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## Ownership structure and disclosure quality: Evidence from management forecasts revisions in Japan

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## ABSTRACT

We investigate the relationship between ownership structure and quality of disclosure in the case of Japanese firms. Our measure of disclosure quality is denoted by the attitude of firms toward voluntary revisions of management earnings forecasts, which are effectively mandatory in Japan. The results show that firms with high foreign and domestic institutional ownership are more likely to provide management forecasts revisions in a voluntary and timely manner. In contrast, firms with high bank ownership have a greater propensity to withhold material changes in management forecast estimates until the very last moment when they are legally compelled to reveal that information. These findings suggest that active investors are able to induce firms to adopt better disclosure practices, while investors with close business ties and access to firms' private information appear to restrict the flow of information to other investors.

## 1. Introduction

Firms have good reasons to disclose private information. The benefits of disclosure involve lower cost of capital, higher stock valuation and greater ability to raise funds, which altogether promote firm growth (Pownall and Waymire, 1989; Diamond and Verrecchia, 1991; Lang and Lundholm, 1993; Botosan, 1997; Francis et al., 2005). However, concerns related to product market competition may prevent firms from disclosing their private information (Verrecchia, 1983; Darrough and Stoughton, 1990; Wagenhofer, 1990; Newman and Sansing, 1993). Attitudes toward disclosure also vary across shareholders. Institutional investors require accurate and timely information to allocate their funds more efficiently (Healy et al., 1999; Bushee and NOE, 2000; Ajinkya et al., 2005). In contrast, controlling blockholders prefer fewer disclosures since their longer horizons imply that they have little to gain from a prompt reevaluation of their shares. Furthermore, Sengupta (2004) argues that controlling blockholders have greater access to the firm's private information and would prefer to maintain their informational advantage by discouraging timely and detailed public disclosures.

Empirical studies based on US firms indicate that quality of disclosure is linked to firms' ownership structure. Using management earnings forecasts as a means for firms to convey private information, Ajinkya et al. (2005) find that institutional ownership is associated with more accurate and less biased disclosures. While their focus is on the role of internal governance structures, Karamanou and Vafeas (2005) show that firms with high institutional ownership are more likely to issue management earnings forecasts that are also more precise, whereas insider ownership is associated with fewer and less precise forecasts. Both studies control for the endogeneity of ownership. However, their variable of interest may not accurately capture firms' disclosure quality. In an environment where forecasts are voluntary, firms can freely choose whether and when to issue forecasts. Accordingly, the decision

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not to issue forecasts does not necessarily indicate poor disclosure, as firms can choose not to issue forecasts simply because they have no incentive to do so. Since prior studies use non-issuers as the control group, the question of whether and how governance structure is associated with the decision to disclose management's private information has not been fully resolved.

In this paper, we investigate the link between ownership structure and disclosure quality using Japanese data. This setting presents several critical advantages. First, Japanese publicly traded firms are strongly encouraged by the stock exchange to issue forecasts of the coming year's earnings at their annual results announcements. Along with the country's much less litigation-prone tradition, such strong requests from the stock exchange make almost all Japanese firms issue forecasts (Kato et al., 2009; Ota, 2010). This unique feature allows us to circumvent potential self-selection (i.e., which firms choose to issue forecasts) and timing issues (i.e., when they issue forecasts). Although their main focus is on how forecasts bias affects the credibility of firms' subsequent forecasts, Kato et al. (2009) use that same feature to confirm that institutional ownership is associated with less biased management forecasts in a setting where forecasts are mandatory. Our study extends these findings by further investigating how differences in the way firms revise their forecasts are associated with initial forecasts biases and how revisions vary with the firms' ownership structure.

