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Transparency: panacea or Pandora's box

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Transparency: panacea or Pandora's box

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Abstract

Purpose – The purpose of this article is to share with executives, public policy makers, and securities analysts some key behavior constraints on transparency seldom addressed in the professional literature. Focus is on unexpected and perhaps counterintuitive issues of transparency and full disclosure.

Design/methodology/approach – Recent contributions from management research are presented to inform behavioral constraints on transparency and full disclosure. A number of studies are reported including research on the herd instinct in market volatility, the private information paradox in competitive strategy, insider trading in technology-intensive companies, symbolic corporate governance reform, and attribution theory and corporate responsibility.

Findings – Executives, public policy makers, and securities analysts should focus on the latest research that impacts their duties.

Originality/value – The paper reports new research which questions "conventional wisdom" that there are few, if any, negative aspects to transparency and full disclosure.

Keywords Strategic management, Governance, Volatility

Paper type Viewpoint

It is conventional wisdom that transparency, openness and full disclosure make for efficient financial markets and exemplary corporate governance. It is persuasively argued that there are few, if any, arguments against those advantages. One of the reasons why this is so is because it is deemed inappropriate, if not undemocratic, to argue for the opposite – secrecy and obfuscation. That may all be true, but surely there is room for quality research which might illuminate some of the unintended, if not counterintuitive notions, of "transparency." Such research might inform public policy makers, management practitioners and securities analysts of consequences that might be unforeseen or even adverse to public or private interest. It may be useful, therefore, to examine some lines of research and analysis. The following are but selections.

Does full, immediate and widespread disclosure of material corporate events lead to more or less volatility in market reaction by creating a "herd instinct" as market participants digest the same information at the same time, thereby causing sharp single direction swings in the market? Is that volatility exacerbated by the immediacy and completeness of the information and distribution mechanisms? We call attention to two opposite insights from management research on the dynamics underlying increased transparency and market swings. The first looks at securities analysts' decisions to initiate or abandon coverage of a company stock and finds that analysts look to their peers in these decisions, using "social proof" or the actions of others to

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infer the value of a company. This "me too" behavior stands in for evidence when analysts remain uncertain and is particularly prone to error during information cascades and market herding (Rao *et al.*, 2001). A second line of work finds that differences in the way securities analysts classify the same stock lead analysts to different conclusions, depending on their industry-based category structure, when interpreting new information disclosed about a company. These differences are not due to underlying company fundamentals; rather the market may be more divergent when processing information about "incoherent" companies because these companies do not fit into prevailing systems of industry classification (Zuckerman, 2004).

Assuming full and open disclosure of company strategy, does disclosure affect the company strategy itself? Do managers, with full knowledge that their strategy will be "open and notorious," water down or temper their strategy because of a concern that it might be misinterpreted, used to the advantage of competitors, or worse – if it fails – the managers might be identified as the provider of a failed strategy? Does that, in turn, cause managers to choose strategies which "regress to the mean" so they will not be blamed, in retrospect, if matters go wrong? Stated another way, does this add to the pressure for management to be risk averse, given the requirement for openness and transparency? Little research has been done in this area, not surprising given the relative recency of "full disclosure" accountability and, of course, the difficulty of designing a meaningful study.

Management theory also recognizes the tension between "doing the right thing" and "knowing the right thing to do" and calls it the "private information paradox": the general impossibility for managers to share with investors private information, which is fundamental to the company's competitive advantage, without also giving competitors access to that same private information, thereby eliminating the company's advantage (Makadok, 2003). There is some anecdotal evidence that managers of public companies withhold detailed guidance on financial prospects and strategy to investors – admitting, "If we were sharing those metrics with you, we would also be sharing all of those metrics with competitors". Management research is just gearing up to look at these issues.

Has the shift in the quality and timing of corporate disclosure and transparency in the wake of financial scandals, stockholder derivative law suits, Sarbanes/Oxley requirements, and the highly publicized collapse of international auditing firms caused capital to flow from public markets, where disclosure is mandated by law, into private, rather than public, equity funds? Or are there other reasons having little to do with disclosure and transparency that account for the huge capital transfers into private equity funds in recent years. And, if that is the case, will this tend to push upward the accumulation of wealth as only those with substantial financial resources have access to such investment opportunities. Or, is it of little consequence if such private equity investments perform no better than, say, publicly traded index funds?

