected cash flows. Even more, under certain conditions, these two values should be equal. This means that the market value of the assets of the company in its basis should have the present value of the expected cash flows from its profitable use. These expected cash flows will be, in a variety of ways, distributed across the company's investors, so that the value of the companies' financing instruments (stocks and bonds and other financing contracts) must be equal to the value of the assets of the company. This is because one deals with the present value of the same amount of expected cash flows, which are allocated with the financing instruments.

One can declare the market value as the intrinsic value that corresponds to the value of the earning strength only in the conditions of a perfect market, which acts as an ideal laboratory for the analysis of the economic impact solely according to the model of the Nobel Prize winners, Modigliani and Miller [16]. Even then, it is valid only in the conditions of the market equilibrium, where all assets and all liabilities are fairly evaluated with market prices [17]. Namely, in the conditions of equilibrium on the perfect market, all assets and liabilities are perfectly marketable and have no doubtful transparent prices. In such conditions, the company is worth as much as its total assets and that is the present value of expected cash income from its holdings. This value must match the value of the obligations of the company

including those implied according to the ownership equity. Overall, it represents the present value of expected cash flows of the bonds and other debts, as well as from the stocks.

We can all agree that a perfect market does not exist. Although the financial markets, at least in the developed countries, can be considered efficient [18], they are far from a perfect market. In fact, the market values the company's earning power. Partly that power is contained in the value of the assets as the financial potential presented in the company's financial statements, and partly, it is the result of some kind of intangible assets that is visible only in the perfect market. Talking about the financial statements leads us to a new controversy, that of evaluation, which is expressed through the concept of fair value of the asset that is embedded in the dual normative basis of financial reporting.

The questionable term fair value, originates from the principles of evaluation of the assets in the financial statements according to the principle of market value. Therefore, the fair value is embodied with the assumptions that it is the result of consensus between at least two parties (buyer and seller) that neither side is not in force and that all sides are well informed. This defines the price which only oscillates around values, so it is only exceptionally equal to true, intrinsic values. Even more, it seems questionable to talk about fair prices if they are not determined in a transparent market with many competitors on both sides (i.e., buyers and sellers). Bilaterally negotiated price can hardly result in satisfaction on both sides. It can hardly be a fair price. Subjective estimations are too often used to determine the fair value, and thus, fair values are even more questionable than historical values based on explicit and documented acquiring costs.

Through the fair value principle, one can easily derive the value of firm's stocks or equity, by solving the balance sheet equation. The equity is equal to the difference between the value of the assets and the value of the obligations. The financial statements present mainly the real, tangible assets, and not the intangible assets that truly define the earning power. By ignoring the various reserves and by treating current, not yet distributed earnings, as retained earnings, the book value of equity can be viewed as par value shares plus a premium at the time of issuing, minus a value for which the company bought it back in treasury. This refers to a paid-in capital which is related to the outstanding stocks. This value is periodically increased with generated and non-distributed earnings (profit), and reduced through losses.

### **3. Communication between the firm and its shareholders**

A public company must continuously communicate with investor's public to shrink the information gap that arises from information asymmetry between the management and existing or potential investors. Because, from the investors' point of view, the focus of communication is in stocks' value, which makes the dominant communication of financial nature. In terms of economic value [19, 20], communicated information should include the description of expected stock and other financing instruments profitability (i.e., the prosperity of the company and profitability) and the description of this profitability risk to establish appropriate discount rate [21]. Therefore, the financial manager plays a key role in the public company as a mediator between the company with its needs for assets and the financial market participant's and their earnings requirements [22].

Clearly, the communication between the public company and the investor's public is the key element of corporate governance. Communication reduces the information asymmetry and allows investors to rationally decide what to do with the public company financing instruments. However, this communication must not expose critical information to the competitor which will ensure that the company achieves greater value for shareholders. Limited communication takes place with the objective to attract the largest circle of investors that will supply the public company with capital and is, as such, targeted to paint an attractive picture of the society to the potential suppliers of capital [23].

Public company communications with investor's public is conducted through various announcements, disclosures, and company activities in areas particularly sensitive to future profitability and the risks of holding the financing instruments of the company. This communication can be continuous or occasional. Continuous communication is achieved by the implementation of the adopted decisions in the areas of financing, investment, and dividend policy. Because it is vital to keep certain information away from the competition, this communication is most frequently implemented through signals that the public investors group receives when such procedures are carried out in the public company. Signaling occurs as a continuous communication that puts pressure on the company to pay close attention to decision-making and how it will reflect with public investors. One of the key signals is those which communicate fair relations with stockholders without any tendencies for expropriation of their wealth.

Information that can be publicly disclosed regardless of the competition can represent occasional or continuous communication. A good example is the publication of declared quarterly dividends, which represents a daily as well as specialized means of communication in many public companies in the US, and has become a regular form of communication. The announcement seeks to show strength and financial stability of public society which can continuously distribute profits to their owners and in this way, ensure a stable growing current income [22].

