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Motives for disclosure and non-disclosure: a framework and review of the evidence

Russell Lundholm and Matt Van Winkle*

Abstract— We develop and utilise a theoretical framework for the purpose of summarising the existing empirical work in the voluntary disclosure area. This theoretical framework posits that the primary goal of voluntary disclosure is reduction of information asymmetry (between managers and investors) and thereby cost of capital. We start with a basic or frictionless market where firms choose to disclose all news except worst possible outcomes. The literature supporting this basic economic setting is then discussed. The bulk of our review discusses results that describe disclosure outcomes when frictions do exist. We organise the empirical findings around three categories of frictions: management a) does not know of any information to disclose, b) can not tell information without incurring a cost, or c) does not care about their firm's current stock price.

1. Introduction

The flow of information coming from investor relation departments over and above the required governmental filings is voluminous. Consider IBM. During the four months from June through September of 2005, IBM offered seven 'IR viewpoints' discussing strategic and operational aspects of their business, five 'Recent Events' announcements, including a webcast discussing their second quarter results, four podcasts discussing key business and technology topics, and two 'IR Corner' announcements of specific business developments. They also posted the audio recording and PowerPoint slides from four executive presentations during this period, as well as the extended response to an institutional investor's question about the strategic importance of microelectronics to IBM. Beyond the financial data in the required filings, these disclosures communicated facts about IBM's market share by product line, its estimates of growth in various markets, specifics on new contracts, the terms of an agreement to sell IBM's PC division, assorted legal settlements, hiring plans, plans to acquire software companies, and a refutation of the analysis in a negative analyst report. These disclosures are in addition to the four full time staff working in the IR department who handle personal contact with the 23 analysts covering IBM. In short, there is a wealth of information flowing from the firm to the investor and it goes well beyond the basic regulatory disclosure requirements.

This paper takes the perspective that the primary purpose of voluntary disclosures emanating from a firm is to minimise the adverse selection caused by investors who, absent such disclosures, are sceptical about the firm's future prospects. Clearly, this

is a simplification – IBM has multiple objectives in providing this information – but the evidence we summarise in this article fits rather neatly into this framework. This is not to say that the actual participants in the game – the managers, investor relations staff, analysts and investors – see the world this way. In fact, the most common articulation an investor relations person will give for their job is 'selling the stock', just as if they were selling the company's primary goods or services.¹ But looking beyond what the agents say to what they actually do, the behaviour of the various parties, as well as collective market forces, seem to respond in a way that is consistent with this economic framework.

What do we mean by 'disclosure?' Like everything in financial accounting, the real issue is not if but when. Even for non-financial information, it is unreasonable to assume that management can bury significant information forever. If IBM is losing market share in its supply chain management business, eventually the market will figure this out, either by direct observation or because IBM fails to deliver on the estimated financial performance for this division. So the question isn't really 'disclose' or 'not disclose'; rather, it is 'disclose now' or 'disclose later'. Some things can be delayed for a significant period; other things will be revealed in the next quarterly filing.

Our summary of the empirical evidence is organised around the following economic setting. Suppose management knows a value-relevant piece of information, outside investors know that

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¹ I base this claim on over 10 years of experience teaching an executive education class for investor relations professionals from Fortune 500 companies. The fact that they are actually not selling anything in a secondary market transaction is not generally acknowledged.

management knows this information, and management can choose to disclose the information or not. If they choose to disclose, the disclosure is completely credible. In this simple game, absent any complications or frictions, there is only one logical outcome. Management will fully disclose its information as long as the news isn't the worst possible outcome. Even if the news is 'bad', to avoid being thought of as having the worst possible news, management will disclose everything. This rather stark prediction is supported by the belief held by outside investors that a failure to disclose must mean that management has the worst possible news. Given this response by outside investors, management is rational to disclose everything as long as the news isn't the worst, which in turn makes the outside investor response equally rational.

Why don't we see full disclosure of all but the worst possible news in the real world? The answer to this question is the basis of this paper. Full disclosure breaks down when frictions enter the picture. We organise the empirical findings around three categories of frictions: management (a) doesn't know, (b) can't tell, or (c) doesn't care.

