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## Do voluntary disclosures of bad news improve liquidity?



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### ABSTRACT

Can managers improve market liquidity and lower the cost of capital by providing voluntary earnings guidance? This study examines the impact of profit warnings on market liquidity and finds that voluntary disclosure of bad news actually improves market liquidity. By conducting an empirical study over the period 1995–2010 on NYSE, NASDAQ and AMEX listed firms, we find that firms that issue profit warnings show enhanced market liquidity during the post-announcement period. We show that profit warnings reduce information asymmetry and lower bid-ask spreads and increase trading volumes. These results are invariant to daily (short run) and monthly (long run) data after controlling for firm specific attributes. The results have major corporate policy implications. By voluntarily disclosing negative earnings guidance by managers, firms will experience significant improvement in market liquidity, thereby lowering the cost of capital. Our results are even more profound for firms that release bad news with extremely negative stock market impact. In other words, voluntary disclosure of bad news is good for market liquidity.

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### 1. Introduction

Equity markets are characterized by information asymmetry (Jensen, 2005; Jensen & Meckling, 1976). Firm's managers have more information about the expected profitability of the firm than investors. Sometimes, the firm's profit performance falls short of expectations and managers voluntarily choose to issue profit warnings (PWs), causing investors to revise their assessment of firm value. Prior literature have examined the impact of firms' disclosure on information asymmetry especially on cost of equity (Leuz & Verrecchia, 2000; Levi & Zhang, 2014). Changes in disclosure and consequent changes in information asymmetry are known to affect liquidity. The main aim of this study is to examine the impact of PWs on different measures of market liquidity, using a unique hand-collected dataset from the United States over the period 1995–2010.

PWs are issued by management before a quarterly earnings announcement where reported earnings will be less than the market consensus forecast of analysts. PWs differ from earnings announcements in the sense that it occurs irregularly and unpredictably across firms and time and convey unique information and are issued well ahead of earnings announcements. PWs are special forms of earnings guidance, which tend to occur when managers realize that they will not be in a position to meet earnings expectations; they can be considered as revised information (management guidance) about prospective firm's performance. PWs provide more material to those investors who attempt to process such information to create private benefits. PWs are voluntary disclosures and like other bad news, such as negative earnings surprises, bond rating downgrades, dividend cuts, analyst downgrades, financial restatements, etc. are meant to reduce information asymmetry in the market.

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PWs thus provide valuable information that has not been evaluated and processed by financial analysts (Jackson & Madura, 2003). How stock prices react to negative news – as news or noise – has been a topic of long-standing interest in finance. Skinner (1994, 1997) and Healy and Palepu (2001) argue that litigation risk<sup>1</sup> potentially induces firms to disclose forward-looking information. Thus, if PWs could reduce information asymmetry and reduce the level of adverse selection in the market, then it could have a positive impact on stock market liquidity around the PW news releases (Balakrishnan, Billings, Kelly, & Ljungqvist, 2014; Glosten & Milgrom, 1985; Kyle, 1985; Verrecchia, 2001). Therefore, announcement of PWs could be good news from the point of market liquidity and, this, in turn, could reduce the cost of capital (Levi & Zhang, 2014).

Diamond (1985), Diamond and Verrecchia (1991), and Balakrishnan et al. (2014) show that managers may sometimes disclose more than what is required by market regulators. However, the market impacts of such disclosures are uncertain as managers do not know the market participants' entire information set (Dutta & Trueman, 2002; Dye, 1998; Dye & Sridhar, 2002; Suijs, 2007). Moreover, the release of new information changes market participants' expectations as well as stock price discovery. Empirical evidence shows that PWs have, on average, a negative abnormal return during the announcement window (Bulkley & Herrerias, 2005; Church & Donker, 2009; Jackson & Madura, 2003, 2004, 2007; Xu, 2008). But, the recent financial crisis has shown that compounding of bad news can affect the market sentiments and liquidity. In this context, an important question is whether negative earnings guidance disclosed by managers, such as PWs, could improve market liquidity or not? Our study is unique as it shows that releasing negative earnings guidance in the form of PWs reduces the information asymmetry in the market and impacts liquidity. The empirical results are based on a large sample of PWs in the United States during 1995–2010. Our study contributes to the literature on the market impacts of bad news by providing rationale for managers to voluntarily disclose lower prospective earnings as it improves market liquidity in the short and medium run. This is important since market liquidity channels have a considerable impact on the discount rate and the cost of equity of firms. The study is organized as follows: Section 2 presents review of the literature. Section 3 presents details on data and methodology. The empirical results are presented in Section 4 and the robustness tests in Section 5. Finally, Section 6 summarizes the results of the study.