A special, extremely significant, part of communication is the financial reporting. Today, it is linked to the quarterly publication report, whereby the annual set of financial statements must pass a public verification from an independent audit. Financial reporting, today is, a standardized form of communication with the investor's public that, along with a standardized set of financial statements, includes specific justifications which make these reports easier to "read" for the interested investor audience. Because of continuity and the importance of this form of communication one cannot avoid cherry picking the information in the reports, in order to show the company as more attractive to investors.

More exhaustive and meaningful form of communication with the investor's public is the company's emission prospectus. Unlike financial reporting, it contains a set of financial statements and a set of pro-forma financial statements of the expected future period, as well as a number of other relevant information. It is a form of occasional communication that is compiled for the purposes of the emission of stocks, bonds, and other public company financing instruments. The most significant prospectus for the public company is the new common stock emission, while other emission prospectuses cover smaller content. How public companies emit bonds and other forms of obligation's much more often than stocks, emission is especially emphasizes occasional form of communication.



Public companies implement other forms of occasional public communications with different announcements of expected business results. It is a tendency that these announcements become more frequent. Because there is no standardized and verified form of communication with the investor's public, such announcements should be taken with a grain of salt because they are largely targeted to attract investors. So, for example, disclosures of the expected sales growth without a good explanation how it will track the growth of profits significantly alters the expected business future of the company.

Periodic financial market crises significantly influence the volume and the frequency of the public company communications with investors, because it represents the opportunity to detect manipulation and deceit. Perfect example is the significant interest in corporate governance, which began after the great depression, so that even today the monograph [4] affects the academic debates about corporate governance. Similar event happened at the turn of the Millennium, after the collapse of the capital markets. This was primarily due to the collapse of the dot.com companies markets and scandals involving large world-known companies such as, for example, Enron, which ranked seventh in 1999 Fortune 500 list of best American companies [24]. This led to the passage of the Sarbanes-Oxley Act (SOX). The law was passed July 30, 2002, and named after Senator Paul Sarbanes and Representative Michael G. Oxley [25].

The reform in the area of corporate governance continued once again soon after the global world economic crisis started breaking down the American mortgage markets. Among the many legal acts and plans for the salvation of the economy, this reform resulted in a "Financial Regulatory Reform" [26]. The legislation seeks to restore confidence in the integrity of the American financial system and create a foundation for financial regulation and supervision that is simpler and more efficient, while protecting consumers and investors. The reform of the financial regulation seeks to achieve five objectives: (1) introduce stricter supervision and regulation of financial firms; (2) to establish a comprehensive supervision of financial markets; (3) to protect consumers and investors from financial abuse; (4) provide the Government with the necessary tools for managing financial crises; and (5) to raise international regulatory standards and improve international cooperation. With regard to communications of public company with investors, this reform underlines the importance of reporting on the risks and the risk management in the society.

In public company communications with investors, it is important to emphasize that it is often burdened by short-term requirements from the financial markets, in particular, in case markets which are overheated or, on the other hand, cooled down. One should look for the company's operation goal in long-term stocks value maximization in the market. In a long run, it is important, as much for the company's stability in generating new values, as it is for the threat to realize suboptimal result for stockholders by focusing on short run and cyclical effects [24]. This problem is associated with the problem of rewarding managers, as well as the whole corporate governance system that should emphasize long-term goals of public companies. It is necessary to emphasize the need to intensively focus on the company's communication with its long-run operations.

## 4. Accounting

Accounting is the most comprehensive and the best record of a company, encompassing various aspects of its business and, as such, serves as the basis for the preparation of financial statements. It can be defined in many different ways. Most definitions highlight bookkeeping as essential component of accounting. In this chapter, we define accounting as the art of communicating financial information of a business entity to the users of that information [27]. This communication takes a form of statements. Mathematical aspects of bookkeeping allow us to treat accounting as a field of mathematics [28]. Furthermore, accounting has to be viewed as an important part of corporate governance, because it is the starting point of company's communication with investor's public. We can distinguish three stages of accounting: bookkeeping, accounting statements, and auditing.

### 4.1. Bookkeeping

Even though it is not the only element of accounting, bookkeeping is the corner stone of the accounting [29]. It is the most comprehensive and detailed economic record of the company and therefore, every business event that is the subject of that evidence must be recorded properly through bookkeeping. Although bookkeeping practice changed throughout the course of history, today, the way we think about it is based on the paradigm of dual-sided bookkeeping. The double-sided entry of business events, which are also the subject of bookkeeping, admired the great writer [30], who declared it as one of the most beautiful inventions of mankind. The magic attraction of bookkeeping provides a system of equations which keeps track of the business enterprise that is, in its implicit form, manifested through eternal equality between the assets and the liabilities. On the other hand, in its explicit form, it demonstrates the interest of the owner in the company, evaluated, of course, from the book value perspective.

Throughout the history of a company, bookkeeping takes continuous snapshot of the state of affairs and operations. When put together, these snapshots animate the history of the company. In that sense, the images of this history present the means for public company communication with investor's public. In this way, the history becomes the baseline for predicting the future, in the extent that it relates business data as a result of business events which are the subject of bookkeeping records. The documentary nature of the bookkeeping notes reduces the possibility of legal manipulation in an effort to make it more appealing to investors, by using the two-sided bookkeeping technique, and through it, it allows easier detection of irregularities. Of course, this applies only to those who are familiar with the bookkeeping math assumptions and canons.

