The effects of a reasonable investor perspective and firm's prior disclosure policy on managers' disclosure judgments

Diane Mayorga, Ken T. Trotman

School of Accounting, UNSW Australia, Australia

ABSTRACT

Security laws and accounting standards suggest that reasonable investors' expectations are an important consideration for disclosure judgments. Regulators have expressed concerns that many disclosure judgments are made without adequate consideration of how investors would evaluate the information. However, the psychological literature suggests that individuals may face difficulties considering the facts from another's perspective. We conduct two experiments to examine whether prompting managers to take the perspective of a reasonable investor affects their disclosure recommendations of a probable negative change in their company's earnings expectations, and whether this effect is impacted by the firm's prior disclosure policy (known that its past preference to be biased towards no disclosure versus unknown). We find that experienced managers are more likely to recommend disclosure when they are prompted to take the perspective of a reasonable investor than when they are not and this effect is stronger when the firm's prior disclosure policy is unknown.

1. Introduction

Securities laws and accounting standards around the world suggest that managers consider the perspective of a 'reasonable investor' when they evaluate whether their listed company has an obligation to inform the investing public of events and circumstances that could materially affect the price of their firm's securities. In fact, the words 'reasonable person' and 'reasonable investor' are pervasive in the legislation of many countries including Australia, UK and USA. However, regulators are concerned that managers are making many disclosure judgments without fully considering the disclosure matter from a benchmark of how a reasonable investor would evaluate the information (Pozen, 2008, p. 80). Research also indicates that managers' disclosure judgments are affected by their firm's preferences and experiences for the way disclosure is managed (hereafter referred to as the 'firm's prior disclosure policy') (e.g., Bamber, Jiang, & Wang, 2010; Gibbins, Richardson, & Waterhouse, 1990; Holland, 2005).

Given the requirement to consider the viewpoint of a reasonable investor when making disclosure decisions, our study investigates whether managers are more likely to recommend disclosure of a probable negative change in their company's earnings expectations when they are prompted to take the perspective of a reasonable investor and whether this effect is increased or decreased when managers know the firm's prior disclosure policy has been biased towards no disclosure. Our study examines the research questions in the context of Australia's Continuous Disclosure (CD) environment although it is noted that CD obligations are also relevant to many other countries including Canada, Hong Kong, New Zealand, Singapore and the UK. Australia's CD regulation requires that companies promptly disclose information that a reasonable person would expect to have a material effect on the price or value of their securities unless certain exceptions are satisfied including that a
reasonable person would not expect the information to be disclosed.¹ Despite the importance of the reasonable investor concept, little empirical evidence exists regarding its effect on the judgments of preparers, audit committees or auditors (for an exception see Altiero, Kang, & Peecher, 2015 who examine perspective taking on auditor judgments).

Research in psychology shows that while individuals have the ability to take another person’s perspective into account (Davis, 1983; Epley, 2008; Epley & Caruso, 2009; Keysar & Barr, 2002), they may face difficulties in getting beyond their own point of view to consider the facts from another’s perspective (e.g., Epley & Caruso, 2009; Epley, Keysar, Boven, & Gilovich, 2004). Additionally, psychological research on the impact of motivated reasoning suggests that individuals face difficulties in evaluating information and making judgments impartially when they have a stake in reaching a particular outcome (Kunda, 1990). For instance, individuals judge evidence supporting their preferred outcomes to be more important and to have stronger implications than evidence contradicting their preferred outcome (e.g., Ditto & Lopez, 1992; Lord, Ross, & Lepper, 1979). Accounting research finds that, given sufficient ambiguity, accounting professionals’ judgments are vulnerable to motivated reasoning effects (Hackenbrack & Nelson, 1996; Kadous, Kennedy, & Peecher, 2003; Peecher, Piercey, Rich, & Tubbs, 2010) and that pre-existing preferences to reach a certain desired outcome indirectly influence professionals’ judgments by affecting the manner in which information is evaluated (e.g., Wilks, 2002). As managers have clear preferences regarding their financial reporting choices (Bamber et al., 2010), we contend that when managers do not consider a reasonable investor’s perspective they may take advantage of the uncertainty surrounding a disclosure issue to arrive at a self-interested disclosure recommendation as long as their disclosure outputs are justifiable.

Our paper reports the results of two experiments. In the first experiment, we manipulate whether managers are prompted to consider the perspective of a reasonable investor (prompt versus no prompt) and knowledge of the firm’s prior disclosure policy (known, that its past preference is biased towards no disclosure, versus unknown) to examine the impact on disclosure judgments for a new subjective disclosure matter. Experienced senior finance managers, mainly company secretaries,² make a disclosure recommendation on whether a probable negative change in the company’s earnings expectations should be disclosed. Our results show that managers make disclosure recommendations that are more supportive of disclosing a negative change in earnings’ expectations when they are prompted to take a reasonable investor’s perspective compared to when they are not and this effect is stronger when managers do not know the firm’s prior disclosure policy.

