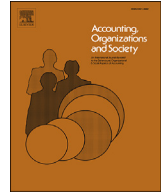
Accounting, Organizations and Society 53 (2016) 50–62

Contents lists available at ScienceDirect

Accounting, Organizations and Society

journal homepage: www.elsevier.com/locate/aos



The effects of a reasonable investor perspective and firm's prior disclosure policy on managers' disclosure judgments☆

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ARTICLE INFO

Article history:
Received 25 June 2013
Received in revised form
16 October 2015
Accepted 17 October 2015
Available online 1 November 2015

Keywords:
Disclosure policy
Perspective taking
Reasonable investor
Reasonable person

ABSTRACT

Security laws and accounting standards suggest that reasonable investors' expectations are an important consideration for disclosure judgments. Regulators have expressed concerns that many disclosure judgments are made without adequate consideration of how investors would evaluate the information. However, the psychological literature suggests that individuals may face difficulties considering the facts from another's perspective. We conduct two experiments to examine whether prompting managers to take the perspective of a reasonable investor affects their disclosure recommendations of a probable negative change in their company's earnings expectations, and whether this effect is impacted by the firm's prior disclosure policy (known that its past preference to be biased towards no disclosure versus unknown). We find that experienced managers are more likely to recommend disclosure when they are prompted to take the perspective of a reasonable investor than when they are not and this effect is stronger when the firm's prior disclosure policy is unknown.

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1. Introduction

Securities laws and accounting standards around the world suggest that managers consider the perspective of a ‘reasonable investor’ when they evaluate whether their listed company has an obligation to inform the investing public of events and circumstances that could materially affect the price of their firm's securities. In fact, the words ‘reasonable person’ and ‘reasonable investor’ are pervasive in the legislation of many countries including Australia, UK and USA. However, regulators are concerned that managers are making many disclosure judgments without fully considering the disclosure matter from a benchmark of how a reasonable investor would evaluate the information (Pozen, 2008, p. 80). Research also indicates that managers' disclosure judgments are affected by their firm's preferences and experiences for the way disclosure is managed (hereafter referred to as the ‘firm's prior disclosure policy’) (e.g., Bamber, Jiang, & Wang, 2010; Gibbins, Richardson, & Waterhouse, 1990; Holland, 2005).

Given the requirement to consider the viewpoint of a reasonable investor when making disclosure decisions, our study investigates whether managers are more likely to recommend disclosure of a probable negative change in their company's earnings expectations when they are prompted to take the perspective of a reasonable investor and whether this effect is increased or decreased when managers know the firm's prior disclosure policy has been biased towards no disclosure. Our study examines the research questions in the context of Australia's Continuous Disclosure (‘CD’) environment although it is noted that CD obligations are also relevant to many other countries including Canada, Hong Kong, New Zealand, Singapore and the UK. Australia's CD regulation requires that companies promptly disclose information that a *reasonable person* would expect to have a material effect on the price or value of their securities unless certain exceptions are satisfied including that a

☆ We thank Robert Bloomfield (editor), two anonymous reviewers, Hun-Tong Tan, and workshop participants at UNSW Australia for their helpful suggestions and comments. We also thank the managers who participated in our study. The first author gratefully acknowledges the helpful comments from her dissertation examiners and the financial assistance of the AFAANZ/CPA/Australia/ICAA/NIA PhD Scholarship.

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http://dx.doi.org/10.1016/j.aos.2015.10.003
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reasonable person would not expect the information to be disclosed.[1] Despite the importance of the reasonable investor concept, little empirical evidence exists regarding its effect on the judgments of preparers, audit committees or auditors (for an exception see Altiero, Kang, & Peecher, 2015 who examine perspective taking on auditor judgments).

Research in psychology shows that while individuals have the ability to take another person's perspective into account (Davis, 1983; Epley, 2008; Epley & Caruso, 2009; Keysar & Barr, 2002), they may face difficulties in getting beyond their own point of view to consider the facts from another's perspective (e.g., Epley & Caruso, 2009; Epley, Keysar, Boven, & Gilovich, 2004). Additionally, psychological research on the impact of motivated reasoning suggests that individuals face difficulties in evaluating information and making judgments impartially when they have a stake in reaching a particular outcome (Kunda, 1990). For instance, individuals judge evidence supporting their preferred outcomes to be more important and to have stronger implications than evidence conflicting with their preferred outcome (e.g., Ditto & Lopez, 1992; Lord, Ross, & Lepper, 1979). Accounting research finds that, given sufficient ambiguity, accounting professionals' judgments are vulnerable to motivated reasoning effects (Hackenbrack & Nelson, 1996; Kadous, Kennedy, & Peecher, 2003; Peecher, Piercey, Rich, & Tubbs, 2010) and that pre-existing preferences to reach a certain desired outcome indirectly influence professionals' judgments by affecting the manner in which information is evaluated (e.g., Wilks, 2002). As managers have clear preferences regarding their financial reporting choices (Bamber et al., 2010), we contend that when managers do not consider a reasonable investor's perspective they may take advantage of the uncertainty surrounding a disclosure issue to arrive at a self-interested disclosure recommendation as long as their disclosure outputs are justifiable.