The documentary nature and ability of data checking based on it, in the base has a premise, that is, the double-sided entry values are estimated on the basis of the occurrence of a business event. Thus, bookkeeping is the base for judging quantity and, in part, quality of the company's economy. For a public company, as the most demanding form of business organization, it arises as the basis of the company communication with investor's public.

## 4.2. Accounting statements

To be able to communicate with different information users about the affairs and business of the company, bookkeeping data need to be presented in a particular shape that is formatted like standard information. On the mathematical basis of bookkeeping, this standard information is provided in the form of accounting statements. The largest number of such statements should be prepared constantly to run all business operations. This makes public company managers on all executive levels who supervise operations, and employees who execute tasks, their basic users. Based on the mathematics principals, bookkeeping and accounting derivatives have become a standard business language for communication with business people, financial experts, and economists, in general. Therefore, accounting statements are an integral part of any organized businesses.

Users of accounting information are the owners of the company, individuals, or a particular group of individuals. In the conditions of separation of entrepreneurial from ownership functions, especially in the conditions when the company becomes public, bookkeeping and the accounting statements based on it, become the basis of communication of public companies with a wide range of existing and potential owners. In this way, bookkeeping and accounting statements become an integral part of corporate management. Statements are subject to standardization and have a responsibility to the public; so, in a certain sense, one can talk about public accounting and public accountants.

Sole creation of accounting statements assumes one acquires the art of classifications and summary of bookkeeping data. This makes the data significant, relevant, and informative to the users enabling them to interpret it with a generally accepted business language [31]. The accounting statements which will communicate the bookkeeping information with the investor's public are those that summarize the entire business of the company: the balance sheet as well as the profit and loss statement. By expanding the requirements for communication and through modern systems of financial reporting, cash flow statements are becoming ever more common form of communication. These accounting statements are used to communicate with the investor's public through ranked statements of changes in financial positions.

Accounting statements are certainly an important part of corporate governance. They are the corner stone of public company communication with all stakeholders that have a direct interest in the company, as well as with potential stakeholders. This includes all those individuals and institutions who may find interest in that company through the mechanism of the financial markets. The corporate governance should focus on supporting to achieve the basic objectives of the company operations, which, for a public company is shown by increasing its common stock value in a long run. For corporate management, this is the most significant of those accounting statements, since through it they ensure continuous public company communication with its investor public over financial reporting mechanism. These are, therefore, the balance sheet and profit and loss account, and cash flow statement.

## 4.3. Auditing

We mentioned earlier that public company communication with investors' public on financial markets is, among other things, a means of attracting money and capital. In other words,

communications of a public company by disclosing data concerning realized and expected business through public announcements on the financial markets are also a means to attracting investors in the company. Speaking from a completely theoretical perspective, only an objective disclosure of data and information about the existing and the expected operations of the society ensures uninterrupted external financing of the company.

In the competitive real world surroundings, public companies struggle to attract as much capital under as favorable conditions as possible by communicating with the public. For a public company, the communication thus becomes the means for a competitive struggle in the money and capital markets. Therefore, it is logical to expect that the company will endeavor to send tampered reports to the public in order to paint a more attractive image of the company. With such an image, the company stands a better chance at raising money and capital on the relevant financial markets. Therefore, the distrust from the investment public toward the information is distributed from within the public company.

Due to the existence of distrust toward the publicly posted information and data that the company communicates with the investor's public about itself, the third component of public company accounting is auditing. Auditing, of course, applies only to that part of the communication that is based on the bookkeeping evidence and encompasses accounting statements. The audit should provide the legitimacy of accounting reports that will be published in the financial statements. It helps to inform the public investor more correctly; however, it is constrained with the basic formats of accounting statements as well as the logic of the business success of the companies that perform the audit. The wider the basis for the valuation of items in the financial statements and the more it is possible to endeavor in creative accounting, the more it is expected that the data will be more improved, or even worsen, depending on the need. The success of the companies performing audit depends on their fees. Furthermore, the company is represented by the management which has personal interest in painting a better picture of the company for their own reward [23]. Regardless of the fact that the company performing audit must seek to perform it *lege artis*, it is difficult to expect that it will not reach to a compromise agreement with the public company or its management in order to survive in the market, and in turn agree to lower the bar in some respects.

## 5. Communication in financial statements

Financial reporting is certainly one of the most important and the most intriguing area of finance standardization. For financial analysis, it is the basic analytical framework based on which it is possible to isolate and determine the underlying fundamental value factors of public companies and their stocks, as well as other instruments of financing. An important part of the financial reporting is the accounting of public companies. However, financial reporting as a whole goes beyond the scope of accounting. Financial supervision and various local practices significantly impact the content and the scope of financial reporting. As a means of communication with the investors, public company financial reporting is strongly influenced by the problem of agents in the conditions of asymmetry of information.