We conduct a second experiment to establish that our results are robust to the way managers are prompted to consider the perspective of a reasonable investor when making disclosure recommendations. We design the experiment to include an indirect approach to stimulate managers’ consideration of a reasonable investor’s perspective. This approach allows us to examine the effect of a reasonable investor prompt on managers’ disclosure recommendations while reducing possible demand effects. In a 1 x 3 experiment, we replicate the reasonable investor prompt manipulation used in the first experiment (i.e., managers are prompted to take the perspective of a reasonable investor or not) as well as add a new prompt condition in which managers rate the likelihood that the disclosure matter would influence a reasonable investor’s investment decision prior to making their own disclosure recommendation. We find that managers in both prompt conditions are more likely to recommend disclosure of a probable negative change in their company’s earnings expectations than managers in the no prompt condition. Our additional analysis shows that managers who are prompted to take the perspective of a reasonable investor are more likely to consider reasons for and against disclosing a probable negative change in their company’s earnings expectations. This suggests that perspective taking may be an effective mechanism to reduce unintentional biases in interpreting and evaluating information.

2. Background and hypothesis development

2.1. Reasonable person concept and Australia’s continuous disclosure regime

‘Reasonable person’ is a legal construct. The term originates from the English legal system enabling issues of ‘ought’ to be resolved by reference to the objective fact of whether a reasonable person would have done likewise (Uren, 2003). In law, ‘reasonable person’, as a reference to a community standard, has been a powerful metaphor for establishing negligence.³ The concept of a reasonable person has also been a significant feature in the professional accounting literature for many decades. For example, in its Statement of Financial Accounting Concepts No. 2, the Financial Accounting Standards Board’s states that “the omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item” (FASB, 1980). The SEC provides guidance that a matter is material “if there is a substantial likelihood that a reasonable person would consider it important” (SEC, 1999). This formulation is reinforced by legal decisions, such as that rendered by the US Supreme Court which held that “an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”.⁴ In more recent auditing and accounting settings, the reasonable person/reasonable investor standard has been applied in determining auditor independence (AICPA, 1988; APESB, 2007), in the consideration of materiality in planning and performing audits (IFAC, 2006; PCAOB, 2010), in the preparation of management’s discussion and analysis (CICA, 2009), in the disclosure of inside trading information (FCA, 2013), in the evaluation of financial statement errors (Pozen, 2013), in the Blyth v Birmingham Waterworks Co (1856) 11 Ex Ch 781. The court found that the defendants could only have been negligent if they had failed to do what a reasonable person would do in the circumstances. This case defined negligence as “the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do. The defendants might have been liable for negligence, if, unintentionally, they omitted to do that which a reasonable person would have done, or did that which a person taking reasonable precautions would not have done.”⁵ In TSC Industries Inc v Northway Inc 426 US 438 (1976). Also, see Mitchell v Texas Gulf Sulphur Co., 446 F2D 90, at 99–100 (10th Circuit, 1971) and Escott et al. v. BarChris Construction Corporation et al., 283 Fed. Supp. (District Ct. S.D. New York, 1968) p. 681.

¹ As required by the Continuous Disclosure (CD) Requirements which consist of Australian Securities Exchange Listing Rule 3.1 and 3.1A and Chapter 6 of the Corporations Act.
² In Australia, company secretaries are part of the executive management team. One of their key responsibilities is to advise the board on the company’s statutory disclosure obligations. They are considered to be officers of the company, and therefore, can be held personally liable and subject to civil penalties in the event their company is found to have contravened the CD provisions of the Corporations Act. In the US, company secretaries are referred to as corporate secretaries.

³ Please cite this article in press as: Mayorga, D., & Trotman, K.T., The effects of a reasonable investor perspective and firm’s prior disclosure policy on managers’ disclosure judgments, Accounting, Organizations and Society (2015), http://dx.doi.org/10.1016/j.aos.2015.10.003
Continuous disclosure is a central tenet of the Australian regulatory landscape for listed public companies. It is primarily based on a combination of Australian Securities Exchange (ASX) requirements and the legislative provisions of Australia’s Corporation Act. Of interest to this study is Australian Securities Exchange Listing Rule 3.1 (ASX LR3.1) which requires an entity to immediately disclose information that a reasonable person would expect to have a material effect on the price or value of the entity’s securities (referred to as “market sensitive information”). Information is market sensitive if it would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the securities. The ASX has acknowledged that determining whether information is market sensitive can be difficult in practice as listed entities are “effectively required to predict how investors will react to particular information when it is disclosed” (ASX, 2013, p. 10). Given this difficulty, the ASX suggests that managers may find it helpful to take the perspective of a reasonable investor when faced with continuous disclosure decisions (ASX, 2013).

2.2. Directional goals and managers’ disclosure judgments

Managers have economic incentives to disclose information opportunistically (e.g., Aboody & Kasznik, 2000) including withholding bad news (e.g., Kothari, Shu, & Wysocki, 2009). For example, managers have incentives related to stock valuation, career concerns and external reputation, and these incentives can drive managers to delay disclosure of bad news in the hope that the firm’s performance will improve before the next required information release, to allow further study and interpretation of the information, or to package the bad news with other disclosures (Graham, Harvey, & Rajgopal, 2005). In addition, managers have preferences to maintain predictability in earnings and financial disclosures (Graham et al., 2005). Managers are likely to use these preferences as a starting point, or judgmental anchor, when assessing new disclosure information and subsequently adjust away from their anchor to take into account the specifics of the new disclosure context.

