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How rumors fly

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ABSTRACT

News media do not always report objectively. In particular, negative rumors encourage news media to hype unconfirmed reports and lead to media bias. In this study, we seek to understand how negative rumors spur corporate clarifications. We find that after rumors surface, news coverage of those rumors by credible sources increases the magnitude of subsequent media bias on target firms. Moreover, we find that the power of a negative rumor depends on the extent to which the public believes the rumor. We focus on how community religious norms affect the public's interpretation of rumors and propose that religious norms among the population surrounding a target firm increase the magnitude of negative media bias on that firm. To counter media bias, we find that firms—especially those with reputations for corporate philanthropy—make technical clarification announcements that provide substantial details. Based on samples of negative rumors in the Chinese stock market from 2006 to 2012, empirical studies provide strong support for our arguments.

1. Introduction

In recent years, a growing number of scholars have studied the positive effects of news media on corporate governance (Dyck, Morse, & Zingales, 2010; Dyck, Volchkova, & Zingales, 2008; Joe, Louis, & Robinson, 2009; Miller, 2006; Peress, 2014), such as reducing information asymmetry between shareholders and firms (Bushee, Core, Guay, & Hamm, 2010; Fang & Peress, 2009; Peress, 2014) to improve the efficiency of financial markets (Tetlock, 2007). Along these lines, investors expect to acquire firm information from news media when it is very difficult for them to get it on their own. In China, information asymmetry between investors and listed firms is particularly large, which often results in insider trading and manipulation of share prices (Chakravarty, Sarkar, & Wu, 1998). Chinese stock markets are full of rumors because of this information asymmetry, which creates uncertainty and ambiguity for investors. Consequently, the news media plays a fundamental role in information dissemination there, and investors largely depend on it for corporate information.

In this paper, we use the *a posteriori* method to define *rumor* as one or more news reports that a target firm denies through one or more official clarification announcements. When information asymmetry exists between firms and investors, investors often eagerly search for more information about target firms after hearing rumors about them. This creates an incentive for news agencies to report on rumors about targeted firms, because doing so can increase page views and print sales. This is particularly the case in China, whose media industry became more profit-driven motivation after reforms in 2004 (Fook, 2007; He, 2008). Now, the Chinese news media may deliberately sensationalize stories (Core, Guay, & Larcker, 2008) through their choice of primary sources, words, and omission of contradictory opinions (Gentzkow & Shapiro, 2006), which may induce bias. In some cases, the Chinese news media will deliberately produce biased reports and then blackmail target firms by threatening to publish those reports. One example is the blackmail perpetrated by 21st Century Media, one of China's most influential news agencies (Xinhua News, 2014).

Several scholars explore the antecedents of media bias in the United States. For example, prior studies propose that political orientation (Djankov, McLiesh, Nenova, & Shleifer, 2003; Houston, Lin, & Ma, 2011), ownership of news institutions (Besley & Prat, 2006), journalist preferences (Gurun, 2010), and economic incentives, including growing readership (Gentzkow & Shapiro, 2006; Mullainathan & Shleifer, 2005) and advertising sales (Reuter & Zitzewitz, 2006) can encourage media bias. However, most research focuses on media bias due to political orientation or advertising, and it often relies on theoretical analyses from different perspectives that lack empirical evidence of how corporations react to media bias.

In this study, we first explore what determines the magnitude of media bias. In Chinese stock markets, information asymmetry highlights the fundamental role of credible media in disseminating corporate messages to investors. If credible media outlets report negative rumors about a firm, for example, that news will get more attention (Fragale & Heath, 2004; Kahneman, 1973), which creates an opportunity for the mass media to profit from reporting rumors about firms. Thus, our study evaluates how the credibility of rumor sources affects the

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magnitude of subsequent negative reporting about target firms, as well as the severity of media bias.

In addition, the extent to which audiences believe rumors from credible sources contingently determines the news value of specific firms. Generally, audiences form their perceptions of a firm based on easily accessible information. Local religious norms may affect the perceptions about that rumor information.

Previous research proposes religious norms influence individual beliefs and encourage individuals and organizations to do good deeds and behave ethically (Du, 2013; Dyreng, Mayew, & Williams, 2012; Hilary & Hui, 2009; Pace, 2013). Even individuals who do not have religious beliefs (Cialdini & Goldstein, 2004) are affected by religious norms. Consequently, religious norms could influence how individuals interpret rumors. For example, in a highly religious community, individuals may expect firms headquartered there to perform legitimately and ethically. Negative rumors undoubtedly violate these expectations and arouse curiosity about the realities of corporate behavior, which may encourage news media to hype rumors to fill that void. In turn, this study also examines how religious norms affect the relationship between the credibility of rumor sources and media bias.

Furthermore, we examine how listed firms disclose information to reduce information asymmetry, especially those engaging in corporate philanthropy. Because media bias worsens information asymmetry between firms and investors, investors may believe biased reporting that changes their perceptions of the targeted firms. Firms can fight back via information disclosure, which can reduce information asymmetry.