### 5.1. Contents of financial reporting

Originally, financial reporting is a standard practice of public company communications with his investor's public. The existing and potential investors invest in stocks, bonds, and other financing instruments a public company offers to the entire public. These instruments are marketable financial assets and are classified, in general, as securities on an active market. They can be considered as consumer goods, i.e., financial assets intended for a wide circle of investors. In this way, the financial reporting becomes a standardized means of communicating the value of a public company and the values of its individual financing instruments, and therefore determines the contents of financial reporting.

Financial reporting is exclusively inherent to public companies which, as a legal entity, function both as investors and investments. Stocks have a central place in this dual nature of public companies that have been created as marketable financial assets, and at the same time represent ideal claims to real assets, or to real investments of the public company in business projects. Stockholders can also have dual roles in the public company. They are also the owners of that company and its real assets, but at the same time, they are investors in the company stocks, and therefore, investors in financial assets [24]. Regardless of the stakeholder's role in the company, their goal is to achieve greater wealth and higher value by conducting financial analysis on underlying financial reporting.

The essence of finance is contained in evaluation and management of value. The value is perceived in the context of economic value which is the result of interdependence of risk and reward. In this way, the financial reporting content comes down to communicating with the investors not only about the expected earning power of the company and the expected yields on its stocks, but also about the risks of achieving the expected results. So that the expectations would not be built solely on promises, financial statements must contain data and information based on which the investors will be able to objectify the expected earning power and the expected stock yields of public companies. Therefore, financial reporting must contain information about the achieved business results of public companies and the risks to which it is exposed. Based on the achieved business results, investors will form expectations about the businesses ability to earn (reward), and according to the determined risk, they will establish appropriate cost of the capital, discount the expected results, and evaluate stocks, as well as other instruments of the public society.

A public company as well as other forms of business use debt to finance their operation. Money lender can also be treated as company investors. This is particularly true for large money lenders of public companies who monetize it by investing in bonds and other fixed income securities of these companies. When borrowing is observed through the scope of a public bond issue that will have an active market, lenders are no longer just the institutional lenders, such as commercial banks, but also the institutional investors, so that the contents of financial reporting must extend to the needs of such investors for the value evaluation and management. They are interested in the public company's business results, but much more in the risks involving their position in the unfortunate event of the company's fall before they return the borrowed money, because they do not have mechanisms to reduce asymmetries of information embedded in direct financial relationships between commercial banks and enterprises, as users of their loan [32].



## 5.2. Accounting and financial reporting

Accounting is inherent to all companies, small and big, private or state, public or private holding company. With all its flaws, accounting remains the best and therefore completely unavoidable part of the overall business statistics. Financial reporting is, on the other hand, different. Originally, it was intended only for the public companies which, in order to obtain the capital, have to communicate with investors. It is, therefore, inherent only to public company and basically unnecessary to all other forms of businesses. This does not mean that there is no need for data and information from other forms of businesses and privately owned companies. Without a doubt, there is a need to control the business and financial flows and to determine the proper tax base. Also, the law requires accounting in order to prevent fraud. Finally, it is an irreplaceable instrument of business people, managers, business and professional associations and chambers for account aggregation and mutual comparisons. In general, it is a necessary product of the existence of business statistics. Even though all these actions could be conducted using standard accounting, however it is rather illogical from the public reporting point of view. Specific reports and documents can be used for special purposes. For instance, tax reports are used to declare tax. During the investigation, the court will analyze various, if not all documentation coming from the company, and a statistician will do the same. All these data are given in a much less complicated form than the financial statements needed by the investor.

Because of the aforementioned characteristics of accounting, primarily because it is the best approach to business statistics, but also because of its ability to document, and in turn track the sequence of individual operations, it is logical that it is the basis for the preparation of financial statements. Therefore, aggregate accounting statements are an integral part of the financial statements. In accordance with the documentary nature, and the objectivity of accounting at the time of a documented business event, these accounts should be formulated on the principle of a historical value. To ensure the financial statements are complete and exhaustive, it is necessary to include the most important risks involving future business events together with these data concerning past operations and financial position of the company. This is due to the fact that investors buy stocks and other instruments of financing of the company on the basis of expected results, and not on the basis of the achieved results.

Today's practice of financial reporting is strongly influenced by various interest groups and various entities of the financial markets. One of the most significant impacts on the practice of reporting arises from the regulatory bodies and financial supervision. No matter what the role of the market regulator in protecting investors is, the preservation of the stability of the financial system is often imposed as the first objective of regulation and financial supervision. Because of the control of financial institutions, their financial placements and investments, financial supervision has imposed the principle where statements of financial assets are derived at the current fair market prices. In order to maintain the consistency of the report, this principle has spread on all real property sections of the financial statements.

## 5.3. Fair vs. historical value

Efforts on financial reporting standardization and harmonization aim to solve a series of controversy of the different basis and practice of reporting. This standardization solved the

dilemma of reporting on either cash or on the accrual basis in favor of the accrual approach. Even though this implied replacing the relatively straightforward approach with the complexities of the philosophy of the recurring profit measurement, this approach was almost unanimously decided between the creators of the standardization of the financial reporting, regulators and supervisors. In order to unify the profit reports, the community seeks to standardize certain methods of calculation, and since it is not possible to ascribe to any universal benefits in all possible circumstances, the application of different methods is allowed, which has to be clarified in the notes on financial statements.