Motivated reasoning research shows that directional goals bias individuals’ beliefs about the perceived likelihood of events (Klein & Kunda, 1992; Kunda, 1990). Desirable events are perceived as more likely to occur when individuals make a subjective interpretation of the events occurring (Irwin, 1953; Irwin & Snodgrass, 1966; Marks, 1951). For example, individuals can interpret their belief that an event has a 60 percent probability of happening to mean that the event is either slightly likely, or somewhat likely, to happen, depending on whether they want to view it as likely (Kunda, 1990, p. 488). Individuals’ interpretation of an event, in turn, can affect their willingness to assume and bet that the event will occur (Arrow & Ross, 1966). Several studies in accounting provide evidence that the decision processes of managers, investors and traders are susceptible to directional reasoning mechanisms (e.g., Hales, 2007; Han & Tan, 2010; Seybert & Bloomfield, 2009; Tayler, 2010). Consistent with motivated reasoning theory, this suggests that managers’ directional goals may bias their judgments about the likelihood of a negative change in earnings expectations as long as their final disclosure recommendations appear reasonable and justifiable based on the available information.

Directional goals are also likely to bias managers’ disclosure judgments when the disclosure issue is ambiguous. Psychological research indicates that ambiguous information allows for multiple interpretations (e.g., Montgomery, 1989) and therefore makes it more likely that directional goals will exert influence on individuals’ judgments (Schweitzer & Hsee, 2002). Even when individuals have goals to process information objectively, they may be unable to do so as their pre-existing directional preferences may foster more extensive defensive processing of ambiguous information (Liberman & Chaiken, 1992). Consistent with this, Hales (2007) demonstrates that when investors were only given explicit incentives to be accurate in their earnings forecasts, their directional goals still biased their forecasts. Consequently, we expect that managers’ directional goals to withhold bad news will lead to a self-serving “do not disclose” recommendation as a starting point for a new ambiguous disclosure matter.

2.3. Effect of perspective taking on managers’ disclosure judgments

When managers are faced with a decision on whether information needs to disclosed, they should consider whether the information will influence a reasonable investor’s investment decision (ASX, 2013). An important question, however, is whether managers can effectively predict how investors will react to particular information when it is disclosed. The psychology literature has long recognized that individuals’ social judgments tend to be egocentrically biased (e.g., Davis, 1983; Epley et al., 2004). One way for individuals to overcome their egocentric biases and tailor their behaviors to others’ expectations is through perspective taking (Batson, Early, & Salvareni, 1997; Davis, 1983; Davis, Conklin, Smith, & Luce, 1996; Epley & Caruso, 2009). Considering others’ perspectives has been found to increase the likelihood of helping another person in need (Batson, 1994), reduce the use of stereotypes when forming impressions (Galinsky & Moskowitz, 2000), increase negotiation effectiveness (Neale & Bazerman, 1983) and diminish a variety of problematic egocentric biases in judgment (Savitsky, Van Boven, Epley, & Wight, 2005; Wade-Benzoni, Tenbrunsel, & Bazerman, 1996).

The anchoring and adjustment model of perspective taking (Epley & Gilovich, 2004; Epley et al., 2004) predicts individuals adopt others’ perspectives by initially anchoring on their own more readily accessible perspective and subsequently adjusting to account for differences between themselves and others until a plausible estimate is reached (Epley & Caruso, 2009; Epley & Gilovich, 2006; Epley et al., 2004; Nickerson, 1999; Tversky & Kahneman, 1974). However, these adjustments tend to be insufficient (Epley et al., 2004; Tversky & Kahneman, 1974), and, as a result, many assessments of others’ perspectives remain egocentrically biased. Psychology research suggests that factors facilitating careful thought will decrease individuals’ egocentric bias in perspective taking (Epley et al., 2004). For example, Epley, Caruso, and Bazerman (2006) demonstrate that when individuals are explicitly asked to consider another’s thoughts, they are more likely to adopt another’s perspective than when individuals are not explicitly asked. In an auditing context, Altiero et al. (2015) find that auditors, who engage in investor-minded tasks prior to making materiality judgments, provide better quality judgments than auditors who do not.

---

5 In Australia, the Federal Court of Australia has considered expert witness testimony in determining whether a reasonable person would have expected disclosure. That is, if the information had been disclosed, would it have had a material effect on the value of the company’s share price? Experts used to provide expert testimony have included experienced share portfolio managers, stockbrokers, analysts, capital market academics and economists. For example, in Australian Securities & Investments Commission v Fortescue Metals Group Ltd [No 5] [2009] FCA 1586 (23 December 2009), the judge, J. Gilmour, considered the relevance of expert opinion of statisticians, stockbrokers and analysts in determining contraventions of CD provisions.

6 In this study, perspective taking refers to the ability to “intuit”, as accurately as possible, another person’s thoughts, feelings, attitudes, interests, or concerns in a particular situation (Chartrand, 1999; Davis, 1983; Epley & Caruso, 2009; Epley, Savitsky, & Gilovich, 2002).
In our study, we explicitly prompt managers to consider the perspective of a reasonable investor. Taking this perspective should increase managers’ attention to a reasonable investor’s disclosure preferences. Managers should also give greater consideration to the ways in which a reasonable investor might perceive the disclosure issue differently. This consideration is likely to motivate managers to adjust from their own personal disclosure preferences and thus lead to less egocentric disclosure recommendations. For example, as investors typically judge more corporate disclosure as better, managers are more likely to consider reasons supporting disclosure when they are explicitly prompted to consider a reasonable investor’s perspective.