## 2. Review of literature

The rationale for issuing PWs rather than waiting until the earnings announcement has been researched extensively. Studies range ranging from litigation risk (Baginski, Hassell, & Kimbrough, 2002; Skinner, 1994, 1997; Soffer, Thiagarajan, & Walther, 2000; and Field, Lowery, & Shu, 2005), reputational costs (Libby & Tan, 1999), entry deterrence (Darrrough & Stoughton, 1990; Donto, 1989), regulatory risk (Jackson & Madura, 2007; Mikhail, Walther, & Willis, 2004; Skinner, 1994; Verrecchia, 2001) to feedback received from financial markets (Kau, Linck, & Rubin, 2008; Langberg & Sivaramakrishnan, 2010; Luo, 2005).

If financial markets are characterized by asymmetrical information, increased disclosure (i.e., PWs) can reduce information asymmetry and reduce insider trading. The asymmetric information theory provides the analytical framework for analyzing the impact of voluntary disclosure on financial markets (Jensen & Meckling, 1976; Leland & Pyle, 1977; Myers & Majluf, 1984; Stiglitz & Weiss, 1981). Investors have imperfect knowledge of firm's prospects, and they are normally concerned whether they are holding or acquiring an overvalued asset. Research has shown that statements which report an adverse outlook for the future prospects of the firm (PWs) do contain market-relevant information, causing investors to revise expectations about the future profitability of the firm (Bulkley & Herrerias, 2005; Church & Donker, 2009; Jackson & Madura, 2003, 2004, 2007; Xu, 2008).

There is considerable literature on voluntary disclosures and its impact on financial outcomes like stock prices, liquidity, etc. Prior literature has examined how high information asymmetry can reduce liquidity (Copeland & Galai, 1983; Glosten & Milgrom, 1985). However, research on the link between voluntary financial disclosure and market liquidity is very limited. Theoretical models of Diamond (1985) and Diamond and Verrecchia (1991) show why managers may choose to disclose more information than mandated by market regulators. Leuz and Verrecchia (2000) argue that increased levels of financial disclosure reduce the information asymmetry and costs of capital. Higher levels of information asymmetry generate transaction costs by including adverse selection between buyers and sellers of shares and increase the discount at which shares are sold and increase the cost of issuing shares. Leuz and Verrecchia (2000) suggest bid-ask spreads and trading volume as proxies for information asymmetry; they find that German firms that commit to higher levels of disclosure experience a 35 percent decrease in bid-ask spreads and a 50 percent increase in stock turnover. There are also studies on analyst evaluations of disclosure quality and liquidity. These studies find that disclosure quality increases market liquidity (Healy, Hutton, & Palepu, 1999; Welker, 1995; Heflin, Shaw, & Wild, 2005). On the other hand, Bardos (2011) find that illiquidity increases after firms restate their financial statements. Further empirical evidence also shows that firms disclose more information when earnings are easier to predict (Chen, Matsumoto, & Rajagopal, 2011). Levi and Zhang (2014) study of U.S. during 1993–2009 found that days before earnings announcements, information asymmetry increases which lead to low liquidity.

There is also considerable literature on the role of trading volume in the pre- and post-earnings announcement periods (Bamber, 1987; Chae, 2005; Kim & Verrecchia, 1991). Changes in trading volume facilitate stock price discovery process.

<sup>1</sup> Rule 10b-5 of the Securities Exchange Act of 1934 could be used against a non-PW firm of either failing to disclose adverse information or disseminating misleading information (Dyl, 1999).

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