We offer some caveats before launching into the details. First, we cannot possibly summarise all the empirical literature that is relevant to this large area. We refer the reader to the excellent summary by Healy and Palepu (2001) as a complement to this paper. Second, we will focus mostly on the literature describing how different frictions influence management's disclosure decisions. We will give much less attention to the subsequent result of the disclosure decision on the firm's cost of capital or other market-determined statistics. This is expedient, as Christine Botosan is summarising this literature in a different paper for this volume. We cannot totally ignore the market response to the disclosure decision, as these responses are exactly what management is trying to influence with its disclosure decisions. In particular, a recurring theme is that increased disclosure benefits the firm by lowering the information asymmetry between management and outside investors, thus counteracting the adverse impact of sceptical investors. There may well be an even greater cost, so more disclosure need not be better; but holding these costs aside for the moment, more disclosure should lower the firm's cost of capital. Chronicling how the costs and benefits change as frictions are introduced into the basic story is the purpose of this paper.

2. The basic disclosure game

We will develop the basic disclosure game by way of an example. One of the most significant statistics for a subscription-based firm that is populating the internet is the customer retention rate. This statistic is the odds that a customer will remain a customer next period. Whether customer acquisition

costs are a good investment or not depends on how long the customer hangs around. So imagine that there are five firms in a particular market, and each has information about their likely customer retention rate per year (equivalently, there is one firm with five possible retention rates). Suppose their information is distributed such that it is equally likely that the retention rate is .5, .6, .7, .8, or .9. Further, the firm knows this statistic exactly, while the outside capital market doesn't know which firm is which, they only know the ex ante distribution. Suppose firms can credibly communicate their information if they want to, but they don't have to. They don't have to say anything, but if they reveal their retention rate, they can't lie. Imagine some perfect auditing system that will back up this disclosure. The key issue here is that the market knows that the firm knows its own type and knows that the firm can choose to disclose the information or not. Finally, suppose that the firm would like the market to have the highest possible assessment of its customer retention rate, regardless of the true rate, because this will lead to the highest market value.

Now, imagine how this game will play out. The firm with the retention rate of .9 could not possibly have better information and therefore clearly finds it in its best interest to disclose this fact. So assume that they do just that. Now look at the game from the point of view of the firm with a .8 retention rate. They aren't the best possible type, but if they fail to speak then the market will rationally assume they must not have a .9 retention rate (because a .9 firm would reveal itself). The market would rationally estimate the retention rate of a firm that doesn't speak to be the average of .5, .6, .7 and .8, which equals .65. In light of this, the .8 firm would be better off disclosing. So suppose they join with the .9 firm and choose to disclose their information. An equivalent argument will apply to the firm with a .7 retention rate – not disclosing is met with a rational market belief that non-disclosing firms must be either .5, .6 or .7, averaging .6, so the .7 firm is also better off disclosing.

At this point we should feel special sympathy for the firm with the .6 retention rate. If it was not possible to disclose customer retention rates then the rational market belief would be the ex ante average of .7 and the .6 firm would enjoy being overvalued. By simply adding the option to disclose, the new equilibrium is such that the .6 firm will be forced to disclose as well. Just like the .8 firm and the .7 firm before them, the .6 firm has the choice to reveal its statistic or be lumped together with firms of lower quality. The .6 firm was been caught in an equilibrium 'trap' and will rationally choose to disclose its lowly .6 statistic rather than take the average of .5 and .6. Finally, the .5 firm can either reveal itself or not but the choice is ir-

relevant; given that all other firms choose to disclose their retention rates, the .5 firm is completely revealed even if it chooses to remain silent.

We submit that this basic story is a fundamental force present in the capital markets. It is supported by a rational 'no news is bad news' market belief. With this as a starting point, a firm can only get away without disclosing information when there is some friction added to the story that makes this market belief irrational. As previously mentioned, the frictions can be sorting into three boxes: the firm doesn't know the information in the first place, the firm can't tell for some other reason, or the firm doesn't care, in the sense that it isn't trying to maximise the market belief in the first place.

3. Are the basic forces at work?

Before we examine more complicated forces, such as the need to hide information from competitors, let's consider whether the basic forces of the adverse selection game are present. Does management actually want to increase the stock price by reducing adverse selection? Does voluntary disclosure actually provide credible information to the market? Does the market respond sceptically in the face of no disclosure, and absent other observable reasons why a firm might choose to not disclose? Does the most simple prediction – that firms are more inclined to disclose private information when their information is good – actually hold in large samples when countervailing forces are not present?

