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Forward-looking disclosure and corporate reputation as mechanisms to reduce stock return volatility

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ABSTRACT

The purpose of this paper is to investigate whether forward-looking disclosures and corporate reputation lead to a reduction in stock return volatility. This study measures financial forward-looking information, by conducting a content analysis of annual reports for a sample of US companies. Since every annual report was manually examined and coded, the study is therefore restricted to the companies listed in Standard and Poor's 100. Results show that financial forward-looking information has significant effects on capital markets. This study contributes to the current literature on voluntary disclosure, by examining the link between the disclosure of financial forward-looking information and stock return volatility. Since stock volatility is linked to information asymmetries and to a higher risk of a company, this analysis implies certain practical implications for both managers and regulators regarding the importance of specific disclosure strategy in capital markets. Moreover, results indicate that forward-looking information disclosed by companies of a higher reputation has a greater effect on stock return volatility. This is the first study that demonstrates that corporate reputation moderates the effects of forward-looking information in capital markets. In addition to the level of disclosed information, the interpretation and the effectiveness of forward-looking information depends on the reputation of a company.

La divulgación de información previsional y la reputación corporativa como mecanismos para reducir la volatilidad de las acciones

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RESUMEN

El objetivo de este trabajo es investigar si la divulgación de información previsional y la reputación corporativa llevan a una reducción de la volatilidad de las acciones. La información previsional financiera es medida mediante un análisis del contenido de los informes anuales de una muestra de empresas estadounidenses. Puesto que cada informe anual fue examinado y codificado manualmente, la muestra se limita a las empresas que aparecen en Standard and Poor's 100. Los resultados muestran que la divulgación de información previsional financiera tiene efectos significativos en los mercados de capitales. El trabajo contribuye a la literatura existente, examinando la relación entre la divulgación de información previsional financiera y la volatilidad de las acciones. Dado que la volatilidad de las acciones se asocia a la existencia de asimetrías informativas y a un mayor riesgo de las empresas, los resultados tienen implicaciones directas para empresas y reguladores respecto a la importancia de las estrategias específicas de divulgación de información previsional. Adicionalmente, la información previsional divulgada por las empresas más reputadas tiene un mayor efecto en la volatilidad de las acciones. Este es el primer estudio que demuestra que la reputación corporativa modera los efectos de la información previsional en los mercados de capitales. La interpretación y la efectividad de la información previsional no depende sólo del nivel de divulgación, sino también de la reputación de una empresa.

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Introduction

In theory, increased levels of disclosure reduce the possibility of information asymmetries, as measured through bid-ask spread, stock liquidity and stock return volatility (Cormier, Ledoux, & Aerts, 2010). Nevertheless, the literature provides no clear definition of the concept of "increased levels of disclosure" (Leuz & Verrecchia, 2000). Previous research suggests that information quality affects the uncertainty about the future of a company and stock volatility (Easley & O'Hara, 2004; Pastor & Veronesi, 2003). Disclosure may take various forms, and not all kinds of information disclosure would have the same impact on capital markets. Both managers and policymakers are interested in ascertaining which information is useful for investors and which can have an effect in capital markets. Specifically, forward-looking information has become crucial, since historical information could be insufficient for investors. Both organisms and researchers have stated the significance of forward-looking information in order to improve the forecasts about a company and ease decision-making processes in capital markets. Despite stock volatility being a concern for both regulators and managers, the association between forward-looking information and stock return volatility remains unexplored. On the other hand, there is an ongoing debate concerning how investors value and interpret the information disclosed by companies (Beyer, Cohen, & Beverly, 2010). Each company transmits a different degree of confidence to the markets. The vast majority of studies have focused on the level of information disclosed, but the effects of disclosure practices can be further varied depending on corporate reputation. Although the resource-based theory emphasizes the importance of corporate reputation, evidence fails to demonstrate that this intangible resource can also influence disclosure practices and changes in the stock price. Since the reputation of the messenger should play an important role in the effectiveness of the message (Mercel, 2004), investors may have a positive emotional predisposition when interpreting information disclosed by firms with a high reputation.