Contemporary circumstance replaced a previous dilemma with the dilemma between the historical and fair price, at which the items will be evaluated in the financial statements. In practice, however, the applications of the combination of these two fundamental approaches to evaluation, as well as frequent changes to financial reporting standards are present. In this sense, one can conclude that in modern conditions, high complexity and variability of regulatory financial reporting basics are present [23]. This practice, of course, implies the need for a trained eye to interpret the presented information of a public company's business operations and other fundamental factors of stock and other financing instruments value.

Traditionally, accounting has been using historical prices to evaluate all items. They were the basis for accounting statements which, together with bookkeeping, enable one to more easily control and revise the financial transactions due to objectivity. Each of these reports reflects the realized prices and values at the time of a transaction and could be verified through a document under which it entered in the bookkeeping evidence. This characteristic of accounting is the key quality that ensured that it is so often used to indicate the status of a business, and the financial health of the company [29]. The problems of the complexity in the philosophy of profit stem from the accounting's orientation to the accrued basis.

Historical price can become questionable the more its booked positions are longer present in the evidence. For non-financial companies this will be reflected on the value of the fixed asset, although these values can be further provoked with the mechanism of calculating accounting depreciation. Financial companies use much more marketable assets whose prices change frequently in the financial markets. It is particularly emphasized at the open-end investment funds, for which the custody bank must daily establish the net asset value (NAV) at which the fund should redeem units from its members. Because the supervision focuses on financial relations and financial institution's supervision, as an active participant in the standardization of financial reporting, it is imposing a fair value for the valuation of items in these reports. This way, the financial statements incorporated additional subjectivity and other problems related to the evaluation.

In principle, there is nothing wrong with the commitment on a fair market value as the basis of valuation of items in the financial statements. The fair market value must include the risks on holding and managing the public company assets, as well as how they are perceived by the investors in the market. This then means that it is enough to present the balance sheet and profit and loss account, as well as complementary aggregate statement on the principle of the fair market value. The problem arises when one needs to determine the fair market value. There is nothing absolute in it, so it is not objective, which makes the assessment based

on finding the fair market value come down to the problem of estimation. All estimates are subjective, and they are the targets. Because estimates are made by those who use the financial statements to attract the investors, it is clear that this presents a problem. Such a decision can make the presentation of the aggregate account the result of creative accounting manipulation.

#### 5.4. Disadvantages of fair value

Previous discussion demonstrated that the market value of firm's assets is equal to the present value of free cash flows from firm's operation and market value of firm's financing instruments only in the conditions of perfect or extremely efficient capital market in equilibrium. Therefore, fair value concept is primarily oriented toward current market prices and it is straightforward to expect that the prices oscillate around real intrinsic value. In addition, fair value concept is targeted and burdened by subjectivity. Furthermore, accounting value of assets is focused on tangible assets rather than intangibles which are rarely the subject of bookkeeping evidence. There is no doubt that is necessary that the public company communicates information concerning intangibles with investor's public, [33, 34], but this communication is different from financial reporting.

Owners' equity can be recognized as a solution to the balance sheet equitation which makes it easy to observe the connection between the recorded and the market value of the stocks. Once the capital is acquired (paid-in capital), its recorded value of stocks increase as the earnings are retained. Earnings are retained so that the company can make profitable investments. This will increase the company's earnings directly from investment operation. Retaining these additional earnings will increase the value of stocks. Capital market is always observing the business operation and investments made by the company. As soon as the market recognizes a profitable investment, their present value will be incorporated in the stock price before it increases earnings from profitable effectuation of the investment. Due to the time it takes the investment firms to boost their recorded values, the values themselves will fall behind the market values so that they can serve as an indicator of the stock price, but at the same time, cannot reflect their fair value.

Another problem of book value for evaluating stocks stems from the residual position of the owner equity in the balance sheet. Starting from the balance sheet equitation it is evident that the owner equity is a variable that depends on two factors: assets value and liabilities value. In this way, the value of the ownership equity depends on the mode in which the positions of assets and debts are evaluated in the balance sheet. In principle, there are two approaches to valuation of the position in the balance: on the concept of historical cost and on the concept of fair value. Today's balance sheet shall be drawn up according to a model that combines these two approaches. This has a dual effect on the value of the ownership equity.

- On one hand, evaluation on historical cost will fall behind the fair value, especially for assets that are present longer in the company operations, because its recorded value is burdened with the passed time and the corrections that only coincidentally match the loss of economic value due to the expiration of the asset lifetime.

- On the other hand, fair value contains subjectivity in its estimate, because most often there is no possibility to objectively estimate fair market value. Moreover, this estimate is burdened with the subjective views of the reporting manager, Chief Executive Director who represents the company, and the executive management. For them, financial statements are the means for attracting investors as suppliers of capital, so it is logical that the presented statements suffer, in some extent, from creative accounting.

