Honesty can keep companies' stock prices up during hard times

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Honesty is the best policy, and a new study from the University of Missouri finds that companies can benefit when they publicly accept the blame for poor performance. Researchers found companies that performed poorly yet blamed other parties—such as the government, competitors, labor unions or the economy—experienced a significant blow to their stock and had difficulty recovering. Companies that accepted blame and had a plan to address their problems stopped the decline in their share prices after their announcement, but those companies that blamed others continued to experience falling share prices for the entire year following their public explanation.

"Honesty is appreciated, especially when it's a difficult message from leaders," said Stephen Ferris, professor and senior associate dean at the MU Trulaske College of Business. "Investors will accept a forthright recognition of an honest mistake, expecting that corrective actions are likely to follow. When firms explain a negative event as due to an external cause, company leaders can appear powerless or dishonest to shareholders."

In the study, Ferris and his co-authors, Don Chance of Louisiana State University, and James Cicon of the University of Central Missouri, reviewed company announcements from 1993 through 2009 and identified 150 announcements describing poor company performance. The researchers found that slightly more than two-thirds of the announcements attributed the poor performance to external forces. One challenge Ferris and his colleagues had was to filter those announcements where poor performance was, in fact, legitimately due to external forces.

"We took care in the study to determine when companies could truly blame outside factors and when the poor performance was their fault," Ferris said. "By eliminating outside factors, such as industry-wide problems, we were able to identify those firms that really had no one or nothing else to blame but themselves. Firms that did admit the problem were able to stop the slide of their stock, and in many cases recovered within a year. Those companies that continued to blame outside factors never saw their stock recover."

Ferris said that just taking responsibility was not the entire solution. When companies accepted the blame, they also had to explain how they were going to fix the problem. Ferris also found that the service length of board members, the number of directors, the independence of the board, and the structure of the administrative team did not have an effect on whether companies accepted responsibility for financial problems or tried to lay blame on external factors.

"Typically, we found firms that blamed themselves also wanted investors to know that they had identified the problem and that they were expecting to improve their performance in the future," Ferris said. "Following these announcements, we noticed a striking separation between companies that accepted responsibility for their performance problems and those that blamed others. Those companies accepting responsibility saw their share price stabilize over the next several months, while those that blamed others continued to experience falling share prices."

Ferris said several factors could be the cause of trying to lay blame on external forces. Those factors include arrogance, pride, fear of litigation, and the inability of company leaders to see their own shortcomings. Of those companies that blamed external factors, 44 percent replaced their CEOs in the following year compared to only 32 percent of companies who accepted responsibility.

More information: The study, "Poor Performance and the Value of Corporate Honesty," will be published in an upcoming issue of the *Journal of Corporate Finance*.

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