This paper extends previous research by analyzing the effect of financial forward-looking information (such as earnings forecasts, expected revenues, and anticipated cash flows) on stock return volatility. This information can provide a major source of corporate disclosure differentiation, since it is verifiable ex-post, and hence its disclosure may lead to greater accountability and an increase in reputational costs. Research has specifically considered the disclosure of forward-looking information of a financial nature, however previous studies have yet to analyse the relationship between this information and stock return volatility. This paper also analyses the effect of the financial forward-looking information disclosed by most reputable firms on stock return volatility. This is the first study that investigates how corporate reputation moderates the effects of forward-looking information. This study extends previous research by showing that, in addition to the level of disclosure and the source of information, the reputation of a firm may also influence the effect in capital markets of the information disclosed by companies. Information disclosed by firms of a higher reputation can better mitigate stock volatility through an enhancement of the credibility of the information.

The sample of this study is made up of the companies in the Standard and Poor's 100 in the year 2009. In order to measure the level of information, all annual reports are individually examined and manually coded. The results show that the disclosure of financial forward-looking information reduces stock return volatility. Managers could benefit from these findings, which support the idea that investors and financial analysts take advantage of financial forward-looking information. Furthermore, these results may well be of interest to regulators, as they could set information requirements more efficiently to reduce information asymmetries in capital markets. Secondly, the results suggest that financial forward-looking information disclosed by companies with a better corporate reputation is more effective in reducing stock return volatility. This evidence is relevant for managers, who must be aware of the importance of the creation and maintenance of corporate reputation in the effectiveness of disclosure strategies.

The paper proceeds as follows. "Theoretical framework and hypothesis development" section contains a conceptual background and the hypothesis development. "Research design" section describes the sample and explains the research design. The main results of the study are presented in "Empirical results" section. Summary and conclusions are provided in "Conclusion remarks" section.

Theoretical framework and hypothesis development

Theory predicts that an increase in the level of disclosure should reduce information asymmetries in capital markets, and this would lead to many potential benefits (Healy & Palepu, 2001). Corporate disclosure is crucial for the functioning of capital markets, and several potential effects have been associated to a reduction in information asymmetries: an improvement in stocks liquidity, a decrease in companies' cost of capital, and an increase in financial analysts' following (Healy & Palepu, 2001). In particular, low levels of volatility suggest fewer information asymmetries, and previous studies have considered stock return volatility as a proxy for information asymmetry (Cormier et al., 2010; Lang & Lundholm, 1993; Leuz & Verrecchia, 2000). Stock return volatility has received a great deal of attention since it is an important issue in both theory and practice. An increase in stock return volatility would lead to a higher perception of the risk of a firm and hence, a rise in the cost of capital of companies (Bushee & Noe, 2000). These authors also state that volatility can become a negative indicator for firm value, thereby making stock-price compensation less effective and/or more costly. The increase of stock volatility in recent years and the expected impact of information asymmetries on stock prices have raised questions about whether financial information can mitigate stock return volatility (Rajgopal & Venkatachalam, 2011). Prior research in the accounting and finance literature offers several reasons why information can affect stock return volatility. Specifically, a decrease in information asymmetries would imply a reduction in the periodic surprises about a firm and make its stock price less volatile (Bushee & Noe, 2000). Pastor and Veronesi (2003) argue that poor information quality affects the uncertainty about the future performance of a company. Easley and O'Hara (2004) find that financial reporting quality influences the information environment of a company and hence, its cost of capital and stock volatility. Nevertheless, the literature lacks any provision of evidence concerning the relationship between the disclosure of forward-looking information and stock return volatility.

Literature on disclosure tends to use general measures of information based on subjective ratings provided by analysts (Brown & Hillegeist, 2007; Haggard, Martin, & Pereira, 2008) or self-constructed indices (Botosan, 1997; Michelon, 2013; Rodríguez-Domínguez & Noguera-Gámez, 2014). The majority of prior studies that have analysed the effect of voluntary disclosure on capital markets have focused on the level of the disclosed information in the annual reports. Although capital market participants are expected to use all sources of information to make decisions about a company, annual report disclosures are shown to be highly correlated with other ways of communication (Botosan, 1997; Lang & Lundholm, 1993). Both mandatory and voluntary information have been addressed by researchers. Specific types of information have been examined: intellectual capital (Husin, Hooper, & Olesen, 2010), segment information (Prencipe, 2004),