In turn, these managers will make disclosure recommendations which are more supportive of disclosing a negative change in earnings expectations compared to managers who are not explicitly prompted. Our expectations are summarized below.

**Hypothesis 1.** Managers are more likely to recommend disclosure of a negative change in earnings expectations when they are prompted to take the perspective of a reasonable investor than when they are not.

### 2.4. Firm’s prior disclosure policy

Psychology research suggests that there are factors that inhibit the anchoring and adjustment model of perspective taking (Epley et al., 2004). Of particular relevance to our study is the effect of the firm’s prior disclosure policy which develops as a result of institutional and market factors as well as firm specific factors including firm traditions and internal politics (Gibbins et al., 1990; Holland, 2005; Holland & Stoner, 1996), personal preferences (Bamber et al., 2010; Brochet, Faurel, & McVay, 2011) and disclosure preferences instituted by the board (Caskey, Nagar, & Petacchi, 2010; Richardson, Tuna, & Wysocki, 2003). To the extent that managers take into account the firm’s prior disclosure policy, it is likely to influence their perspective taking processes.

### 2.5. Effect of firm’s prior disclosure policy when there is a reasonable investor prompt

Epley et al. (2004) suggest that individuals engage in anchoring and adjustment only when it is clear that their views represent a reasonable starting point. In situations where individuals’ own perspective is irrelevant, they state that quite different perspective taking processes may be involved. For example, when managers know their firm’s prior disclosure policy is biased towards no disclosure, they are more likely to anchor on their firm’s prior disclosure policy when assessing the perspective of a reasonable investor. Further, managers are likely to insufficiently adjust from this anchor point because knowledge of firm’s preferred policy yields an acceptable disclosure recommendation without too much cognitive thought. In particular, psychological research indicates that the adjustment process is effortful and individuals tend to terminate the adjustment process once a plausible judgment is made (Epley & Gilovich, 2006). This implies that knowledge of the firm’s preference will diminish managers’ willingness to exert extra cognitive thought to seek a more objective disclosure judgment. Consequently, we expect managers’ consideration of a reasonable investor’s perspective will be less when they know the firm’s prior disclosure policy is biased towards no disclosure as their anchoring and adjustment process will be influenced by knowledge of the firm’s disclosure preferences. Thus, relative to when the firm’s prior disclosure policy is unknown, we expect that managers will be less likely to recommend disclosure when they are prompted to take a reasonable investor perspective and the firm’s prior disclosure policy is known. Our expectation is shown as the solid line in Fig. 1 as an upward sloping line from the reasonable investor prompt known condition to the reasonable investor prompt unknown condition.

### 2.6. Effect of firm’s prior disclosure policy when there is no reasonable investor prompt

Motivated reasoning theory indicates that individuals arrive at their preferred outcomes subject to their ability to construct seemingly rational justifications for their choices and decisions (Kunda, 1990) and that individuals engage in the minimum of reasoning to reach their preferred outcome even if more bias would still be viewed as reasonable (Boiney, Kennedy, & Nye, 1997). Further, psychological research suggests that when individuals face situations with greater uncertainty surrounding the appropriate decision, they may find it easier to justify a preferred outcome (Hsee, 1995, 1996; Schweitzer & Hsee, 2002).

Uncertainty surrounding the appropriate disclosure recommendation can be influenced by knowledge of the firm’s prior disclosure policy. When managers know that the board has expressed concerns about management’s prior history of disclosing information that is difficult to quantify, there is more certainty about the firm’s disclosure preferences, and correspondingly less of a need for managers to engage in a mentally costly evaluation of the evidence to arrive at a justifiable disclosure recommendation, in this case a “do not disclose” recommendation. On the other hand, when managers do not know the firm’s prior disclosure policy, there is less certainty as to whether the board will support or oppose disclosure for the new disclosure issue and managers will need to devote extra mental thought to arrive at a defensible disclosure recommendation. Managers are therefore likely to make a more thorough examination of the evidence, irrespective of its direction, to prepare themselves for a variety of reactions to their recommendations. The motivated reasoning literature indicates that deeper processing of both sides of an issue includes automatic goal-driven processes that bias individuals toward reaching and justifying preferred outcomes (Kunda, 1990; Pecher et al., 2010). Managers’ more thoughtful, but biased, information processing is therefore likely to result in a “do not disclose” recommendation. This discussion implies that managers who do not know the firm’s prior disclosure policy are likely to make stronger “do not disclose” recommendations than managers who know that the firm’s prior disclosure policy is biased towards no disclosure. This would suggest that the dotted line in Fig. 1 slopes downwards from left to right.

