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Strategic information disclosure when there is fundamental disagreement

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ABSTRACT

This paper develops a theory of strategic information disclosure with disagreement. Managers of firms are voluntarily communicating subjective information, and prior beliefs about the strategy to maximize project value are rational but heterogeneous, potentially generating fundamental disagreement. Three main results are derived. First, not all firms disclose (subjective) information about strategy. Second, more valuable firms, and those whose strategies investors are more likely to agree with, disclose *less* information in equilibrium. Third, improved corporate governance leads to *lower* executive compensation and *less* information disclosure. An implication of the analysis for banks is that greater strategic information disclosure may increase the probability of bank runs—banks may *choose* to be opaque because transparency makes them fragile.

"For as the interposition of a rivulet, however small, will occasion the line of the phalanx to fluctuate, so any trifling disagreement will be the cause of seditions."
Aristotle in *Aristotle's Politics: A Treatise on Government*

1. Introduction

If you manage a better (more valuable) firm, should you disclose more or less information? The usual intuition says more, because you have less to hide and more to "advertise". This paper shows,

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however, that this intuition is wrong when it comes to *strategic* information disclosure – better firms optimally disclose *less*. The theory of optimal strategic disclosure developed here explains why: strategic disclosure has the potential to invite disagreement between the firm and investors and has implications for the allocation of control rights over productive activities.

Firms – both financial and non-financial – frequently voluntarily disclose information about their strategies. These disclosures are sometimes in the narrative section of the company's annual report and sometimes in communications with the press or analysts.[1] Such information – like corporate/managerial vision (e.g. Van den Steen, 2005) – is inherently qualitative and subjective in nature, and therefore associated with multiple interpretations related to whether these strategies are best for the firm (see, for example, Santema et al. (2005)). For example, whereas most western companies see emerging markets as a major component of their growth strategy, Maas (2008) reports Lars Sorensen, CEO of Denmark's pharmaceutical firm Novo Nordisk, as expressing disagreement that this was best for his firm. He communicated his company's growth strategy as being focused on developed markets: "... going to see our main growth in the UK, in the US, central Europe and Australia, as these countries use considerable resources to deal with inflammatory diseases".

There is also considerable heterogeneity in the amount of such disclosure (see Broberg et al., 2009; Santema et al., 2005). For example, a firm may announce that it plans to raise additional equity to expand its operations. However, the firm has considerable discretion over the extent to which it explains *how* it plans to expand. Will it expand by increasing the geography over which it operates? Will it expand by buying smaller competitors? Will it expand by investing in process technology that lowers its manufacturing cost, enables selling its product at a lower price and thereby increases demand? Will it expand by investing more in product innovation? These are details of strategy that the firm could choose to disclose or withhold, and different agents may have different opinions about which strategy is value-maximizing for the firm.

To understand the central insight of this paper about these issues, note that subjective information disclosure has both a cost and a benefit to the firm. The cost is that it potentially generates disagreement even among agents who observe the same information signal, whereas the benefit is that it lowers the cost of capital. This tradeoff allows us to address a host of questions. First, why do companies sometimes disclose subjective information about strategy and sometimes prefer not to? Second, will more valuable firms, as well as those for which the likelihood of investors agreeing with the chosen strategy is higher, disclose more or less information? Third, how does (voluntary) information disclosure interact with executive compensation and corporate governance?

These questions are addressed in two layers. The first layer examines information disclosure with potential disagreement among two risk-averse contracting parties in a general setting where one agent controls the choice of action in production and the other agent controls the provision of costly input (like capital or observable effort) to make production possible. The question is whether the agent choosing the action reveals this choice to the agent providing the productive input. The second layer specializes this general model to one in which there is a firm that is deciding whether to disclose information about a strategy choice prior to an equity issue to raise financing for a project. Included in this is an analysis of the interaction between strategic information disclosure and corporate governance.

The main results are as follows. First, some firms disclose (subjective) information about strategy and some do not, because both the disagreement-based cost of disclosure and the cost-of-capital-based benefit of disclosure depend on the extent of agreement between the firm and investors, and this agreement varies cross-sectionally. The inherently subjective nature of strategy makes it prone to different interpretations by agents with heterogeneous beliefs (which are rational in the sense of Kurz (1994a,b)) and this could generate different opinions about the optimal course of action. This difference of opinion, when it occurs, is costly to the firm because investors will either lower their valuation of the firm or simply refuse to provide financing to even a "good" project if they believe

[1] There is substantial communication between the CEO and analysts that occurs outside of the written communication in the Annual Report. In the Annual Report, this communication typically appears in Section 7 (Management's Discussion and Analysis of Financial Conditions and Results of Operations) and in Section 7a (Quantitative and Qualitative Disclosures about Market Risk). See Kogan et al. (2009) for empirical evidence that such disclosures are informative for predicting the firm's future stock return volatility.