Our paper reports the results of two experiments. In the first experiment, we manipulate whether managers are prompted to consider the perspective of a reasonable investor (prompt versus no prompt) and knowledge of the firm's prior disclosure policy (known, that its past preference is biased towards no disclosure, versus unknown) to examine the impact on disclosure judgments for a new subjective disclosure matter. Experienced senior finance managers, mainly company secretaries,[2] make a disclosure recommendation on whether a probable negative change in the company's earnings expectations should be disclosed. Our results show that managers make disclosure recommendations that are more supportive of disclosing a negative change in earnings' expectations when they are prompted to take a reasonable investor's perspective compared to when they are not and this effect is stronger when managers do not know the firm's prior disclosure policy.

We conduct a second experiment to establish that our results are robust to the way managers are prompted to consider the perspective of a reasonable investor when making disclosure recommendations. We design the experiment to include an indirect approach to stimulate managers' consideration of a reasonable investor's perspective. This approach allows us to examine the effect of a reasonable investor prompt on managers' disclosure recommendations while reducing possible demand effects. In a 1 x 3 experiment, we replicate the reasonable investor prompt manipulation used in the first experiment (i.e., managers are prompted to take the perspective of a reasonable investor or not) as well as add a new prompt condition in which managers rate the likelihood that the disclosure matter would influence a reasonable investor's investment decision prior to making their own disclosure recommendation. We find that managers in both prompt conditions are more likely to recommend disclosure of a probable negative change in their company's earnings expectations than managers in the no prompt condition. Our additional analysis shows that managers who are prompted to take the perspective of a reasonable investor are more likely to consider reasons for and against disclosing a probable negative change in their company's earnings expectations. This suggests that perspective taking may be an effective mechanism to reduce unintentional biases in interpreting and evaluating information.

2. Background and hypothesis development

2.1. Reasonable person concept and Australia's continuous disclosure regime

'Reasonable person' is a legal construct. The term originates from the English legal system enabling issues of 'ought' to be resolved by reference to the objective fact of whether a reasonable person would have done likewise (Uren, 2003). In law, 'reasonable person', as a reference to a community standard, has been a powerful metaphor for establishing negligence.[3] The concept of a reasonable person has also been a significant feature in the professional accounting literature for many decades. For example, in its Statement of Financial Accounting Concepts No. 2, the Financial Accounting Standards Board's states that "the omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item" (FASB, 1980). The SEC provides guidance that a matter is material "if there is a substantial likelihood that a reasonable person would consider it important" (SEC, 1999). This formulation is reinforced by legal decisions, such as that rendered by the US Supreme Court which held that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote".[4] In more recent auditing and accounting settings, the reasonable person/reasonable investor standard has been applied in determining auditor independence (AICPA, 1988; APESB, 2007), in the consideration of materiality in planning and performing audits (IFAC, 2006; PCAOB, 2010), in the preparation of management's discussion and analysis (CICA, 2009), in the disclosure of inside trading information (FCA, 2013), in the evaluation of financial statement errors (Pozen,

[1] As required by the Continuous Disclosure (CD) Requirements which consist of Australian Securities Exchange Listing Rule 3.1 and 3.1A and Chapter 6 of the Corporations Act.

[2] In Australia, company secretaries are part of the executive management team. One of their key responsibilities is to advise the board on the company's statutory disclosure obligations. They are considered to be officers of the company, and therefore, can be held personally liable and subject to civil penalties in the event their company is found to have contravened the CD provisions of the Corporations Act. In the US, company secretaries are referred to as corporate secretaries.

[3] In Blyth v Birmingham Waterworks Co (1856) 11 Ex Ch 781. The court found that the defendants could only have been negligent if they had failed to do what a reasonable person would do in the circumstances. This case defined negligence as "the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do. The defendants might have been liable for negligence, if, unintentionally, they omitted to do that which a reasonable person would have done, or did that which a person taking reasonable precautions would not have done."

[4] *TSC Industries Inc v Northway Inc* 426 US 438 (1976). Also, see *Mitchell v Texas Gulf Sulphur Co.,* 446 F2.D 90, at 99–100 (10th Circuit, 1971) and *Escott* et al. *v. BarChris Construction Corporation* et al., 283 Fed. Supp. (District Ct. S.D. New York, 1968) p. 681.

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