Works in Progress: Abstracts

“Commitment, Signaling, and Disclosure Regulation”

Abstract: This paper examines the role of disclosure regulation as a commitment device for firms and its interaction with signaling activities. Disclosure regulation enhances the credibility of firms’ disclosures by imposing ex post punitive cost on distorted disclosures. Compared with signaling, disclosure regulation as a commitment device has its benefit and cost. On one hand, effective disclosure regulation does not incur dead-weight loss because in equilibrium no firms distort their disclosures. The ex post punitive cost serves as a deterrent and is not actually triggered. In contrast, in a signaling equilibrium, the firm has to incur real cost to make it too costly for others to imitate. On the other hand, disclosure regulation has its inefficiency. Not only does the incentive problem of regulators compromise the effectiveness of disclosure regulation, but regulators (or courts) are also prone to the statistical errors in verifying disclosures ex post. Therefore, disclosure regulation could only imperfectly substitute for signaling. Besides providing a possible explanation for the pervasiveness of disclosure regulation, the model also predicts that more disclosure regulation is associated with less use of costly dividend policy and less concentrated insider ownership.

“Information Asymmetry, Information Precision, and Investors’ Welfare”

Abstract: This paper studies the consequences of information asymmetry and information precision for investors’ welfare in a market with perfect competition. I demonstrate that both information asymmetry and information precision affect the welfare of uninformed and informed investors. On one hand, keeping investors’ average information precision constant, information asymmetry among investors makes uninformed investors worse off and informed investors better off. Because informed investors could use their private information to change their portfolios more swiftly than uninformed investors, uninformed investors are always on the wrong side of trading. On the other hand, keeping constant the degree of information asymmetry between uninformed and informed investors, greater average information precision reduces the welfare of both groups of investors. Less uncertainty about a firm’s future payoffs induces investors to compete more fiercely for the firm’s stocks, and such heightened competition drives away the surplus investors gain from holding the firm’s stocks. Since Lambert, Leuz, and Verrecchia (2006, working paper) has demonstrated that it is the improvement in investors’ average information precision, not the reduction in information asymmetry per se, that reduces cost of capital, the results in this study highlight the observation that cost of capital does not summarize the impact of information asymmetry or information precision on investors’ welfare.

“Common Knowledge and Momentums”

Abstract: This paper re-compare earnings momentum (post-earnings-announcement drift) and price momentum as a test of the theory of price inertia proposed by Morris and Shin (2006 AER). When investors with differential information are concerned about the beliefs of others, events in the distant past become common knowledge and are gradually impounded into prices. Prices contain both earnings information and non-earnings information. Earnings information is more likely to become “common knowledge” over time than non-earnings information, because it is more systematically maintained over time. Therefore, the predictive power of past returns could be only a noisy proxy of the predictive power of past earnings information. The three empirical tests in this paper support this hypothesis. The first two tests demonstrate the inappropriateness of using cross-sectional tests that were typically employed in previous literature, because two momentum strategies require distinct portfolio formation rules and holding periods. The third test runs a fair horseracing by comparing the two return series from two strategies when both follow their own optimal formation rules and holding periods. The return series from earnings momentum explains that from price momentum, but the reverse is not true. Therefore, earnings momentum subsumes price momentum.
Research Statement

I have done some work and will continue to focus on the role of accounting disclosure in capital market. Dispersed ownership of modern corporations has many consequences, of which agency problems are the best known. However, some other implications of the dispersed ownership that have fundamentally changed the nature of accounting practice and research have not received the attention they deserve. In particular, a public firm operates in a capital market populated by investors who have differential information and preferences. Contracting between investors and the firm’s manager could be very expensive under some circumstances and many interesting issues about the firm’s communication with the capital market arise in this context.

My primary interest is in the role of disclosure regulation in the diverse capital market. Disclosure regulation is usually justified by market failure: either financial disclosure is a public good or it has externality. I am formalizing another rationale for disclosure regulation in one of my current projects. Disclosure regulation enhances the credibility of the firm’s disclosure by imposing an ex post punitive cost on distorted disclosure. Compared with the firm’s signaling activities (e.g., dividend policies and ownership structure) and private contracting (e.g., surety bond, insurance, and private litigation), disclosure regulation as a commitment device for the firm has its unique cost-benefit structure. The imperfect substitution between disclosure regulation, signaling activities, and private contracting has a number of empirical implications.

After proposing the role of disclosure regulation as a commitment device for the firm, the next question is how to measure the economic consequences of disclosure quality. Since it is empirically difficult to measure investors’ welfare, cost of capital has been extensively used as the proxy for investors’ welfare. My job market paper examines the implicit assumption behind this trend. I identify the necessary and sufficient conditions under which disclosure quality reduces cost of capital and improves investors’ welfare. These conditions are not equivalent, nor do they subsume each other. Therefore, cost of capital is not a sufficient statistic for investors’ welfare.

The second issue I am working on is about the role of accounting disclosure in shaping investors’ higher order beliefs. That everyone knows a piece of information does not necessarily result in the information being common knowledge. When investors have differential information and investment horizons, they second-guess others’ beliefs and behave like in a “Keynesian beauty contest.” In one paper, I study how investors “rationally overuse” accounting disclosure relative to their private information and its implication for market efficiency. I am also empirically testing one empirical implication of the theory that earnings momentum subsumes price momentum. In the future, I plan to propose another rationale for disclosure regulation: it increases the extent to which accounting information becomes common knowledge among investors. This direction is closely related to an emerging literature on global games in economics and finance.

The third issue is the interplay between the firm’s disclosure and its learning from stock prices. A tenet in economics is that prices aggregate information inherently dispersed among market participants. Presumably, the manager of the firm could learn something new about the firm’s prospect from stock prices and use it to improve the firm’s decisions. However, the firm’s attempt to extract information from stock prices changes investors’ expectations about the firm’s value and thus such attempt interferes with the market aggregation process. The firm’s disclosure of its own information could further complicate the issue.

In sum, I am curious about the consequences of dispersed ownership beyond agency issues. My ultimate goal is to combine the agency issues within the firm with the diverse nature of the capital market in order to better understand the role of accounting in modern corporations.