Journal of Financial Economics 117 (2015) 190–223

Contents lists available at ScienceDirect

Journal of Financial Economics

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

When firms talk, do investors listen? The role of trust in stock market reactions to corporate earnings announcements ☆

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ARTICLE INFO

Article history:
Received 27 August 2012
Received in revised form
17 January 2013
Accepted 20 January 2013
Available online 17 August 2013

JEL classification:
F39
G14
G28
G39
M41

Keywords:
Culture
Trust
Corporate earnings announcement
Investor reaction

ABSTRACT

We examine whether the level of trust in a country affects investors' perception and utilization of information transmitted by firms through financial disclosure. Specifically, we investigate the effect of societal trust on investor reactions to corporate earnings announcements. We test two competing hypotheses. On the one hand, corporate earnings announcements are perceived as more credible by investors in more trusting societies and, therefore, elicit stronger investor reactions. On the other hand, societal trust mitigates outside investors' concern of moral hazard and reduces the value of corporate earnings announcements to them, thereby weakening their reactions to these events. We analyze the abnormal trading volume and abnormal stock return variance during the earnings announcement period in a large sample of firm-year observations across 25 countries, and we find that both measures of investor reactions to earnings announcements are significantly higher in more trusting countries. We also find that the positive effect of societal trust on investor reactions to earnings news is more pronounced when a country's investor protection and disclosure requirements are weaker, suggesting that trust acts as a substitute for formal institutions; when a country's average education level is lower, consistent with less educated people relying more on trust in making economic decisions; and when firm-level information asymmetry is higher, supporting the notion that trust plays a more important role in poorer information environments.

1. Introduction

Earnings announcements represent one of the most important channels of communication between a firm's managers or insiders and outside investors. How effective these disclosure mechanisms are in transmitting value-relevant information to outside investors and how capital market participants perceive and react to this information have been the subject of a large and growing body of research in finance and accounting (e.g., Beaver, 1968; Diamond and Verrecchia, 1991; Kim and Verrecchia, 1991a, 1991b, 1994; Harris and Raviv, 1993; Kandel and Pearson, 1995; Bamber et al., 2000; Bailey et al., 2006; Landsman and Maydew, 2002; DeFond et al., 2007).

☆ We thank Lee-seok Hwang, Nick Seybert, Tao Shu, Min Shen, Cong Wang, Min Zhu, participants at the 2013 China International Conference in Finance, 2012 Washington, DC, Summer Accounting Symposium, 2012 Korea Accounting Association conference, 2013 American Accounting Association International Accounting Section midyear meeting, University of Richmond, University of Baltimore, and especially the referee, Mark DeFond, and the editor, Bill Schwert, for helpful comments that significantly improved the paper. Mikhail Pevzner gratefully acknowledges the financial support from the Ernst and Young Professorship at the University of Baltimore. Fei Xie gratefully acknowledges the financial support from the National Natural Science Foundation of China (NSFC-712722ftab21) and the Wells Fargo Chair at Clemson University. Xiangang Xin gratefully acknowledges the financial support from the start-up grants of City University of Hong Kong (7200315).

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0304-405X/$ - see front matter © 2013 Published by Elsevier B.V.
http://dx.doi.org/10.1016/j.jfineco.2013.08.004

In particular, one stream of literature (e.g., Alford et al., 1993; Ali and Hwang, 2000; Hung, 2000; DeFond et al., 2007) investigates the cross-country variations in investors' reaction to corporate earnings announcements around the world and identifies several structural factors such as investor protection, earnings quality, and financial reporting frequency as among the chief determinants of such variations.

