Why CEOs delay sharing bad news—and how to stop it

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An important part of a CEO's job is to communicate a business's value to shareholders. Good news is usually shared with investors right away, but bad news tends to lag. A new study from the University of Georgia Terry College of Business examines why CEOs delay the release of bad news and how that can change.

Top managers face a double-edged sword when they communicate news to shareholders. Being open about a firm's recent trajectory is good for investors, but can be harmful for a CEO's career.

"The CEO doesn't want to get fired, and is concerned with how the market will view his or her performance as a manager if they release poor company performance," said John Campbell, an associate professor of accounting at the Terry College. "The idea, then, is that the CEO will delay the release of bad news as long as possible in hopes that good news will come along to offset it, so that the bad news never has to be released."

These career concerns can create a barrier to open and timely dialogue between the firm and its investors. In an effort to understand this phenomenon, prior academics found something of note. Since the passage of Regulation Fair Disclosure in 2000, which requires CEOs to disclose company news to all investors simultaneously, CEOs seemed to no longer delay the release of bad news.

"One set of researchers noticed that CEOs stopped delaying bad news

after the passage of Reg. FD, a regulation that has absolutely nothing to do with career concerns. So we were puzzled by that," Campbell said. "If I'm a CEO under Reg. FD, I can still delay bad news. I just don't tell anyone. So we decided to look into it."

Their findings are included in a paper called "Do Career Concerns Affect the Delay of Bad News Disclosure?" that Campbell co-authored with fellow Terry College professor Stephen Baginski, Terry doctoral candidate Lisa Hinson and David S. Koo at the University of Illinois Urbana-Champaign (and a Terry College Ph.D. graduate from 2013). The paper was presented at the 2015 Canadian Academic Accounting Annual Conference

The authors found that Regulation Fair Disclosure doesn't eliminate the delay of bad news release, but it did change the way firms forecast their earnings. More importantly, the authors find that previous researchers' failure to account for these changes in forecasting behavior led to overstated conclusions on the effectiveness of Regulation Fair Disclosure on eliminating bad news delay.

"We look at management forecasts, and around this time, managers started issuing more range forecasts versus point forecasts," said research co-author Lisa Hinson. "Basically, the manager would say 'We expect earnings per share to be between 2 and 6 cents' instead of saying, 'We expect it to be 4 cents.'"

Around the same time, CEOs became more likely to simultaneously issue earnings forecasts for the next quarter and announce the earnings of the previous quarter. Taking these new findings into account, the researchers concluded that Reg. FD did not have much of an effect on the release of bad news relative to good news.

So what explains the delay of bad news disclosures? Money.

Specifically, the kind of severance compensation paid to CEOs. The researchers found that top-level severance pay helped alleviate the fear of being fired, freeing CEOs to open up about failures.

"There's a lot of people who think that CEO severance pay is a rip-off," Campbell said. "They look at it and say, 'Why are you paying this guy so much money when he was fired at his job?' But if it reduces the manager's career concerns enough, they will take actions that they otherwise might not have. They take more risk and, in this case, accelerate the disclosure of bad news. They don't feel as concerned about being fired in the short run."

The key word being "enough." Severance packages (or ex-ante agreements) are standard for many C-suite jobs. But not all are created equal. To keep CEOs open and honest about their forecasts, their compensation needs to be in the top 50 percent, Campbell said.

That's equal to about $8 million, or nine times a typical CEO's yearly salary.

"If you give a manager enough severance, they reach the point where they don't differentiate between good and bad news, they disclose to investors on an equally timely basis," Campbell said.

That level of transparency translates into better conditions for investors overall, the authors said.

"It's typically good to encourage CEOs to take risks and invest in positive net-present-value projects," Hinson said. "And the markets generally like to know information as soon as the managers know, rather than getting it at a delay. It keeps capital market participants informed and leads to more efficient capital allocation."

More information: Stephen P. Baginski et al. Can Contracting on Career Concerns Induce CEOs to Provide Timely Disclosure of Bad News?, *SSRN Electronic Journal* (2015). DOI: 10.2139/ssrn.2537580

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