Apart from the fact that the book value will lag behind the market value, it may not reflect other market views according to the unique property which the analyzed company utilizes in its operations [14]. Book value also does not reflect the views of the unique and total earning power of the company or the earning power of specific segments of the overall operations of the company. Throughout the history of the capital market, it has been proven time and time again that the market favors activity from which it expects rapid growth and the benefits of using new technologies. Here we indicate only some of the problems that impair the ability to use the book value as a substitute for the fair market value of the stocks:

- Failed company. Over-indebtedness of the company which has not filed bankruptcy because its debts are not yet due can have an added value with respect to the recorded value. This is due to the effects of agents making high-risk investments, or the distribution of earnings to the owners, etc. It is about taking full advantage of the optional value of unlimited liability as a put option on the value of the property contained in the equity of the indebted enterprises [35].
- Positive assessment of efforts in R&D from the market. Although it is difficult to recognize the true net present value of an investment in the research and development, market can pay a premium on option for a company which is assessed as innovative in a particular industry expecting positive cash flows from exploitation of the results of R&D in the future, or the added value of patents and licenses resulting from this research [36].
- Positive assessment of the company's additional future investment opportunities due to the undertaken investment in technology changes, production processes, the introduction of new products, and the entry into new markets [37].
- Market assessment of the impact of acquired subventions or guarantees from the State or local community [38].
- Market assessments of several externality effects as well as externalities which occur between the company and its investment opportunities, etc.

### 5.5. Earnings management

Earnings management, creative accounting, or window dressing are euphemisms that talk about using the allowed methods and procedures of financial reporting, which certainly do not reflect the spirit of fair reporting. Earnings management aims to paint a more favorable (or unfavorable) image of a company in the presented financial reports. Even though it is not illegal, earnings management is highly nonethical, especially when it is made to create the greater basis for management compensations.



Financial statements are the means of communication with the public company's investor's public. They are also the means of attracting investors, and serve as a sort of advertising material which the company gradually creates for its capital "suppliers." Certainly, the power of this promotive sheet stems from the creation of the economically eligible earnings through an extended period of time. Also the creation of economically eligible earnings is a prerequisite for preserving the independence of the company, and the defense against hostile takeovers. One could compare the company's financial statements with a person's CV. In the curriculum vitae, as well as in the financial statements, individuals will strive to present the facts in a way which helps them accomplish the expected results.

No doubt that the financial reporting standardization and harmonization increase the quality of financial reporting worldwide. It is to be expected that this practice decreases the level of earnings management. Many countries with different tradition of financial reporting and investor's protection practice adopted International Financial Reporting Standards (IFRS). However, earnings management practices tend to be distinct for each country [39]. Furthermore, the application of IFRS does not guarantee the elimination of earnings management. IFRS ever more applies fair market value principles for judging aggregate accounts in financial statements which extend the subjectivity and target estimations. However, it is possible to achieve the same effect through historical price estimates.

All estimates of the market value have a subjective nature. When they are performed for public presentation, these estimates are also targeted. The fear of loss of capital suppliers, or the fear of falling stock prices caused by dissatisfied stockholders and which might attract hostile actions toward the company management, are the reasons enough for the management to reach for little creativity in its estimates. Even more logical is that the person who wants to paint a good picture of him or herself to the public, sees himself in a fairer light, rather than see through the eyes of independent objective observer. Does it not seem illogical that the investors, who should create their estimates on the basis of published reports, receive estimates from those who seek money from these investors?

Earnings management is partly limited with the necessity for financial statements auditing which reinforces their legitimacy. Auditing is a strong tool for agency cost reduction. However, auditing has its limitations as well. Partly these limitations come from difficulties in the possibility of eliminating the subjectivity from the estimated financial statement items. The second limitation is related to the fact that an audit is performed for the needs of shareholders and the investor's public in order to objectify published data in the financial statements. The fact is, however, that the auditors are hired and paid by the company's management board, which the audit should control.

The practice of targeted evaluation regarding the prices manipulation and fraud related to financial reporting is more intense in conditions of the overheated financial markets, when things are going well and control mechanisms are relaxed, rather than after the fall, when all the market participants "are cold" and scarred. Therefore, the history of the financial markets can be observed through various forms of manipulation and fraud, and the efforts in regulations to minimize or even avoid them completely. The results of regulatory efforts are additional creativity, new procedures, and methods of manipulation and fraud. More significant cuts and changes to the regulations are performed normally after the collapse, as was the case



with millennial collapse and the efforts of regulatory bodies and States to rectify the situation for the future. Of course, such a regulation causes additional costs of corporate governance for public companies. It has, of course, happened and with the already mentioned SOX [40–42].

The practice of financial reporting is under the influence of financial supervision and obtains the stability of the financial system primarily oriented to the protection of creditors, not the investors and their need for fundamental analysis. The stand point of the possibilities of manipulation and the missing tools against them that have investors toward financial supervision and its direct control subjects, and the standpoint of the implementation of the fundamental analysis of the orientation toward the fair market value seem illogical. Presentation of the aggregate account with estimated entries on the undisputed documented historic value together with the practice of publication of the risk which is exposed to the operations of the public company seems more logical for the purposes of the valuation of the company as investments, or for the purposes of the valuation of its common stock. Starting from the previous practice, it is possible that the financial statements contain a set of aggregate accounts estimated at fair market value and documented historic value together with a report about the risks.