3.1. Is the disclosed information useful?

This seems like a ridiculous question in the abstract – why would anyone care about disclosure decisions if the fodder of press releases and webcasts was not useful information? The counter-argument is that all investor relations department do is provide fluff and useless spin on the mandatory accounting disclosures. Prior to the development of the voluntary disclosure literature, this would have been the most likely response from an accounting academic trained under the tyranny of the efficient markets hypothesis.

Consider the most direct evidence on this point. Bowen et al. (2002) finds that conference calls are informative in the sense that conference call use is correlated with more accurate analyst forecasts. More compelling, is the evidence provided by Bowen et al. that shows the most inaccurate analysts show the greatest improvement after the introduction of conference calls. In a related article, Kimbrough (2005) finds that conference call initiation significantly reduces serial correlation in analyst errors and post earnings announcement drift. Another result suggesting voluntary disclosure provides useful information comes from Lang and Lundholm (1993), where the authors show that

disclosure ratings are negatively correlated with the correlation between earnings and returns. Intuitively, this result implies that if the correlation between earnings and returns is low, the mandatory disclosures (financial statements, earnings, etc.) are not that informative. Firms in this situation can then choose to voluntarily disclose better metrics of performance.

For the purpose of this review, we assume that managers' incentives are sufficiently aligned with shareholders that increasing the stock price is a reasonable motive to ascribe to them. Given the prevalence of stock-based compensation plans (e.g. Hall and Liebman (1998) report that by the mid-1990s nearly 90% of Fortune 500 firms used stock-options in executive compensation plans), our assumption is reasonable in most instances.

3.2. Evidence supporting the basic model before complications

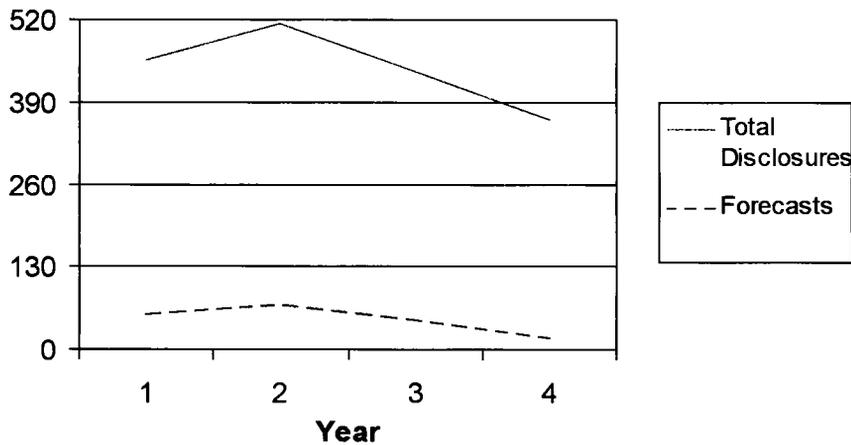
While this review focuses on the recent literature, a few earlier results are worth mentioning to establish that the basic adverse selection force described above is actually at play in the real world. Lang and Lundholm (1993) establish the result that disclosure ratings are increasing in firm performance and are greater around public offerings. The results support the intuition that managers choose to disclose more when the information is good and when they care more about the current stock price. Lang and Lundholm (1996) provide evidence that the disclosure achieves desirable effects. These benefits include increased analyst following, more accurate earnings forecasts, less dispersion and lower volatility in forecast revisions. These types of effects have been shown to reduce firms' cost of capital in theoretical research.

Another important disclosure concept is that the 'to disclose or not disclose' decision is, in fact, meaningless. The question is better framed as 'disclose now and have the truth revealed later'. Lundholm and Myers (2002) address this principle by showing that firms with more informative disclosure (as measured by analysts' disclosure ratings) have current stock returns which are more highly correlated with future earnings. They argue that more disclosure results in more of forward-looking information being reflected in the current stock price. Essentially, firms cannot cheat fate; if they don't disclose the information the underlying economic events will still manifest themselves in the accounting income and, ultimately, in the cash flows.