However, research in accountability (see Lerner and Tetlock (1999) for a review), predecisional distortion (e.g., Richiutti, 2004; Wilks, 2002) and motivated reasoning (e.g., Clyd & Spilker, 1999) demonstrate that knowledge of a relevant audience’s views can significantly affect accounting professionals’ decision making. Although this research suggests that knowledge of the firm’s prior disclosure policy will impact managers’ disclosure recommendations, overall it is not clear whether managers will be less or more likely to recommend disclosure when they are not prompted to take the perspective of a reasonable investor and know the firm’s prior disclosure policy is biased towards no disclosure. This would suggest that the dotted line in Fig. 1 is closer to the reasonable investor prompt known condition. The dotted line in Fig. 1 illustrates the graphical representation of our expectation.

As depicted in Fig. 1, we predict an interaction between the reasonable investor prompt and firm’s prior disclosure policy such that the difference in managers’ disclosure recommendations is greater when the firm’s prior disclosure policy is unknown than when it is known. We formally state this interaction hypothesis below:

**Hypothesis 2.** The effect of a prompt to take the perspective of a reasonable investor on managers’ disclosure recommendations is...
disclosure policy. Disclosure Judgment

one of the author’s PhD dissertation with time deadlines. 
terminated data collection at the end of eight months as this study formed part of
per cell given the challenges in recruiting professional participants who had

dependent variables in the study.

greater when the firm’s prior disclosure policy is unknown than when it is known.

3. Method-Experiment One

3.1. Participants
 Sixty senior managers and directors who contribute to their
public companies’ financial information disclosure decision-making processes participated in the experiment. The authors personally recruited potential participants over an eight month period by contacting professional associations, university advisory and alumni networks and industry contacts as well as by directly contacting top management of public firms. From these contacts, the authors mailed 89 research packets. Sixty senior managers and directors completed and returned the research materials, for a response rate of 67 percent.7 Participants were promised confidentiality of information and an A$50 (approximately US$35 at the
time) gift voucher for participating in the study.

The participants comprised 40 company secretaries, nine CFOs/financial controllers, five directors, five CEOs and one commercial/investor relations manager.8 Sixty-one percent of the participants have significant work experience (e.g., greater than 20 years) with a firm listed in the Australian Securities Exchange (ASX) top 200 listing companies by way of market capitalization. The other 39 percent of participants had a minimum of 10 years of significant work experience.9 The participants had an average rating of 8.14

3.2. Case materials
 The case was adapted with significant modifications from Tan and Trotman (2010). At the beginning of the case, managers learn the following:

In this study, you will be asked to assess a specific matter that has recently come to the attention of management and provide to the Board of Directors a recommendation based on whether you believe [a reasonable investor would expect that] the information should be disclosed.10

The ‘specific matter’ deals with whether information regarding a probable negative change in forecast revenue requires immediate disclosure under Australia’s CD regulation.

The case materials contain selected historical financial results for the company over a two-year period (revenue, operating profit, EPS), and projections for the current year (forecast revenue, forecast operating profit, forecast EPS and analysts’ consensus EPS forecast). This is followed by details of the disclosure matter which involves a probable negative change in forecast revenue for a major new contract with a government department for leasing of satellites for high-bandwidth. The contract includes significant penalty clauses related to satellite downtime. The company previously released a revenue forecast for the contract for the current year

7 Prior to data collection, we decided to collect a minimum of fifteen observations per cell given the challenges in recruiting professional participants who had experience in making continuous disclosure decisions for ASX listed firms. We terminated data collection at the end of eight months as this study formed part of one of the author’s PhD dissertation with time deadlines.

8 These positions generally sit on the firm’s Disclosure Committee (Kwak, Ro, & Suk, 2012; Mayorga, 2013). Disclosure committees manage the process of making financial information disclosure decisions. If the firm doesn’t have a disclosure committee, these managers may be involved in the disclosure process indirectly through their role as an internal governance advisor to the CEO and board.

9 Once participants had returned the research materials, they emailed the researchers stating that they had completed the case so that a gift certificate could be sent in appreciation of them taking part in the research. Hence, the researchers have the names of all the study’s participants. To calculate their work experience level, we accessed external sources (e.g., annual reports, LinkedIn). For 92% of the sample, we are able to report actual experience levels. For the remaining 8%, we are only able to report a minimum of 10 years work experience. For confidentiality reasons, we could not link names to individual research instruments.

10 Participants’ current position, familiarity with making CD decisions and the number of times they had been involved in making similar types of CD decisions did not differ significantly (p > 0.10) across the four experimental conditions. Participants’ current position did not interact significantly with any of the independent variables in the study.

11 The phrase in brackets was only given to the reasonable investor prompt conditions.
with no allowance for penalties. Management has received preliminary evidence suggesting that downtime has exceeded the permitted level and believes it is probable that some penalty costs will be incurred but they are uncertain of the extent of these potential penalty payments.

Participants are given information which shows various revenue and earnings per share projections after recognizing estimates of penalties ranging from 100 percent to 33.3 percent of the potential penalty and the estimated decrease in forecasted EPS for the different levels of penalties. Depending on the assumption a participant adopts with respect to potential penalties, the impact on projected operating profit will range from nil decrease (assumes no penalty) to an eight percent decrease (assumes the maximum amount of penalties). Thus, the case requires participants to exercise significant judgment in determining whether the matter is quantitatively and/or qualitatively material. For example, recognizing 33.3 percent of potential penalties is three percent of projected operating income and it moves the company’s forecasted EPS from above to below the analysts’ consensus EPS and results in a change in earnings trends from prior years. Recognition of one-third of the penalties also affects ratios used to evaluate the company and is a change from the projected revenue disclosures made earlier in the year. The participants need to consider both quantitative and qualitative materiality.