## 5.6. Management compensation

The practice of rewarding the management of companies on the basis of the achieved business results has additional forces to earnings management. In this way, the company managements are double motivated for publishing the good business results; once for securing capital provider and second time for personal gain made through shares in the profits and protection from risk of takeover and loss of its position in company.

Manager's reward system is certainly one of the key controversies in modern public companies. One of the recommendations for the investment of the famous Warren Buffett is to buy shares of companies that are run by the fair management. Fair management is one who does not take excessive fees for their work, especially the options on the stocks of the company which they run [43]. With this, Buffet has directly linked to Graham [24], who is also against management compensation in stock options. In addition, here, EFFAS [44] recommendation is: *Remuneration systems should be based on the sustainable, long term development of a company. Extremely high remuneration packages (including base salary, bonus, and stock options) should not occur, since they will not be based upon any realistic underlying business trend. If this is the case, management assumes neither responsibility nor risk. People who are excessively highly remunerated will not necessarily be interested in the long lasting success of their company.*

The significance of the problem of rewarding managers illustrates this EFFAS [44] recommendation about paid out dividends vs. paid out bonuses: *This is a crucial and short-term orientated issue. Investment banks, or universal banks in which investment banking is a very significant component, have been paying out overall bonuses in amounts that are similar in size to the overall annual dividend. This practice should be ceased, because shareholders have the right to receive an appropriate dividend payout that is directly related to the overall net profit of a company.* In addition, problem is that this reward, in fact, grants management to itself rather than stockholders. Furthermore,

managers have the possibility to reinforce yield on options in short term due to asymmetries of information. In addition, dividend payments vs. retention of earnings in the public company represent means of reducing the problem of agents and the potential costs of the agents. That being said, the payout of the bonus becomes direct cost of agents, which does not make sense from the standpoint of motivation and management monitoring.

## **6. Communication on risk**

Financial statements are determined as accounting reports on realized earnings power and financial potential. Based on them, one can make judgments about the expected earning power, as well as about the presentation of the risks associated with them. Financial statements presented on the fair market value basis implicitly include risks, but they do not eliminate the need for risk reporting.

### **6.1. Risk contained in fair value**

Risk is implicitly included in fair market value, because market prices oscillate around assets' intrinsic value, and that is established as present values of expected cash flows discounted by risk-adjusted discount rate. However, this does not mean it satisfies the needs of reporting about the risks of a company's earning power. It is just the opposite.

First, the fair market value can be determined relatively easily for a very small number of company assets, and it is possible to provoke if so the determined values are truly fair. This means that for the majority of assets, it is all about the estimated value instead of the fair market value. Furthermore, it is a subjective assessment made by the company's management as an agent of stockholders and future company equity suppliers. Rational investors with risk aversion could not make unbiased decisions based on that information, regardless of what behaviorists thought about them [45].

Second, due to the assessment subjectivity and its burdens of potential conflict of interests between management and stockholders, such assessments are targeted and subjected to manipulation significantly more than this was thought possible based on historic values. These extremely biased information that are based on management's estimates, should serve the investors for their assessment.

Third, only on the perfect market is the value of the company assets equal to the value of its liabilities and equity, and these assets are valued fairly only in conditions of the market equilibrium. Presentation of the assets' fair market value in financial reports does not include a majority of intangibility. It is presented as the sum of the estimated value of the individual, mostly tangible, assets, rather than its value as a whole. Namely, the company's earning power depends not only on the assets which it holds, but also on how those assets are used. The ability to use assets could be judged by observing how it is used in business projects. This means that the earning power is committed by the company's business portfolio, so the value of the business portfolio should match the value of the liabilities and equity, with included

adjustments for additional financial risk. When you include the business portfolio approach in the values analysis, the group of companies and the need for group reporting further complicates the valuation.

Fourth, and also connected with the previous, the assets' fair value implicitly includes the risks of keeping the individual forms of assets. In no way does it include business risks that are connected with the way of combining these assets and using them in the company operations. Thus, it is evident that reporting based on a fair value is not intrinsically connected with risks of expected earning power of the company, and thus, it provides insufficient information about the risks for the investors in the company owners' equity. The risks included in the assets' fair value are not essential for equity investors, but for creditors, and especially for commercial banks that modify its internal credit ratings and so reduce the asymmetry of information in relation to other investors.

## 6.2. Risk management

Risk and yield are key value components. Value is realized by risk-reward trade-off during specific time. In the context of economic value, risks determine risk-adjusted discount rate for discounting expected yields, expressed by cash flows. According to modern portfolio theory, the only relevant is systematic or market risk, meaning the risk that could not be avoided by diversification [46, 47]. These assumptions are built into the CAPM [48] as still the most popular model for establishing risk-adjusted discount rate.