In China, many firms do this by releasing clarification announcements. Some firms disclose detailed information, called a technical clarification; others just ceremonially reply to the rumors (Zavyalova, Pfarrer, Reger, & Shapiro, 2012). Therefore, the extent to which rumors encourage media bias could determine whether firms use technical clarifications. This in turn helps us understand how firms cope with rumors and media bias.

Besides the choice of what to disclose, firms also care about whether investors believe their disclosures. Trust matters. Prior research indicates philanthropy can create an advantage by bolstering a company's reputation (Gardberg & Fombrun, 2006; Godfrey, 2005) and legitimacy (Du & Vieira, 2012), thereby making its disclosures more believable. Consequently, a record of philanthropy may help firms fight rumors and media bias too.

Our paper contributes to prior research in several aspects. First, prior studies of media bias mainly focus on American firms and explore media bias induced by political factors and advertising. Our study discusses how media bias arises and how listed firms react to media bias in the context of Chinese stock markets. Second, prior research proposes that religion disciplines individual and corporate behaviors. However, our research finds evidence that news media capitalize on religious norms to sell biased information to a curious public after hearing negative rumors. Our finding extends prior research and emphasizes that religious norms can also have a negative influence on society. Third, we investigate whether listed firms actively use technical-clarification announcements to combat media bias, which extends previous studies about media bias and provides evidence of how firms cope with media bias. Fourth, our work extends prior research on corporate philanthropy and finds new empirical evidence that listed firms with good corporate philanthropy records are apt to make technical announcements. Taken together, this study visualizes a dynamic procedure to understand how rumors fly.

2. Research framework and hypotheses development

2.1. Media bias

Media bias is a fluctuation in the cumulative tenor of reports on a target firm over conventional levels within an observed window, and it occurs when several news agencies report negative rumors about a target firm. In some ways, this is similar to how investors affect stock prices. If most news agencies (investors) put a negative slant on reports about a target firm (sell the stock), the cumulative tenor of the reporting (stock price) becomes negatively biased (falls). Accordingly, from a corporate perspective, media bias can affect a company's survival. However, previous studies do not consider what determines the magnitude of media bias when a firm is the subject of negative rumors.

Prior research does find that several factors, including politics (Djankov et al., 2003; Houston et al., 2011), competition for readership (Gentzkow & Shapiro, 2006; Mullainathan & Shleifer, 2005), advertising revenue (Reuter & Zitzewitz, 2006), media ownership (Besley & Prat, 2006), editorial preferences (Gurun, 2010), and corporate behaviors (Petkova, Rindova, & Gupta, 2013) lead to media bias. For example, governmental control may bias media coverage of specific events (Houston et al., 2011). Besley and Prat (2006) propose that governments may also affect reporting by building cozy relationships with news agencies. Guo and Lai (2014) find advertisers also reinforce media bias, especially when they have strong bargaining power over news agencies and can advertise in multiple outlets. Reuter and Zitzewitz (2006) also find the similar evidence.

In addition, media bias produces negative economic results. Specifically, the public may make suboptimal decisions based on biased media coverage, which generates losses and decreases the demand (Anderson & McLaren, 2012; Hennig-Thurau, Houston, & Sridhar, 2006; Rinallo & Basuroy, 2009). In addition, media bias distorts the allocation efficiency of social resources and reduces social welfare (Ellman & Germano, 2009; Mullainathan & Shleifer, 2005). Nonetheless, in China, research on media bias is extremely scant. We fill that gap.

2.2. Research framework

As stated, we explore the magnitude of media bias after negative rumors surface and subsequently how target firms react to biased reporting. More specifically, we consider three issues. First, we consider whether credible rumor sources induce serious media bias. Second, we consider the extent to which religious norms encourage news agencies to publish biased reports on firms headquartered in highly religious areas. Third, we examine how rumor-targeted firms fight media bias via clarification announcements, especially those with reputations for corporate philanthropy. Taken together, the research framework is shown in Fig. 1.

2.3. Credibility of rumor sources and the magnitude of media bias

Where rumors come from is an important factor that influences the extent to which biased information about targeted firms spreads. The emerging securities markets and inferior information disclosure system in China induces information asymmetry, so media, especially credible media, play the critical role of dispersing information. Negative rumors (about things such as inferior product quality, pollution, financial fraud, etc.) spread easily due to information asymmetry, and stakeholders are more likely to believe these rumors, especially if they're reported by credible media (Fragale & Heath, 2004; Hovland & Weiss, 1951).

Because rumors are unverified, ambiguous, and uncertain, individuals have a strong motivation to seek additional information in order to mitigate the confusion (Bandura, 2001). Negative rumors in particular may challenge the public's perception of a target firm, but credible

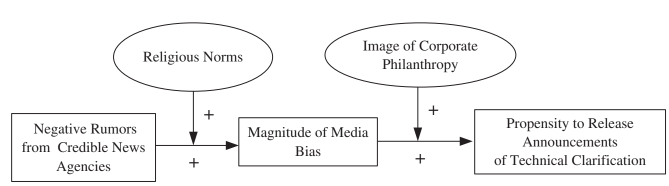

Fig. 1. The research framework.