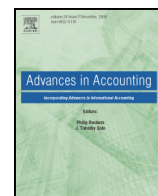




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# Corporate risk-taking, firm value and high levels of managerial earnings forecasts<sup>☆</sup>

Michael J. Imhof<sup>a,1</sup>, Scott E. Seavey<sup>b,\*</sup>

<sup>a</sup> W. Frank Barton School of Business, Wichita State University, Clinton Hall, Room 332, Wichita, KS 67260-0087, United States

<sup>b</sup> College of Business Administration, University of Nebraska-Lincoln, 391 CBA, 1240 R Street, Lincoln, NE 68588-0488, United States

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### ABSTRACT

We examine the impact of high levels of managerial earnings forecasts, an important form of voluntary disclosure, on corporate risk-taking and firm value. Theory and anecdotal evidence suggest that a policy of high disclosure may reduce managers' willingness to invest in higher-risk, higher-return projects. We first verify, as in prior research, that corporate risk-taking is associated with higher future firm value. We then document a negative relation between firms with high levels of forecasting and corporate risk-taking. Finally, we provide evidence suggesting that high levels of managerial earnings forecasts reduce the positive association between corporate risk-taking and future firm value. Our results are robust to alternative measures of corporate risk-taking and future firm value, and alternative definitions of high levels of managerial earnings forecasts. Our results may be of importance to varying interests as they highlight the potential for high levels of earnings forecasts to inhibit corporate risk-taking and lower firm value.

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## 1. Introduction

Theory suggests that disclosure may increase managers' chances of being fired or reprimanded for poor decision-making (Hermalin & Weisbach, 2012; Trueman, 1986). Consequently, in firms committed to high levels of voluntary disclosure, managers may be less willing to invest in riskier, yet potentially profitable projects. Following this reasoning, we examine whether high levels of managerial earnings forecasts, an important form of voluntary disclosure, are associated with lower corporate risk-taking. Because risk-taking should have a positive impact on shareholder wealth (e.g., Fisher & Hall, 1969; Merton, 1974; Shin & Stulz, 2000), we further examine whether, through a reduction in

corporate risk-taking, high levels of managerial earnings forecasts are associated with lower firm value.<sup>2</sup>

To test our predictions, we first confirm, as in prior research, that future firm value is increasing in corporate risk-taking, defined as the degree of uncertainty in a company's income stream (Merton, 1974; Shin & Stulz, 2000; Wright, Ferris, Sarin, & Awasthi, 1996). We then show that corporate risk-taking is decreasing in high levels of managerial earnings forecasts. Given this result, we estimate a series of interaction models to examine the impact of high levels of managerial earnings forecasts on future firm value. Our results suggest that in firms already committed to high levels of managerial earnings forecasts, incremental forecasts may significantly weaken the normally positive association between corporate risk-taking and future firm value.

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\* Corresponding author. Tel.: +1 402 472 7541; fax: +1 402 472 4100.

E-mail addresses: michael.imhof@wichita.edu (M.J. Imhof), sseavey2@unl.edu (S.E. Seavey).

<sup>1</sup> Tel.: +1 316 978 6021; fax: +1 316 978 3215.

<sup>2</sup> This logic does not run counter to theoretical and empirical disclosure research suggesting that voluntary disclosure improves a firm's information environment (e.g., Beyer et al., 2010; Healy & Palepu, 2001), nor to research suggesting that there may be governance benefits of voluntary disclosure (e.g., Bushman & Smith, 2001). We argue that in firms committed to already high levels of earnings guidance there is likely to be a negative relation between earnings forecasts and corporate risk-taking. It is in such firms that theory suggests that managers' career concerns will be most sensitive to increases in disclosure (Hermalin & Weisbach, 2012). Therefore, we focus our empirical tests on high forecasting firms.

Our findings contribute to research examining the consequences of voluntary disclosure and specifically managerial earnings forecasts. Disclosure theory focuses primarily on how voluntary disclosure impacts a firm's information environment (Beyer, Cohen, Lys, & Walther, 2010; Core, 2001). Yet a handful of analytical studies consider how voluntary disclosure affects managers' career concerns (Hermalin & Weisbach, 2012; Trueman, 1986) and managers' investment decisions (e.g., Bertomeu, Beyer, & Dye, 2011; Kanodia, Singh, & Spero, 2005). Our study provides empirical evidence that the provision of managerial earnings forecasts may affect managers' decision-making with regards to firm investment.

Additionally, we contribute to the literature examining the determinants and consequences of corporate risk-taking. Wright et al. (1996) find that both institutional ownership and insider ownership are associated with greater corporate risk-taking, while Barger, Lehn, and Zutter (2010) show that the Sarbanes–Oxley Act is associated with a decrease in corporate risk-taking. Our study shows that disclosure in the form of managerial earnings forecasts may also be a determinant of corporate risk-taking, at least in firms committed to high levels of forecasts. Furthermore, Wright et al. (1996) note that “corporate risk-taking behavior is critical to firm performance.” We extend prior studies that examine whether and when firm investment impacts firm performance/value by providing firm-level evidence of a positive association between corporate risk-taking and future firm value.<sup>3</sup>

The remainder of the paper is organized as follows: In the next section we discuss relevant literature and develop testable hypotheses. In Section 3 we outline our empirical models and in Section 4 we discuss our sample, present descriptive statistics and report and discuss our main empirical results. In Section 5 we conclude the paper.

