Stay Distinct, Stay Silent:

The Impact of Business Strategy on Disclosure Choice[*]

Rajiv D. Banker[†] Wei Shi[‡] Luofeng Zhou[§]

Nov 2020.

Abstract

Firms implement strategies and pick up disclosure choices under the same umbrella. In this paper, we investigate how firms make disclosure choices in line with their business strategies. Using validated textual measures based on earnings conference calls and 10-Ks, this paper provides novel evidence on how firms make disclosure choices given their business strategies. Although analysts tend to ask more product-related questions to innovative firms during calls, these firms successfully protect their secrets via more non-answers to proprietary-related questions, gaining competitive advantages and then capitalizing them into their firm-values. Overall, the evidence suggests that firms make disclosure choices consistent with their business strategies.

JEL Classification: Potentially X00

Keywords: Business Strategy; Earnings Conference Calls; Financial Disclosure; Textual Analysis

[*]The intention of this preliminary draft is in support of Luofeng Zhou's PhD applications. Due to the limit of pages, only the abstract and introduction of this paper are included.

[†]Temple University. Email: banker@temple.edu

[‡]Deakin University. Email: wei.shi@deakin.edu.au

[§]Columbia University. Email: luofeng.zhou@columbia.edu

1 Introduction

Managers are concerned about revealing their firms' "secrets" and harming their competitive position when deciding the voluntary communication with investors (Graham, Harvey, and Rajgopal, 2005). As business strategy is crafted to maintain competitive advantage (Porter, 1985), it is important to understand firm disclosure from the perspective of firm strategy. On the one hand, firm disclosures are critical elements that maintain the functioning of the capital market. Tremendous efforts have been made to measure each firm's specific disclosure choice, ranging from the propensity, frequency, and the tone of the disclosure (e.g., Loughran and McDonald, 2011, 2014; Thomas, Zhang, and Zhu, 2020). Factors that account for the variations in disclosure practice include the unravelling result, uncertainty of information endowment, proprietary cost, and litigation risk (Beyer et al., 2010). On the other hand, business strategy, which firms employ to achieve certain performance (Mintzberg, 1987), seems to be missing in the discussion. Dating back to Porter (1985), business strategy is typically implemented via the value chain. Given the valuation impact embedded in the disclosure decision (Verrecchia, 2001), a natural question is how firms make disclosure decisions in line with their business strategy. In this paper, we provide insight on how business strategies impact firms' disclosures.

To survive, it is vital for firms to design and implement a set of business strategies. The strategies include strategic positioning and build-up of their competitive advantages. The implementation of different strategies will result in different organizational characteristics. To put it into words of the seminal work Miles and Snow (1978), defenders will focus on cost efficiencies, while prospectors tend to support product innovation and market responsiveness. Analyzers, however, will be somewhere in between and tend to champion process adaptation and planned innovation (Miles and Snow, 1994). As strategies are implemented under one umbrella within a given firm, it is intriguing to investigate how firms make disclosure choices in line with distinct business strategies. In particular, there is a paucity of studies examining the intersection between disclosure choice and business strategy that might enrich our understanding of disclosure as well as how firms create and maintain competitive advantage.

Ex ante, however, it is an empirical question as to why business strategies would impact disclosure choice. First, there might be no relation between the two. Regardless of the strategies that firms adopt, as long as investors demand disclosure in times of, for example, economy-wide uncertainty, firms will release information to investors to alleviate the information uncertainty. Second, there could be a positive association between business strategies and disclosure choices. Firms seeking defender strategies will economize on all aspects of business activities, including disclosures. Prospectors, on the other hand, would make more disclosures given their reaction to a product launch. In other words, first movers might move first in all aspects of firm policy. Third, there could be negative association between business strategies and disclosure choices. Firms seeking prospector strategies would make fewer disclosure so as to leverage their first mover advantage and staying silent may help the firms reap the benefits. Defenders, on the other hand, would disclose more as their focus on lower profit margins and higher turnover would suggest severe competition on product price. In this paper, we rely on a dictionary-based textual measure upon earnings calls and 10-K filings to measure business strategies and disclosure choices to provide insight on how the two interact.

To address this research question, we first retrieve the SEC filings for the 2002-2018 period and extract Item 1 in 10-Ks for U.S. firms to construct a firm-year level strategy measure following Banker and Ma (2019). We then verify our textual measure of business strategy by replicating the analysis in Banker and Ma (2019). After verification, we retrieve the earnings conference call transcript from Thomson One for the period of 2002-2018. Employing the technique similar to Gow, Larcker, and Zakolyukina (2020), we identify non-answers in earnings conference call and construct both firm-year and question-answer level measures. We then merge the two measures and retrieve additional variables from Compustat and CRSP for regression analysis. There are 27,742 firm-level observations in the final sample, totaling 3,071,006 question-answer level observations for 3,470 unique firms[1].

