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Management Forecasts, Idiosyncratic Risk, and the Information Environment☆

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ABSTRACT

Management forecasts are an important source of information for the Japanese stock market. In this paper, we use management forecast error as a proxy for disclosure quality to investigate the relationship between disclosure quality and idiosyncratic risk. We find that management forecast error is positively related to idiosyncratic risk, suggesting that high-quality public information reduces idiosyncratic risk. Furthermore, we present evidence that management forecast error is less positively related to idiosyncratic risk in relatively good information environments.

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1. Introduction

Studies (e.g., Campbell, Lettau, Malkiel, & Xu, 2001; Morck, Yeung, & Yu, 2000) have identified an increase in the level of average stock return volatility. This paper uses management forecast error as a proxy for disclosure quality to investigate the relationship between disclosure quality and idiosyncratic risk. Japan's stock exchanges ask firms to forecast the following year's key accounting figures. Although not all firms are required to provide these forecasts, most listed firms do.¹ Ota (2010) suggests that management forecasts have higher correlation with and incremental explanatory power for stock prices than realized income, indicating that management forecasts represent an important information source for Japanese stock markets.

This study contributes to the literature in two ways. First, we investigate the relationship between the quality of disclosed information and firm risk. Rajgopal and Venkatachalam (2011) argue that good information reduces firm risk: the higher the quality of accruals, as proposed by Dechow and Dichev (2002), the lower a firm's idiosyncratic risk. Okuda and Kitagawa (2011) investigate the relationship between five earnings quality measures (e.g., accruals quality, earnings predictability, and earnings smoothness) and idiosyncratic risk during a period of accounting standard reform in Japan. They find that the higher a firm's quality of earnings, the lower its idiosyncratic risk, which is consistent with the findings of Rajgopal and Venkatachalam (2011). Contrariwise, Hutton, Marcus, and Tehrani (2009) find that financial statement opacity measured by discretionary accruals is positively

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¹ In Iwasaki et al. (2012), for example, 95.42% of listed companies covered during the sample period (1997–2009) reported management forecasts.

associated with stock return synchronicity because firms with high synchronicity have less idiosyncratic information in their stock price. [Datta, Datta, and Singh \(2014\)](#) show that the relationship between financial statement opacity and idiosyncratic risk is not found if they use the performance-matched discretionary accruals developed by [Kothari, Leone, and Wasley \(2005\)](#) and the two-way clustered standard error proposed by [Petersen \(2009\)](#). Therefore, the effect of financial information transparency on idiosyncratic risk remains as an empirical question. Unlike these studies, we consider management forecast accuracy as a proxy for the quality of the disclosed information and examine the relationship between management forecast error and idiosyncratic risk.

Second, we examine how the effects of management forecast error differ according to the quality of the information environment. [Botosan \(1997\)](#) finds that for firms in a poor information environment, greater disclosure is associated with a lower cost of capital. [Aman \(2011\)](#) finds an interactive effect between forecast credibility and media coverage of earnings performance. This study uses firm size and analyst following as proxies for a firm's information environment.

Our analyses indicate that management forecast error is positively related to idiosyncratic risk, suggesting that high-quality disclosed information reduces idiosyncratic risk, which is consistent with [Rajgopal and Venkatachalam \(2011\)](#). We further show that management forecast errors are less positively related to idiosyncratic risks for larger firms and firms with analyst following, suggesting that management forecast accuracy is less important for firms with good information environments.

Our research motivation is similar to that of [Aman \(2011\)](#). However, our analyses are distinctly different from those of [Aman \(2011\)](#). First, we do not use R2, but instead use the variance of the residual from a regression of a firm's stock returns. [Li, Rajgopal, and Venkatachalam \(2014\)](#) found that these are not interchangeable. They found that idiosyncratic return volatility increases with poorer earnings quality in a within-country setting, and that after controlling for beta, a scaled idiosyncratic volatility measure also increases with poorer earnings quality.

Our research motivation is also similar to that of [Abdel-Khalik \(2008\)](#). His paper analyzes the relationship between analysts' forecasts dispersion and idiosyncratic volatility. Compared to it, our paper focuses on management forecasts. There are two merits of focusing management forecasts in Japan. First, almost all firms provide these forecasts. Second, as [Ota \(2010\)](#) finds, financial analysts in Japan heavily depend on management forecasts in formulating their own forecasts.

Third, we do not focus on management forecast bias, but on management forecast accuracy. Some managers may want to boost or reduce their forecasts, which results in management forecast bias becoming positive or negative. Owing to such management intentions, these instances do not serve as appropriate proxies for disclosure quality. In comparison, management forecast accuracy decreases not only when managements intentionally increase or decrease management forecasts, but also when they are less able to forecast their earnings. This latter is appropriate as a proxy for disclosure quality.

The rest of this study proceeds as follows. In [Section 2](#), we discuss the hypothesis development; in [Section 3](#), we discuss the research design; in [Section 4](#), we describe the sample selection and descriptive statistics; and in [Section 5](#), we present the results. The final section concludes the study and suggests future research possibilities.

2. Hypothesis development

Theoretical support for a negative association between disclosure level and idiosyncratic risk is found not only in the accounting literature but also in the financial literature. For example, [Diamond and Verrecchia \(1991\)](#) show that improving disclosure reduces stock market volatility. [Easley and O'Hara \(2004\)](#) employ a model indicating that a firm's disclosure policy can influence its idiosyncratic risk.

In response to these studies, [Rajgopal and Venkatachalam \(2011\)](#) use the quality of earnings as a proxy for the quality of disclosed information and find that it is negatively associated with lower idiosyncratic risk. [Okuda and Kitagawa \(2011\)](#) also show that the higher a Japanese firm's quality of earnings, the lower its idiosyncratic risk.

In addition to financial reporting, management forecasts are also a major channel of disclosed information. The Tokyo Stock Exchange and other Japanese stock exchanges ask that firms forecast the following year's key accounting figures. Although not all firms are forced to provide their forecasts, virtually all listed firms do. Management forecasts have thus attracted both practical and academic attention. [Ota \(2010\)](#) suggests that management forecasts have the highest correlation with and incremental explanatory power for stock prices.

These arguments lead to our first hypothesis:

Hypothesis 1. Management forecast errors are positively correlated with idiosyncratic risks.

Next, we turn to the interaction between the information environment and disclosed information. Analytical models in accounting usually assume that information noise can be reduced by signals (e. g. [Christensen & Feltham, 2003 Chap.3](#)). This assumption suggests that the effect of one signal is reduced if the other signals are more correlated with "true" value of the firm. This means that on the one hand, a poor information environment suggests that there is little alternative information to predict a firm's future cash flow other than accounting information. Therefore, high-quality accounting information could reduce investor noise. On the other hand, if the information environment is rich, investors can easily access other information sources and reduce their uncertainty. In such a situation, investors may pay less attention to disclosed information.

There are several studies that find that the information environment is related to the amount, type and quality of disclosed information. [Botosan \(1997\)](#) finds that the association between the cost of equity capital and disclosure levels is less significant

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