Evidence items were facts drawn from the background information about the client and details of the specific disclosure matter which participants read prior to evaluating the evidence. The case consisted of ten evidence items supportive of disclosure and ten items not supportive of disclosure.

3.3. Design

This experiment employed a 2 x 2 between-subjects factorial design. The first independent variable was Reasonable Investor Prompt (Prompt versus No Prompt). Both conditions were instructed to assume the role of company secretary, assess a potential disclosure matter and provide to the board of directors a recommendation on whether the information should be disclosed. Participants assigned to the no prompt condition were asked to assess a specific disclosure matter that has come to the attention of management and provide a recommendation to the Board of Directors based on “whether you believe the information should be disclosed”. Participants assigned to the prompt condition were asked to “step into the shoes of a reasonable investor” and assess a specific disclosure matter that has come to the attention of management and provide a recommendation to the Board of Directors based on “whether you believe a reasonable investor would expect that the information should be disclosed”. We chose the term ‘step into the shoes of a reasonable investor’ based on the terminology used in Pozen (2008). To heighten participants’ awareness that their disclosure judgments should be based on whether a reasonable investor would expect disclosure, the case instructions emphasized for the prompt condition that it is important to react to the disclosure matter “as though you are providing a disclosure recommendation based on what you believe a reasonable investor would provide”.

The second independent variable was the Firm’s Prior Disclosure Policy (Known versus Unknown). Participants assigned to the known condition read the following immediately before reviewing the background information and evaluating evidence:

At the last Board of Directors’ meeting, the board of Germa Satellite Limited expressed its concern that management has been overly vigilant and conservative in disclosing information in situations where it was difficult to quantify the magnitude of the event. All the directors indicated that releasing speculative information may potentially harm the firm’s share price for no underlying economic reasons.

The words “at the last Board of Directors’ meeting” were included in the firm’s prior disclosure policy to ensure that the information contained in the firm’s prior disclosure policy description is independent of the information on the new disclosure matter. This is important as the study investigates whether a prior disclosure policy influences how new disclosure decisions are impacted.

To heighten their awareness of the board’s concern (see Peecher, 1996; Wilks, 2002), participants are then asked to list three reasons why a listed company would prefer to delay disclosure of information where it is difficult to quantify the magnitude of the event and to rank these reasons in order of their impact on managers’ disclosure judgments with the first reason being the most influential and the third being the least influential. Participants assigned to the unknown conditions are not given the firm’s prior disclosure policy in their research packet.

3.4. Procedures

Individuals who had agreed to participate in the study were randomly assigned to one of the four experimental conditions. Each participant received by mail a numbered (for randomization and control purposes) research packet. On the outside of the research packet there were written instructions for the participant which stated the importance of completing the task in one sitting and completing the task individually and without discussion with colleagues. The instructions stated that the participant was one of a small group of professionals involved in this important study and that their participation was highly valued (Gibbins & Trotman, 2002). Participants then read the background information about the company, the specific disclosure issue, the revenue projections and the potential associated revenue write-downs.

Participants first read and evaluated 20 evidence items related to whether a revised earnings forecast was warranted under ASX’s Listing Requirements. These items indicated reasons managers may disclose or not disclose the specific disclosure issue. For

---

12 The evidence items were developed based on the following sources: Tan and Trotman (2010), a review of Australian, US and UK case law on the application of an obligation to disclose material information where that information is subject to uncertainty, and a review of enforcement actions for breaches of CD requirements undertaken by Australian Securities and Investment Commission.

13 Tetlock, Skitka, and Boettger (1989), Green, Visser, and Tetlock (2000) and Wilks (2002) use the following words “insufficiently [overly],” strongly and “consistently” respectively to increase the participants awareness of their evaluative audience’s view on their experimental task. Consistent with this research, this study uses an adverb, ‘overly’, to heighten participants’ awareness of the firm’s prior disclosure policy.

14 All reasons provided by managers suggest that the firm’s prior disclosure policy manipulation induced them to believe that the firm’s prior disclosure policy supports less disclosure.

15 In addition to the two independent variables, four random orderings of evidence were constructed and fully crossed with the four conditions to reduce potential order effects. This resulted in 16 research instruments. This order variable is non-significant in the ANOVA analyses (p > 0.10) and does not interact with any other variables in the model. Thus, this variable is not further discussed.