The results show that firms that adopt prospector strategy tend to have more non-answers during earnings conference calls. The results hold after we control various factors that affect firms' disclosure choices, including competition, financing needs, firm size, complexity, and managerial incentives, among others. Overall, the results highlight the importance of business strategy in shaping the disclosure choice. We also examine two potential contributing factors to identify what drives this relation. One is the proprietary cost and the other is uncertainty in information endowment. Results show that although both contribute to the relationship, proprietary cost seems to be the dominant factor.

The results also show that analysts tend to ask more product-related questions dur-

[1] The number of observations is comparable to that in Gow, Larcker, and Zakolyukina (2020).

ing earnings calls when the business strategy focuses on product differentiation. The non-answers, in combination with business strategy, can have a real economic impact. We find that for firms adopting prospector strategies achieve higher firm value by engaging in non-answers during conference calls. Overall, the evidence suggest that firms pursue disclosure policies that are consistent with their business strategies.

We also investigate the mandatory disclosure properties by examining the readability of annual report. On the one hand, prospectors may withhold information as in the earnings conference call to protect their proprietary information, which leads to less readable annual report. On the other hand, however, the potential for regulatory scrutiny and litigation risk may inhibit the tendency to fabricate disclosure information; therefore, prospectors might not have a less readable annual report. The results show that prospectors' annual reports are more readable[2] compared to their defender counterparts. The evidence is thus consistent with the notion that firms use mandatory and voluntary disclosure as a substitute in guiding investors' expectations.

This paper makes the following contributions to the literature. First, to the best of our knowledge, this paper provides the first large sample analysis that documents the impact of business strategies on disclosure choices. Most of the literature so far focus on the managerial characteristics, incentive schemes, information asymmetry, and governance mechanism that potentially drive the disclosure choice. Little is known regarding the impact of business strategy. Our results on the significant effect of business strategy on disclosure choice highlights the needs to integrate firms' fundamental to better understand firms' disclosure decisions. Second, from the perspective of strategies, disclosure decisions are subject to the overall objective of the firm. Therefore, the paper also contributes to the strategy literature by introducing the disclosure dimension into the value chain that eventually contributes to the competitive advantage of the firm. Last, our results on the differential impact of business strategy on voluntary versus mandatory disclosure also provide insight on the recent debates regarding the relationship between the two. As firms adopt different strategies and they shape disclosure choice, it is thus important to take business strategy into account when making disclosure decisions.

[2] We use Gunning-Fog index as a proxy of readability.

References

Rajiv D. Banker and Xinjie Ma. Business strategy and financial accounting research: A text-analysis approach. *Working Paper*, 2019.

Anne Beyer, Daniel Andrei Cohen, Thomas Z. Lys, and Beverly R. Walther. The financial reporting environment: Review of the recent literature. *Journal of Accounting and Economics*, 50(2):296–343, 2010.

Ian D. Gow, David F. Larcker, and Anastasia A. Zakolyukina. Non-answers during conference calls. *Working Paper*, 2020.

John R. Graham, Campbell R. Harvey, and Shiva Rajgopal. The economic implications of corporate financial reporting. *Journal of Accounting and Economics*, 40(1):3–73, 2005.

Tim Loughran and Bill McDonald. When is a liability not a liability? textual analysis, dictionaries, and 10-ks. *Journal of Finance*, 66(1):35–65, 2011.

Tim Loughran and Bill McDonald. Measuring readability in financial disclosures. *Journal of Finance*, 69(4):1643–1671, 2014.

Raymond E. Miles and Charles C. Snow. *Organizational Strategy, Structure, and Process.* 1978.

Raymond E. Miles and Charles C. Snow. *Fit, failure, and the hall of fame : how companies succeed or fail.* 1994.

Henry Mintzberg. The strategy concept i: Five ps for strategy:. *California Management Review*, 30(1):11–24, 1987.

Michael E. Porter. *Competitive Advantage: Creating and Sustaining Superior Performance.* 1985.

Jacob K. Thomas, Frank Zhang, and Wei Zhu. Measuring the information content of disclosures: The role of return noise. *Working Paper*, 2020.

Robert E. Verrecchia. Essays on disclosure. *Journal of Accounting and Economics*, 32(1):97 – 180, 2001.