## 2. Relevant literature and testable hypotheses

Information theories such as *signaling theory* (e.g. Spence, 1973) and *agency cost theory* (e.g., Jensen & Meckling, 1976; Myers & Majluf, 1984) recognize that outside investors face information related risks due to the separation of ownership and control in the corporate setting. These risks relate to information asymmetries between managers and investors as well as information asymmetries between groups of investors (i.e., informed vs. uninformed). Disclosure theory and empirical evidence suggest that managers can reduce these risks through voluntary disclosure (Botosan, 1997; Dye, 1990; Jorgensen & Kirschenheiter, 2003; Lang & Lundholm, 1996; Welker, 1995).

While most studies consider the goal of disclosure to be a spreading of information risk across the economy, some theoretical models indicate that disclosure can influence management's investment decisions. For instance, Trueman (1986) suggests that voluntary disclosure improves shareholder monitoring and argues that a manager's incentive to disclose stems from a desire to signal his/her ability to observe changes in the firm's economic environment and adjust production accordingly. Thus a firm's voluntary disclosure policy will be linked to managers' operating decisions by both shareholder monitoring and managers' desire to signal their quality.<sup>4</sup> Subsequent research recognizes the monitoring benefits of voluntary disclosure but contends that too much disclosure can actually harm the firm. Kanodia et al. (2005) argue that there is an optimal degree of imprecision in investor knowledge about a firm's true value and growth opportunities which allows managers to focus on long-term performance, rather than on short-term expectations, and is therefore good for both current and future investors. Their models suggest that high levels of disclosure have the potential to lead to myopic and potentially value-destroying

corporate investment in the short-run, likely because improved shareholder monitoring may threaten managers' self-preservation. This conclusion is analogous to Core (2001) who points out that “...too much disclosure can be as costly as too little disclosure” (p. 446). Hermalin and Weisbach (2012) also argue that increases in disclosure may increase career risks to managers, resulting in lower risk-taking if managers are not adequately compensated.

Based on these theories, we investigate whether high levels of managerial earnings forecasts are associated with lower corporate risk-taking and ultimately firm value. Before doing so, we consider the question of why managers would agree to provide voluntary disclosure if it increases their own career risks. The answer can be found in Verrecchia (2001) who argues that it is the commitment to voluntary disclosure, and not necessarily the form of voluntary disclosure, that will impact managers' operating decisions. When firms commit ex ante to providing disclosure, bad news is likely to be revealed along with good news. Consequently, the anticipation of investor response to voluntary disclosure as well as improved shareholder monitoring may force managers to hone their project selection skills. Building on Verrecchia's argument, we propose that in the context of Trueman (1986); and Kanodia et al.'s (2005) models, it is the policy of disclosure (committed or not), rather than the form of disclosure, that is likely to impact managers' investment decisions.<sup>5</sup> For this reason we focus on a policy of managerial earnings forecasts over a three-year period and investigate whether firms that provide relatively high levels of forecasts take fewer corporate risks, relative to all other firms.

To investigate the impact of high levels of managerial earnings forecasts on corporate risk-taking, we first consider the relation between corporate risk-taking and firm value. Theory suggests that corporate risk-taking, defined as the selection of projects that have varying uncertainties associated with their expected future cash flows (Wright et al., 1996), on average increases firm value (e.g., Fisher & Hall, 1969; Jensen & Meckling, 1976; Merton, 1974; Shin & Stulz, 2000). Empirical studies support this conjecture (e.g., Baugess, Slovin, & Sushka, 2012; Houston, Lin, Lin, & Ma, 2010; John, Litov, & Yeung, 2008). In untabulated tests, we find that for our full sample of firms (i.e., both high disclosers and control firms) there is a positive relation between corporate risk-taking and firm value.

After establishing a positive link between risk-taking and firm value, we then examine whether firms providing high levels of managerial earnings forecasts exhibit lower corporate risk-taking. We predict they do because in these firms, managers' career concerns will be most sensitive to incremental forecasting. Stated formally and in the alternative form, we predict:

**H1.** High levels of managerial earnings forecasts are negatively related to corporate risk-taking.

After establishing a generally negative link between high levels of managerial earnings forecasts and corporate risk-taking, we assess the impact on shareholder value of reduced corporate risk-taking in high forecasting firms. Based on H1 we predict that high levels of managerial earnings forecasts will be associated with a weaker positive relation between corporate risk-taking and future firm value. Stated formally and in the alternative form:

**H2.** In high forecasting firms, managerial earnings forecasts are associated with a weaker positive relation between corporate risk-taking and future firm value.

<sup>5</sup> We also note that though voluntary disclosure is generally at the discretion of managers, managers may have less of a choice about whether or not to voluntarily disclose than one would surmise. Cheng, Luo, and Yue (2013) point out that “...managers [often] have greater discretion over the precision of their earnings forecasts than over whether to provide forecasts in the first place” (Cheng et al., 2013, pg. 1576). Additionally, anecdotal evidence suggests that managers often feel pressured to disclose (Brav, Graham, Harvey, & Michaely, 2005; McCarthy, 2008) from a firm's Board of Directors, activist shareholders, regulators, analysts and/or other influential stakeholders.

<sup>3</sup> See McConnell and Muscarella (1985); Chung, Wright, and Charoenwong (1998); Dehning, Richardson, and Stratopoulos (2005).

<sup>4</sup> This is similar to the labor market scenario described by Spence (1973), where job-seekers can signal their own quality with a college education, differentiating their productivity potential from the rest of the workforce.

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