16 ASX LR3.1 requires that once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity’s securities, the entity must immediately tell ASX that

---

Please cite this article in press as: Mayorga, D., & Trotman, K.T., The effects of a reasonable investor perspective and firm’s prior disclosure policy on managers’ disclosure judgments, Accounting, Organizations and Society (2015), http://dx.doi.org/10.1016/j.aos.2015.10.003
example, evidence items included “Last year a competitor reported an earnings’ downgrade due to penalty costs associated with downtime” and “There is considerable uncertainty as to what will be the total downtime for the year for this particular contract”. Evidence items were evaluated individually using a 15-point bipolar evidence evaluation scale with the –7 endpoint labeled “extremely supportive of NOT disclosing immediately” to the 7 endpoint labeled “extremely supportive of disclosing immediately” and the center point labeled “neutral”. Participants then made disclosure recommendations on a 15-point bipolar disclosure judgment scale with the –7 endpoint labeled “clearly not required to be disclosed immediately” and the 7 endpoint labeled “clearly required to be disclosed immediately” and the center point labeled “completely uncertain”. This disclosure recommendation was used for testing Hypothesis 1 and Hypothesis 2. The labeling on both scales followed Tan (1995), Wilks (2002) and Ricchuite (2004) with modifications to the wording to suit the task context. Following the disclosure recommendation, participants rated the importance of each evidence item in reaching their disclosure recommendation using a 10-point response scale with the 1 endpoint labeled “not at all important” and the 10 endpoint labeled “very important”. This measure was used in additional analysis to further explain our results. Specifically, we examine whether their ratings of the importance of each evidence item in their final disclosure judgment differ between experimental conditions (Tables 3 and 4). Finally, participants completed a questionnaire which included demographic questions and manipulation check questions.\(^\text{17}\)

4. Results—Experiment One

4.1. Manipulation checks

To examine the effectiveness of the firm’s prior disclosure policy manipulation, managers were asked to indicate the board’s concern that management had been: (a) overly vigilant and conservative in disclosing information that was difficult to quantify or (b) no concern was mentioned. Twelve of the 60 participants failed to provide correct answers to this manipulation check.\(^\text{18}\) As the inferences drawn from this study do not change when these 12 managers are excluded, they are included in the analysis.

As the securities exchange listing rules relate disclosure to what a reasonable person would expect direct questions on whether a reasonable investor perspective is taken are likely not to be very reasonable investor perspective, it was more likely that the managers in the prompt conditions actually considered a reasonable investor’s perspective.

4.2. Hypothesis tests

Table 1 shows descriptive statistics across experimental conditions for managers’ disclosure judgments. The means for the prompt unknown, prompt known, no prompt known, and no prompt unknown conditions are –0.20, –1.80, 2.80 and –4.73 respectively. The overall mean is –2.38. Fig. 2 presents the results graphically and Table 2, Panel B reports results of an analysis of variance (ANOVA). We find a significant main effect of the reasonable investor prompt (\(F_{1,56} = 8.459, p = 0.005, \text{two-tailed}\)) and a marginally significant reasonable investor prompt by firm’s prior disclosure policy interaction (\(F_{1,55} = 3.449, p = 0.069, \text{two-tailed}\)). Table 2, Panel B reports our planned contrast tests. Consistent with hypothesis 1 managers are more likely to recommend disclosure of a negative change in earnings expectations when they are prompted to take the perspective of a reasonable investor (combined mean = –1.00, Table 1) than when they are not prompted (combined mean = –3.77, Table 1) (\(t_{56} = 2.908, p = 0.003, \text{one-tailed, Table 2}\)).\(^\text{20}\)

Hypothesis 2 predicts that the effect of the prompt to take the

---

\(^\text{17}\) Feedback received from participants suggests that completion of the case materials ranged from 45 min to one hour.

\(^\text{18}\) Nine participants who failed this manipulation check were in the unknown condition for the firm’s prior disclosure policy variable.

\(^\text{20}\) We also conducted an untabulated ANOVA for evidence evaluation as the dependent variable. The means for the prompt unknown, prompt known, no prompt known and no prompt unknown conditions are –1.05, –1.24, –1.73 and –2.41 respectively. Neither reasonable investor prompt (\(p = 0.162\)), nor firm’s prior disclosure policy (\(p = 0.079\)) or their interaction (\(p = 0.050\)) are statistically significant. Using the same contrasts as above, we find marginal support for the proposition that managers evaluate evidence as more supportive of disclosure when they are prompted to take a reasonable investor perspective than when they are not (\(t_{56} = 1.417, p = 0.081, \text{one-tailed}\)). We do not find support for the reasonable investor prompt by firm’s prior disclosure policy interaction (\(t_{56} = 0.672, p = 0.253, \text{one-tailed}\)). For the simple main effect tests, we find marginal support in the unknown condition (\(t_{56} = 1.477, p = 0.073, \text{one-tailed}\)) but not in the known condition (\(p = 0.300, \text{one-tailed}\)).
perspective of a reasonable investor on managers’ disclosure recommendations is greater when the firm’s prior disclosure policy is unknown than when it is known. The difference in managers’ disclosure recommendations between the two prompt conditions is 4.53 (i.e., \(t_{56} = 4.73\), \(p = 0.20\)) when the firm’s prior disclosure policy is unknown and 1.00 (i.e., \(t_{56} = 2.80\), \(p = 0.18\)) when it is known. A planned contrast test indicates that, as predicted by Hypothesis 2, this difference is significant (\(t_{56} = 1.857, p = 0.035, \text{one-tailed}\)).