Does full and open disclosure increase the probability of insider trading or create incentives for the few to surreptitiously discover high value material events before they are publicly available? Have the recent rules and regulations promulgated by the SEC, Sarbanes/Oxley and the FASB adequately addressed the disclosure issues involved in off balance sheet and over-the-counter derivatives, particularly where accounting and disclosure requirements may not track or measure the economic realities of the financial product? Similarly, do the new rules cover a more fundamental corporate

issue – accounting for "intangibles?" Intangible assets such as patents, unpatented results of R&D projects, proprietary software, brand names, reputation, and the know-how and skills of employees are pivotal to the innovation process, particularly in R&D companies, and are at the heart of creating economic value. In spite of their obvious importance, investors are provided with little information about these assets, even under newly revamped disclosure requirements. We do know, however, that intangible resources matter to company managers. Indeed, management theory has placed "resource-based" competitive advantage at the top of the agenda. Moreover, recent work looks closely at stock purchases by company insiders and finds that shareholders view R&D intensive companies differently and that managers in these firms are able to time trades to take advantage of impending breakthroughs in technology (Coff and Lee, 2003; Ahuja *et al.*, 2005). Research opportunities in these areas are plentiful and are reminders of the magnitude of disclosure issues that remain unresolved.

To what extent is it feasible or desirable to develop a procedure for measuring and reporting of opportunities lost, i.e. measuring the implications of a failure to act? Is this not as important a measure of company performance and strategy as overt action? Is there not room for research – perhaps through case studies or intensive interviews – to determine whether negative company performance might be attributed to the failure to act imaginatively or quickly rather than the typically disclosed, overt and transparent actions. How might we make transparent those invisible actions, never taken, in order to better assess management? Conversely, how might we determine whether visible or proactive interventions have "caused" adverse or positive outcomes—an area hardly touched by current corporate disclosure policy? And, how might such findings be made transparent? Although academic research has looked at the implications of failing to implement meaningful corporate governance reforms, it finds only "symbolic" reforms to be frequent and widespread – particularly where management dominates the boards of directors (Westphal and Zajac, 1998, 2001). But even this research focuses primarily on corporate governance rather than the implications of omissions to act in developing, for example, a competitive strategy for a rapidly changing industry environment.

Finally, how might disclosure and transparency facilitate the assessment of public policy and (for company stockholders) whether a particular positive or negative outcome is "caused" by the intervention to which it is attributed? The element of "human behavior" has been heavily researched in the cognitive and behavioral literature, e.g. do we attribute mistakes to others to avoid being identified as the provider of unwise interventions, develop mechanisms of "plausible deniability," or shift blame for negative outcomes but take credit when results are good? Rarely are managers held to the test of proving (they are hardly even asked) that their intervention "caused" a given effect and that the outcome was not contextual, random or coincidental. In the world of management and politics, outcomes are rarely tested by cause and effect analysis. All of these quite human characteristics are of even greater impact when strategy and performance is public, transparent and attributed. Early work in management has used attribution theory – how people explain their own and others' behavior to understand how managers justify company performance (Bettman and Weitz, 1998; Staw *et al.*, 1983). Fundamental work is just beginning to look at the central role of "intentionality" in explaining how a specific intervention leads to a given

result (Malle, 2004). But it is not at all clear that securities analysts, for example, actually look at whether a specific intervention "caused" a given result. Prospects for management research in this area will clearly need better cognitive models and disclosure of corporate "intentions" at the time they are initiated in order to conduct this kind of research. New qualitative methodologies perhaps will help test the optimistic claims by managers of favorable causal conventions.

Of course, the foregoing is not meant to be inclusive. Nor are the examples given easily researchable. Moreover, we do not mean to imply that transparency has failed or has produced, on balance, negative consequences which have outweighed its usefulness. That is not the case. To the contrary, transparency has provided a vehicle for new and imaginative research techniques in the academic community and in some cases is an extension of research methods and subject matters already being looked at. We also hope that professional managers, analysts, and commentators will look for ways to improve practice and inform public policy by using new research methodology and research findings.

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