Second, once forecasts are issued, firms are not only encouraged by the stock exchange to update these forecasts but are also legally required by the Financial Instruments and Exchange Act to disclose revised forecasts in case significant changes in management estimates arise. The existence of such legal requirement enables us to distinguish those firms that provide revised forecasts voluntarily and to further identify the situations in which firms are most likely to delay the release of new information until the last moment. As the extent to which disclosure provides "useful" information to market participants depends on when it is released (Sengupta, 2004), we consider voluntary revisions of existing forecasts disclosed during the fiscal year as an indication of better disclosure, and legally compelled revisions issued after the fiscal year-end as an indication of poor disclosure. In the sense that we investigate when revised forecasts are released, this study can also be viewed as contributing to the literature on disclosure timing decisions.

A third advantage of using Japanese firms comes from their distinct ownership structure and the way corporate ownership is reported in Japan. First, foreign (mainly institutional) investors are separated from domestic institutional investors. This enables us to test more precisely which type of institution exercises a greater influence on a firm's disclosure behavior. Ajinkya et al. (2005) recognize this heterogeneity but are only able to use concentrated institutional ownership as a proxy for the ability of institutional investors to elicit private information. Moreover, recent studies indicate that independent institutions are able to confront management in order to meet their objectives (Ferreira and Matos, 2008). Foreign investors fit this category of investors, as they do not have business relationships with the firms they invest in. Accordingly, we expect foreign ownership to be associated with better disclosure compared to domestic institutional ownership.

In addition, business groups with extensive inter-corporate and bank shareholdings are common in Japan. These business groups were formed around a main bank to pool resources and mitigate business risks (Goto, 1982; Nakatani, 1984; Hoshi et al., 1991; Aoki and Patrick, 1995; Verrecchia and Wang, 2011; Zhang et al., 2016). Coordination and alignment of this group involves the sharing of information with the managers of other member firms. For instance, meetings (known as *shacho-kai*) are regularly scheduled between the presidents and directors of the various member firms. Since firms affiliated to a business group have straightforward access to bank and inter-corporate loans, their incentives to maximize firm value before raising equity in the capital markets are lower compared to unaffiliated firms.<sup>1</sup> Affiliated firms should also be reluctant to disclose information that might be used to expose the abuse of minority shareholders (e.g., tunneling of resources from a particular firm to the benefit of other member firms). Accordingly, we expect affiliated firms, i.e., firms with a high level of bank and corporate ownership, to be characterized by less disclosure.

The empirical results are largely consistent with our hypotheses. Firms with higher foreign or domestic institutional ownership tend to make better disclosures. More precisely, domestic institutional investors are associated with more timely forecasts revisions, whereas foreign investors are associated with forecasts revisions that are both more frequent and timely. In contrast, firms under the control of banks tend to have poor disclosure practices, while firms with large corporate shareholdings do not appear to have significantly different disclosure practices. Overall, this study contributes to explain the cross-sectional difference in corporate disclosure by showing that the incentives of a firm's major shareholders play a significant role. Shareholders who are likely to benefit from receiving better information appear to induce firms to release timely forecasts revisions. In contrast, shareholders who have little to gain from a prompt release of information appear to influence firms to make fewer and less timely revisions. These findings, which are not biased by potential self-selection and timing issues, confirm the results of Ajinkya et al. (2005) and Karamanou and Vafeas (2005) in a context where large shareholders that have strong business connections with the firm (banks and other firms) play a significant role. Our study also extends Kato et al. (2009) by providing new evidence that ownership structure is associated with a firm's propensity to release or withhold private information, and not just with the precision of its forecasts. This result is consistent with Sengupta (2004), who reports that higher institutional ownership is associated with shorter lags in reporting annual earnings, while ownership by blockholders that have access to private information is associated with longer lags.

The remainder of this paper is organized as follows. Section 2 provides an overview of the Japanese institutional setting and develops the hypotheses. Section 3 presents the sample and the research design. Section 4 reports and discusses the empirical results. Section 5 concludes with a summary and discussion of avenues for future research.

<sup>1</sup> Chen et al. (2008) make a similar observation to justify that family firms make fewer earnings forecasts.

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