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The effect of conference calls on equity incentives: An empirical investigation

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A B S T R A C T

Conference calls have become increasingly common in recent years, yet there is little empirical evidence regarding the effect of conference calls on executive compensation. In this study, we examine the effect of voluntary disclosures on equity incentives. We hypothesize that voluntary disclosures, as measured by conference calls, affect executive compensation contracts. Using a dataset of 6263 firm-year observations from both conference call and non-conference call firms, our results are consistent with the argument that the board of directors substitutes voluntary disclosures for more costly corporate governance mechanisms. Alternatively, in firms where CEOs have less equity incentives, the owners demand more voluntary disclosures. The results of this study should be of great importance to executives and capital market participants internationally, such as investors and analysts, since we provide evidence that conference calls affect incentive based compensation contracts, which were shown in prior studies to be value relevant.

1. Introduction

Over the past two decades equity incentives via stock-based compensation have become a very important feature of the contracting environment between shareholders and executives (Core et al., 2003). The fundamental reason for the use of stock-based compensation is to align the interests of shareholders and managers by tying executive wealth to stock performance (Frydman and Sacks, 2010;

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Murphy, 1999; Bebchuk and Fried, 2003). Because executive effort is unobservable, compensation risk is imposed on executives in order to motivate them to take actions that are in the best interest of the shareholders. In addition, the stock price contains information that investors have about the managers' actions and so it may be useful for contracting purposes. Therefore, equity incentives are more important in firms with higher information asymmetry, monitoring difficulties, and agency costs.

Managers, however, make voluntary disclosures of unverifiable private information in the form of management earnings forecasts, press releases, conference calls, and/or published financial statements. These disclosures reduce information asymmetry and influence market prices (Beyer et al., 2010; Aboody and Kasznik, 2000; Wang, 2007; Karamanou and Vafeas, 2005; Larcker and Zakolyukina, 2012). It is this relationship between information asymmetry, voluntary disclosures, and stock based compensation that this study explores.

In this study we hypothesize that voluntary disclosures affect compensation contracts. This hypothesis draws from arguments and findings in the corporate governance literature. The main argument in the literature is that a high level of information asymmetry, and thus monitoring difficulties, requires the implementation of more powerful, and possibly more costly, corporate governance mechanisms to help align managers and shareholders interests (La Porta et al., 1998; Berger, 2011; Bebchuk and Weisbach, 2010). Bushman et al. (2000, 2004) provide evidence suggesting that firms with less informative financial statements substitute more costly governance mechanisms, such as more powerful equity incentives, to compensate for their less useful accounting numbers. Firms with poor financial statements, however, can compensate for the lack of information by inducing the manager to voluntary disclose his private information instead of adopting more costly corporate governance mechanisms. Our hypothesis is analogous to the substitutability argument of Bushman et al. (2004). Therefore, we hypothesize that firms can substitute costly corporate governance mechanisms (equity incentives) by committing to more forthcoming voluntary disclosure policies.

Managerial incentive contracts and disclosure policies are endogenous and are modeled as a system of simultaneous equations. The model resembles a demand-supply specification, and can take similar interpretation. So, an alternative interpretation of our hypothesis is that in firms with lower equity incentives shareholders will *demand* more voluntary disclosures in order to satisfy their monitoring needs.

In this study, conference calls proxy for a firm's voluntary disclosure policy. An important characteristic of conference calls is that they constitute ex-ante commitments to voluntary disclosures. A maintained assumption is that firms that host conference calls provide higher quality of voluntary disclosures to the market (Matsumoto et al., 2011; Kimbrough and Loius, 2011). So the latent variable of interest is the quality of voluntary disclosure that takes the form of conference calls if it exceeds a hurdle. A firm's compensation policy is proxied by the manager's portfolio of equity incentives (Core and Guay, 1999).

Using a dataset of 6263 firm year observations of which 3204 are conference call firms and 3059 non-conference call firms, we show that conference calls affect equity based compensation contracts. This study differs from the extant research in the following respects. First, we examine whether voluntary disclosures can improve contract efficiency or substitute for other more costly corporate governance mechanisms. Second, we use conference calls to proxy for the voluntary disclosure policies of firms. Conference calls provide a unique setting to study voluntary disclosures because of their characteristics: they are unscripted and unregulated, interactive, and unlike earnings forecasts they constitute ex-ante commitments to voluntary disclosures.

In Section 2, we provide background, motivation and hypothesis development. Section 3 presents the research design. Section 4 presents the empirical results and robustness tests. The final section concludes.

2. Background, motivation and hypothesis

Over the past two decades conference calls have become a popular venue for managers to disclose information. The majority of conference calls take place a few days after quarterly earnings announcements. A typical call opens with the CEO and the chief financial officer discusses in detail the financial performance of the company. The discussion is followed by a question-and-answer session, where