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Financial statement comparability and expected crash risk☆

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ABSTRACT

This study examines the impact of financial statement comparability on ex ante crash risk. Using the comparability measures of De Franco et al. (2011), we find that expected crash risk decreases with financial statement comparability, and this negative relation is more pronounced in an environment where managers are more prone to withhold bad news. We also provide evidence that comparability can mitigate the asymmetric market reaction to bad versus good news disclosures. Our results suggest that financial statement comparability disinclines managers from bad news hoarding, which reduces investors' perceptions of a firm's future crash risk.

1. Introduction

Comparability is a unique qualitative characteristic of financial information that enhances its usefulness (Financial Accounting Standards Board, or FASB, 2010). Differing from relevance (reliability), which focuses on the predictive (confirmatory) aspect of accounting information, the FASB defines comparability as the quality of information that enables users to identify similarities and differences in financial performance across firms. In this sense, comparability is particularly important to investors in the equity and debt markets, since their investing and lending decisions essentially involve evaluations of alternative opportunities or projects and these decisions cannot be made without comparable information (FASB, 1980).

Despite the importance of comparability emphasized by policymakers, empirical studies on comparability are relatively scarce and evidence of its usefulness is limited (Schipper, 2003). De Franco et al. (2011) empirically examine the benefits of comparability by focusing on analyst forecast accuracy, coverage, and dispersion. Subsequent studies have examined the impact of comparability on debt market participants' assessment of firm credit risk (Kim et al., 2013), acquisition decisions (Chen et al., 2014), and managers' propensity to issue earnings forecasts (Gong et al., 2013). Other studies examine

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comparability by focusing on the adoption of International Financial Reporting Standards (IFRS) (e.g., Lang et al., 2010; DeFond et al., 2011, 2013; Barth et al., 2012, 2013; Yip and Young, 2012; Wang, 2014).

Motivated by the limited research on information comparability, this study examines the impact of financial statement comparability on ex ante crash risk, which represents investors' subjective assessment of future stock price crash risk. Interest in investors' perceptions of crash risk has been increasing, particularly since the 2008 financial crisis. In the advent of the crisis, investors' lack of confidence and fear of further decreases in prices have been identified among the various culprits behind the dramatic price declines. In discussing responses to the recent financial crisis, Blanchard (2009), then the chief economist of the International Monetary Fund (IMF), outlined, "So what are policymakers to do? First, and foremost, reduce uncertainty. Do so by removing tail risks, and the *perception* of tail risks." Thus, understanding what affects investors' perceived crash risk warrants our research.

Prior studies on crash risk often attribute stock price crashes to managers' intentional information management (Bleck and Liu, 2007; Hutton et al., 2009; Kim et al., 2011a, 2011b; Kim and Zhang, 2015). At the center of this information theory are managers' incentives and ability to hide bad news. When hidden bad news accumulates to a certain threshold, it will come out all at once, resulting in an abrupt, large-scale decline in stock price, namely, a stock price crash.

Recent studies on comparability suggest that a firm's financial reporting comparability can lower users' information acquisition and processing costs and increase the quality of financial information (De Franco et al., 2011b, 2011a; Barth et al., 2012; Kim et al., 2013; Chen et al., 2014). For example, Kim et al. (2013) argue that comparable financial statements make it easier for investors to understand and evaluate firm performance, since fewer adjustments and less judgmental calculations with accounting numbers are needed when comparing a firm's performance with that of its peers. De Franco et al. (2011) argue that comparability facilitates information transfer among comparable firms, such that investors make sharper inferences about their economic similarities and differences.

We argue that these benefits of comparability reduce managers' incentives and ability to withhold bad news. This is because, by having access to and being able to understand information from comparable firms, investors can not only gain a better understanding of a firm's performance but also obtain some of the bad news about it through inferences based on the performance and/or disclosures of its comparable peers, even in the absence of its disclosure.[1] Since investors may have already obtained some of the undisclosed bad news about a firm by analyzing its comparable peer firms, the benefits to managers from bad news hoarding are likely to be smaller while the associated costs are likely to be higher. Therefore, the improved comparability disinclines managers from engaging in bad news hoarding behaviors. We thus predict that investors perceive those firms with more comparable financial statements to be less crash prone.

To test our prediction, we employ firm-specific measures of financial statement comparability based on De Franco et al. (2011), who define comparability as the closeness between two firms' accounting systems in mapping economic events to financial statements. We measure firm-specific ex ante crash risk as the steepness of the implied volatility smirk.[2] Using a large sample of firms with traded options from 1996 to 2013, we find that financial statement comparability is significantly and negatively associated with the steepness of the implied volatility smirk.[3] For instance, we find that, on average, the volatility smirk is 9.52–11.90 percent higher for firms in the bottom decile of comparability than for firms in the top decile.[4] These results are in line with our prediction that financial reporting comparability decreases the ex ante crash risk perceived by investors in the options market.

We further explore the settings under which we expect the comparability-crash risk relation to vary cross-sectionally. We find that the negative relation between comparability and investors' perceived crash risk is more pronounced for firms in a lower-quality information environment, for firms with weaker external monitoring, and for firms operating in a less competitive industry. These results suggest that the effect of comparability on investor-perceived levels of crash risk is more pronounced when managers' incentives and/or ability to hide bad news is less constrained.

To corroborate our conjecture that financial statement comparability disinclines managers from withholding bad news, we examine the effect of comparability on voluntary corporate disclosure of bad versus good news. Kothari et al. (2009) find greater stock market reactions to managers' disclosure of bad news than to that of good news, suggesting a general tendency for managers to accumulate and withhold bad news relative to good news. Employing the methodology in Kothari et al. (2009), we find that financial statement comparability can mitigate the asymmetric market reaction to voluntary releases of positive versus negative dividend changes and that of good news versus bad news management earnings forecasts. This finding lends credence to the view that financial statement comparability tends to constrain managers' bad new hoarding behavior.

[1] This notion of using information from a firm's comparable peers to assess its performance is well established in the literature. Accounting textbooks almost invariably emphasize the necessity of using a firm's comparable peers in judging its performance (e.g., Libby et al., 2009). Recent studies have documented the use of peer information in determining managers' compensation (e.g., Albuquerque et al., 2013), in making analyst earnings forecasts and stock recommendations (e.g., Bradshaw et al., 2009; De Franco et al., 2011·, 2015), and in applying audit analytical procedures (e.g., Hoitash et al., 2006; Minutti-Meza, 2013).

[2] The option smirk curve is widely recognized as an indicator of investors' expected crash risk (Dumas et al., 1998; Bates, 2000). This paper uses the terms *implied volatility smirk*, *volatility smirk*, and *implied volatility skew* interchangeably.

[3] Daily equity option trading data from OptionMetrics are only available from 1996 on.

[4] This economic effect is based on the ordinary least squares (OLS) results shown in Table 2.