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Shadows in the Sun: Crash Risk behind Earnings Transparency

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Abstract

Prior studies suggest that earnings and non-earnings information can be complementary to each other (Lundholm, 1988). Given the co-existence of both components, a lack of non-earnings information can end up boosting earnings explanatory power on returns in certain circumstances, producing spuriously high earnings transparency (ET) in Barth et al. (2013). This scenario is plausible when insiders are motivated to exploit their information advantage and discretionarily alter non-mandatory disclosure strategy. Conditional on higher insider trading profit, we uncover a positive relation between the firm-specific earnings transparency and crash risk. In addition, the above relation is more pronounced with respect to selling and profitable insider transactions. Overall, we demonstrate a potential dark side of high earnings explanatory power on stock returns, conditional on higher likelihood of non-earnings information hoarding.

Keywords: Information Complementarity; Earnings Transparency; Crash Risk; Insider Trading

JEL Classification: G01, G14, M41, M48

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