4. Managers care about increasing stock price using disclosures

Miller (2002) studies a sample of firms who start off with unambiguously good news; in particular, they have enjoyed an extended period of seasonally adjusted earnings increases. The study finds that

Figure 1
Disclosures by 36 firms with eight consecutive earnings increases followed by an earnings decrease
(source: Miller, 2002)



the disclosure quantity increases steadily as the news continues to be good, and the market responds positively. The market reaction is positive in the sense that returns average 1.2% over the three days surrounding bundled disclosures (i.e. two or more disclosures at the same time). In this study disclosures include financial forecasts, earnings announcements (including supplementary explanations), operations decisions and personnel announcements. This result establishes that the disclosures appear to possess information content and that they are generally good news disclosures. However, as the firm sees that the string of earnings increases is about to end, the disclosures get remarkably short-sighted. The common explanation for this is that 'the future is too hard to see', which, as discussed below, is a great way to try to beat the 'no news is bad news rational response'. And when the news turns out bad, the level of disclosure also decreases.

Figure 1 shows that disclosures peak in year 2 (the year during which the sample firms experience the greatest performance). For example, in year 2 the 36 firms provided a total of 70 financial forecasts. In year 4 (when the performance decline was well underway) only 18 such forecasts were provided. A similar result is shown globally in Healy et al. (2004), who find a significant relation between performance and disclosure for a sample of nearly 800 firms from 24 countries in the Pacific Rim and Europe.

Other research establishes a key element of the disclosure game: the credibility of voluntary disclosures. Firms cannot simply announce to the world that they are great; they must provide credible information supporting such claims. Hutton et al. (2003) show that good news disclosures are often accompanied by verifiable forward-looking

statements and good news without the forward-looking information garner smaller market reactions. In contrast, the authors find that bad news announcements require no explanation for the market to respond.

To this point we have described a theoretical model that describes how some firms make disclosure choices and how other players (analysts, investors, etc) respond to these choices. We also briefly summarised some key empirical findings consistent the idea that the basic forces described in the model are at work in the capital market. The next step is to describe why the 'full disclosure' prediction isn't observed in the real world. In other words, what frictions exist that will cause the basic game to break down and, correspondingly, cause some firms to disclose more than others?

As discussed above, there are three main sources of friction that can cause the full disclosure prediction to fail. All work by creating an alternative explanation for why a firm didn't disclose other than the 'assume the worst' belief that supports the full disclosure prediction. The first friction is if the managers choosing disclosures simply do not care to play the game – they are not motivated to increase the stock price. This is possible if the managers do not have the same incentives as do a firm's shareholders. If managers do not care about their firm's stock price then (within the context of the simple model) they have no motivation to disclose any information. The second friction is that managers may have competing motivations. If there are ways in which firm value is affected by disclosure, other than investors evaluating disclosures for investment decisions, then firms may not disclose good news. A common example is disclosure can help competitors learn about a firm and react to the detriment of that firm. Third, lack of

disclosure can result if managers' simply don't know anything with reasonable certainty about their firm. The following sections summarise recent findings supporting the existence of the three frictions.

5. Don't care

The full disclosure prediction from the basic model falls apart if managers aren't trying to maximise the current stock price. While it is difficult to imagine managers not caring about stock prices at all, it is likely that the level of concern for the current price varies across managers and time periods. Settings where there are large variations in managerial stock ownership are natural places to look for this affect. The important empirical result is first established in the literature by Nagar et al. (2003). The authors show that disclosure, measured as analyst ratings or frequency of management earnings forecasts, increases when the CEO compensation is more heavily weighted toward the stock price and when the CEO owns more of the firm.

Guo et al. (2004) finds that firms with managers who retain the majority of their shares after the firm's IPO do not disclose as much as managers who sell a significant portion of their shares. Intuitively, this result shows that managers who stand to personally profit the most during an IPO provide the most disclosure to the market. This is not to say that managers not selling shares do not care at all about stock price; it is simply that they do not care as much as managers making direct personal profit. In related work, Rogers (2005) shows that managers tend to disclose more when they are buying firm shares on their own account and disclose less when they are selling shares. Rogers uses liquidity as a proxy for disclosure, limiting the conclusions drawn from the work as there are numerous other factors affecting liquidity.

