Early disclosure of risks can reduce decline in stocks, study finds

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Early, enhanced information provided by a 10-K (an annual report required by the SEC about a company's financial picture) helps investors with risk management, according to new research from the University at

Buffalo School of Management.

Available online ahead of publication in the *Journal of Accounting and Public Policy*, the study examines the impact of the risk factor disclosures the Securities and Exchange Commission (SEC) has required since 2005—and whether those disclosures lessen the chance a firm will experience a large decline in stock returns.

"This research supports the SEC and other regulatory agencies' drive to increase disclosure," says study co-author Szu-Yin "Jennifer" Wu, Ph.D., clinical assistant professor of finance in the UB School of Management. "Enhanced disclosure can improve a firm's information environment, leading to better outcomes for firms and market participants alike."

To examine the impact of these mandated disclosures, Wu and her co-authors analyzed four main data sources: risk disclosures in 10-K filing from the SEC's Electronic Data Gathering, Analysis and Retrieval database; nearly 35,000 firm-year observations from 1996 to 2013; and CRSP and Compustat datasets for pricing, trading and annual financial data.

The study found that practitioners can reduce large negative events, such as Enron's financial collapse when management hid financial losses, through early disclosure. Wu says the firms that see the greatest reduction in risk are those with better corporate governance, less transparent information environment, or those that are more vulnerable to shareholder litigation.

"The risk of a lawsuit encourages firm managers to disclose bad news earlier in mandatory disclosures to prevent costly shareholder lawsuits," says Wu. "In a similar vein, well-governed firms are associated with the more timely and relevant release of information."

For publicly traded companies and investors, these results lend credence to the importance of disclosures in reducing the decline in stock returns.

More information: Shiu-Yik Au et al, Do mandatory risk factor disclosures reduce stock price crash risk?, *Journal of Accounting and Public Policy* (2023). DOI: 10.1016/j.jaccpubpol.2023.107077

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