The risk of achieving expected cash flows is one of the key value components. It is therefore logical that risk management is one of the areas of value management and a means of achieving greater value. Primarily, this is the management of financial risks, and therefore diversification imposes as a means of reducing risk. Diversification helps avoid a significant part of the total risk, the specific part, based on the principle "don't keep all eggs in the same basket." Diversification is basis for financial investments portfolio management. Although the diversification scope of the real investment is limited, diversification can also reduce the risk of keeping such investments. Thus, regardless of the controversy should the company diversify its activities or not, today, it is difficult to find a mono product company.

The increased importance of risk management outside the diversification area appeared at the beginning of 1970s, when, due to leaving the Breton Woods Agreements and the oil shock, significant currency and interest rate risks have emerged. At the same time financial futures contracts, financial options, and other financial derivatives appeared, as the powerful tools to reduce, and even eliminate these risks [49]. The most intense managing of such specific financial risks was in the banks and financial institutions, partially due to the fact that these companies employed most highly educated and well-trained financial analysts, and partly under the influence of financial supervision [50]. Specific risks managing practice transferred to non-financial companies, so that it has become an integral part of the corporate governance [51].

In modern conditions, risks management becomes an organized activity. Financial institutions are encouraged by financial supervision. Other public companies also require organized

risk management rather than managing only specific risks. In the US, the before-mentioned financial regulation reform foresees reporting on risk management, which implicitly requires organization of these efforts.

Risk reporting and accounting reports are identified as an integral part of the financial statements presented to the public companies stockholders and equity investors of these companies. In this context, setting requirements for this reporting by those who have an impact on the reporting practice are an important step and challenge for the improvement of financial reporting and communication between public company and existing and potential investors in ownership equity. It would not be a good to identify risks reporting, as an integral part of the financial reporting, with drawing up of the accounting reports, as has been the case until now, because communication with the public exceeds the accounting responsibility and activity. Also, it would not be a good thing to reduce risks reporting on the reporting of risk management, which is today's financial supervision request from financial institutions, because it is again reporting evaluated by those who send specific picture to the investors' public.

## 7. Conclusion

Although the financial function is one of the fundamental functions of every company, Chief Financial Officer (CFO), as stated in this analysis, is needed only for the public companies. He or she is a member of the company's Board whose key task is permanent communication with the investor's public. In that sense, he is the procurator of the Chief Executive Officer (CEO) in the area of mediation between the needs of the company for the money and capital and investor's public. CFO is also responsible for other financial operations: treasurer and controller of the business. Thus, CFO is the most responsible person for the financial statement presentation, as the CEO Deputy, who bears the ultimate responsibility running the business. An accountant may only be responsible for the preparation and the presentation of accounting statements. Because accounting statements are the basis for the financial statements preparation, the responsibility of the accountant is internal, toward the CFO and the Board, and not external, toward the investor's public. Financial officer is not required in private companies because the integrity of the communication for them is an unnecessary and an expensive activity. These companies report for tax purposes and some wider control requirements of the State.

Based on the analysis of the practices and institutional framework of the company's communication with the investor's public, in the context of the totality of corporate management, a special attention is paid to the communication through financial reporting, as it is today commonly observed in the standard set of financial statements, which are indeed accounting statements presented with the combination of historical and fair market prices. The chapter determinates that this reporting practice is not oriented toward investors in public company equities, because this practice enables sufficient insight in the expected earnings power and the risks to achieve it. In that context, a request is set that the correct financial reporting

oriented to existing and prospective investors in the company equity, must contain a sufficient objectivized description of the reached earnings power and financial potential in accounting reports to establish the expected earnings power and risks to achieve it, in order to establish the appropriate discount rate.

Today's financial reporting is institutionally complex because of mixed evaluation bases, historical and fair market value. Standards constantly change, most commonly by broadening the evaluation toward fair market value. This reporting is oriented toward the evaluation of fair market value of assets that the company owns rather than the evaluation oriented to company earnings power that is in the focus of equity investors. Thus, this reporting is oriented to lenders. Assets fair market value orientation is not comprehensive, because it commonly excludes externalities, uniqueness of assets combining and intangibles from evaluation. Therefore, it is oriented to lenders showing tangible assets value as company debts collateral. The fair value of assets lags behind earnings power valuation, at least because the evaluation of earnings retained as investment potential are recognized by the market through the net present value of expected investments. Also, fair value is targeted and burdened with subjectivity and evaluation toward painting a picture that will attract investors as the suppliers of company capital.

The chapter develops literature review around the quality of company communications and its potential impact on firm value and firm valuation. It is also primary oriented on financial reporting as the analytical framework for fundamental analysis of the company and its common stocks. Thus, review is limited on this main form of communication. Therefore, it is interesting to investigate the impact of other form of firm communications with investor's public on equity valuation. Another interesting area of investigation is the possibility of impact of fair market principles on earnings management. According to the goals of the chapter, there are many possibilities for further investigation in secondary and primary data, to determine factors that can improve financial reporting and other form of communication with equity investors, particularly about the risk exposure of the firm.

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