In this paper, we examine whether the stock market reaction generated by earnings announcements is related to one important country characteristic that has so far eluded prior research, i.e., the level of societal trust in a country. Gambetta (1988) defines trust as the subjective probability that an individual assigns to the event of a potential counterparty performing an action that is beneficial or at least not harmful to that individual, and it is a key element of culture and social capital (Putnam, 1993; Fukuyama, 1995; Guiso et al., 2006, 2010).[1] Consistent with the notion that trust underlies virtually all economic exchanges (Williamson, 1993), it has been shown that a higher level of trust facilitates economic growth and social efficiency (La Porta et al., 1997; Knack and Keefer, 1997; Zak and Knack, 2001), international trade and investment (Guiso et al., 2009), financial development (Guiso et al., 2004, 2008b), and corporate financing and merger and acquisition (M&A) transactions (Bottazi et al., 2011; Duarte et al., 2012; Ahern et al., in press).[2] Yet, the impact of trust on the effectiveness of information transmission from managers to outside investors remains an unexplored issue. This is surprising considering that much of the corporate governance reforms and regulations enacted in the aftermath of the corporate scandals at Enron and WorldCom in the early 2000s (e.g., the Sarbanes-Oxley Act of 2002) were aimed at restoring investor trust in corporations in general and corporate financial reporting and disclosure in particular.[3] Economic theory also suggests that trust can play an important role in the interaction between managers and outside investors given incomplete contracting and the potential for moral hazard (Williamson, 1993; Guiso et al., 2008b; Carlin et al., 2009). Self-serving managers have incentives to obfuscate reported financial results in an attempt to conceal their firm's true performance and obstruct investors' monitoring activities (Leuz et al., 2003). Recognizing such incentives, investors rationally view and react to firms' financial reporting with a certain dose of reservation. Trust, which reflects "the subjective probability individuals attribute to the possibility of being cheated" (Guiso et al., 2008b), clearly has the potential to influence investors' attitude toward and reaction to corporate earnings announcements, but its actual impact can be difficult to predict ex ante.

On the one hand, a key determinant of the stock market reaction to a firm's release of accounting information is the perceived credibility of the information. Prior research establishes that higher perceived credibility of reported earnings enhances stock market's reaction to earnings announcements. For example, the stock market reacts more strongly to earnings announcements by firms employing higher-quality auditors (e.g., Balsam et al., 2003; Teoh and Wong, 1993) and to voluntary disclosure by firms that have established a reputation for credible voluntary disclosure (Rogers and Stocken, 2005). We expect that, in countries with a higher level of societal trust, investors assign a lower probability to managers behaving opportunistically and manipulating financial results. Therefore, they perceive firms' financial reporting as more credible, and, thus, respond more vigorously to the information contained in corporate earnings announcements.

On the other hand, the reaction that earnings announcements are able to generate in the capital market also depends on outside investors' desire or need for information. It is well recognized that managers often do not act in the best interest of shareholders due to the separation of ownership and control (Jensen and Meckling, 1976) and this agency conflict is exacerbated by the information asymmetry between managers and shareholders (Myers and Majluf, 1984). Among other objectives, one purpose of corporate financial reporting is to provide outside investors with information that they can use to evaluate and monitor the decision making of managers. Therefore, investors are more likely to closely follow a firm's earnings announcements and react strongly to the information therein when they face greater information asymmetry and perceive a higher probability of managerial opportunism. To the extent that shareholders in more trusting countries are less concerned about expropriation by corporate insiders and are more likely to hold the view that managers are trustworthy and forthright (Guiso et al., 2008b), they could pay less attention to earnings announcements. As a result, we predict that trust could in fact subdue investors' reaction to earnings news.

We examine the two competing hypotheses in a large sample of about 53,000 firm-year observations across 25 countries spanning the years from 1995 to 2008. Following prior studies such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) and Guiso, Sapienza and Zingales (2008b), we capture a country's level of societal trust by its citizens' average response to a question in World Values Surveys (WVS): "Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?"[4] We measure investors' reaction to earnings announcements by abnormal return

[1] Guiso, Sapienza, and Zingales (2006, 2010) synthesize and improve upon a number of different definitions of culture and social capital proposed in the sociology and economics literatures. They define culture as "customary beliefs and values that ethnic, religious, and social groups transmit fairly unchanged from generation to generation," and social capital as "persistent and shared beliefs and values that help a group overcome the free rider problem in the pursuit of socially valuable activities."

[2] See Guiso, Sapienza, and Zingales (2006, 2010) for excellent reviews of the literature on the effects of culture and social capital on economic outcomes.

[3] See, e.g., "Sarbanes-Oxley law has been a pretty clean sweep," *USA Today*, July 29, 2007.

[4] As noted by Guiso, Sapienza, and Zingales (2010), an individual's response to this question captures her level of generalized trust, i.e., trust toward generic members of the population in her own country. In robustness analysis, we find that our results continue to hold when we use a measure that captures individuals' confidence in corporations. Because corporations are ultimately run by individuals, we choose to use the generalized trust measure in most of our analysis.