Some current work focuses on peripheral corporate mechanisms that in theory have been shown to further align shareholder and managerial incentives. Ajinkya et al. (2005) provides evidence that managers choose to supply greater disclosure when outside directors hold board seats and when institutional investors hold large amounts of their firms' stock. Outside directors and institutional investors are conjectured to be shareholder advocates and theoretical research has shown they can exert more influence than individual shareholders by overcoming organisational costs. If directors and institutions have influence on managerial decisions and represent shareholders then their presence increases incentive alignment. Related work by Karamanou and Vafeas (2005) finds that disclosure increases under the influence of effective boards and audit committees. These two papers used managerial forecasting as the primary disclosure proxy.

While this strand of literature is new and not yet

fully developed, the evidence is consistent with the model's notion that the full disclosure equilibrium is influenced by the degree to which firm management has the same incentives as do the owners of the firm.

6. Can't tell

The basic game described above assumes that the direct costs of disclosure are zero and the only party to the disclosure is the capital market. However, what if it costs money to create and disseminate a credible disclosure? And what if other parties are also privy to the disclosure and they sometimes use the information to the detriment of the firm? A rich area of recent development in the accounting literature describes situations where there are costs to disclosure that impinge upon the firm.

Several papers have examined the relation between competitive pressure and disclosure. Intuition suggests that when a firm has particularly good private information it may not want its competitors to know about it for fear that they will enter the market or in some other way impose costs on the firm. This friction, if anything, has become stronger in recent years with increased disclosure regulation and more rapid information dissemination. Regulation FD has removed the previously viable option of disclosing good news to analysts only and thereby affecting stock prices without revealing the information to competitors. In today's environment any news a firm wishes to disclose to the market will also be communicated to competitors. In this vein, Botosan and Stanford-Harris (2005) examine segment reporting disclosures. They use retroactive segment reporting disclosures required by the FASB's Statement of Financial Accounting Standard #131 to show that firms that had previously chosen to hide segment information were often firms making high profits in low competition segments. Further evidence is provided by Guo et al (2004) who find, for a sample of biotech IPOs, that firms are more forthcoming if they are further along in the product development cycle or have patent protection for their products.

Political and competitive costs are examined in conjunction by Bhojraj et al. (2004). During the electric utility deregulation of 1996–1997, firms that were uncertain about the amounts of recoverable costs the government would allow tended to disclose less positive information. After firms locked in their rates, good news disclosures increased but were muted in cases where strong product competition forces were present.

Johnson et al. (2001) examine legal costs as an impediment to disclosure. The authors find more forward looking disclosure among high-technology firms after the Private Securities Litigation Reform Act of 1995. The act specifically provided

for protection against class action suits based on failures to meet financial projections and forward looking statements. The authors find that the increase in disclosure was greatest for the firms that were previously at the most risk for litigation.

7. Don't know

The last friction we discuss is that firms simply have nothing to disclose. Of course managers of firms must know something, but it is possible they do not know anything more than what is required in mandatory disclosures. Additionally, there may be many situations where managers know something with such great uncertainty that legal worries (see above) or application of Generally Accepted Accounting Principles prevent them from providing the disclosures. The 'don't know' friction has been largely untested in the accounting literature. This is a result of the obvious difficulty of measuring what a manager does not know. In particular, it is much easier to credibly commit to knowing something than it is to credibly commit to not knowing something.

One result does suggest that managers are already disclosing everything that they do know. Heflin et al. (2003) find that there is no improvement in analyst forecast accuracy or reduction in forecast dispersion after Regulation FD² (Fair Disclosure), despite the increase in forward looking statements that occurred after the law. This is indirect evidence that perhaps not much else is known by managers with sufficient certainty to be useful information for the market. Nonetheless, the 'don't know' defence is the primary tool of investor relations departments when being harassed by analysts for more information.

8. Conclusion

There are countless reasons firms give for not disclosing information that the capital market could use to more accurately value the firm. Most reasons sort into one of the three boxes we describe in this paper. The empirical evidence shows that firms and the capital market seem to respond to their environment in a way that is broadly consistent with the basic full disclosure model and attendant frictions that alter the model's full disclosure prediction.

² Regulation Fair Disclosure was a rule prohibiting firms from privately disclosing value-relevant information to selected market participants without simultaneous public disclosure. This ruling was primarily targeted at the practice of giving information to preferred analysts. The law went into effect on 23 October 2000.

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