4.3. Additional analysis

Psychology research suggests that individual’s pre-existing beliefs and preferred outcomes are “sticky” as a result of biased information processing (for a review of this research see Koonce & Mercer, 2005). Individuals tend to be more critical of evidence which disconfirms their preferred beliefs or outcomes (Ditto, Munro, Apanovitch, Scepansky, & Lockhart, 2003; Edwards & Table 2 Panel B). Simple main effect tests (also shown in Table 2 Panel B) show that the prompt only has a significant effect on managers’ disclosure judgments in the unknown condition (\(t_{56} = 3.370, p < 0.001, \text{one-tailed}\)) and not in the known condition (\(t_{56} = 0.743, p = 0.230, \text{one-tailed}\)).
Table 3
Experiment One: importance of evidence to disclosure recommendations.

<table>
<thead>
<tr>
<th>Reasonable investor prompt</th>
<th>Type of evidence</th>
<th>Non-supportive of disclosure</th>
<th>Combined non-supportive</th>
<th>Supportive of disclosure</th>
<th>Combined supportive</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Firm's prior disclosure policy known</td>
<td>Firm's prior disclosure policy unknown</td>
<td>Combined supportive</td>
<td>Firm's prior disclosure policy known</td>
<td>Firm's prior disclosure policy unknown</td>
</tr>
<tr>
<td>Combined</td>
<td>5.91 (1.39) [30]</td>
<td>5.90 (1.54) [30]</td>
<td>5.90 (1.46) [60]</td>
<td>7.34 (1.12) [30]</td>
<td>7.00 (1.70) [30]</td>
</tr>
</tbody>
</table>

This table presents descriptive statistics for managers' ratings of the importance of evidence to their disclosure recommendations. After making their disclosure recommendation, participants were asked to rate on a 10-point scale, ranging from “not at all important” to “very important”, the importance of each evidence item in making the disclosure recommendation.

Prompt — participants are prompted to take the perspective of a reasonable investor.
No Prompt — participants are not prompted to take the perspective of a reasonable investor.
Known — participants are told that the firm's prior disclosure policy is biased towards no disclosure.
Unknown — participants are not given information about the firm's prior disclosure policy.

Table 4
Experiment One: mixed design ANOVA for the effects of reasonable investor prompt and knowledge of the firm's prior disclosure policy on managers' disclosure judgments.

<table>
<thead>
<tr>
<th>Source</th>
<th>df</th>
<th>Mean square</th>
<th>F-statistic</th>
<th>P values</th>
</tr>
</thead>
<tbody>
<tr>
<td>PANEL A: Tests of Within Subjects Effects</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Type of Evidence</td>
<td>1</td>
<td>48.133</td>
<td>34.072</td>
<td>0.000</td>
</tr>
<tr>
<td>Type of Evidence × Reasonable Investor Prompt</td>
<td>1</td>
<td>9.747</td>
<td>6.900</td>
<td>0.012</td>
</tr>
<tr>
<td>Type of Evidence × Firm's Prior Disclosure Policy</td>
<td>1</td>
<td>0.800</td>
<td>0.567</td>
<td>0.454</td>
</tr>
<tr>
<td>Error (Factor)</td>
<td>56</td>
<td>1.413</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PANEL B: Tests of Between Subjects Effects</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reasonable Investor Prompt</td>
<td>1</td>
<td>0.768</td>
<td>0.284</td>
<td>0.596</td>
</tr>
<tr>
<td>Firm's Prior Disclosure Policy</td>
<td>1</td>
<td>0.901</td>
<td>0.333</td>
<td>0.566</td>
</tr>
<tr>
<td>Reasonable Investor Prompt × Firm's Prior Disclosure Policy</td>
<td>1</td>
<td>1.323</td>
<td>0.489</td>
<td>0.488</td>
</tr>
<tr>
<td>Error (Factor)</td>
<td>56</td>
<td>2.706</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Reported p-values are two-tailed.
Within Subjects Factor is Type of evidence.
Level 1 equals average importance rating for information supportive of disclosure.
Level 2 equals average importance rating for information non-supportive of disclosure.
Between Subjects Factors.
Reasonable Investor Prompt (prompt versus no prompt).
Firm's Prior Disclosure Policy (known versus unknown).

ANOVA results are shown in Table 4, with the managers' ratings of the importance of evidence supportive of disclosure and evidence non-supportive of disclosure as a within subjects factor and reasonable investor prompt and firm's prior disclosure policy as between subjects factors. Table 4 shows that neither of the between subjects main effects or their interaction are significant (reasonable investor prompt: F_{1,56} = 0.284, p = 0.596, two-tailed; firm's prior disclosure policy: F_{1,56} = 0.333, p = 0.566, two-tailed; interaction: F_{1,56} = 0.489, p = 0.488, two-tailed). There is a significant two-way interaction for the type of evidence and reasonable investor prompt (F_{1,56} = 6.90, p = 0.012, two-tailed). Tests of within subjects effects show that for participants in the two prompt conditions combined there are no significant differences between the importance rankings of evidence supportive of disclosure (combined mean = 6.27) and evidence non-supportive of disclosure (combined mean = 6.96). In contrast, for participants in the two no prompt conditions combined, the importance rankings of evidence non-supportive of disclosure (combined mean = 5.54). This result shows that managers in the no prompt conditions rated evidence non-supportive of disclosure more positively than evidence supportive of disclosure. In contrast, managers in the prompt conditions rated evidence supportive of disclosure as more important than evidence non-supportive of disclosure.

For our study, this would suggest that managers will be more likely to adopt biased information processing strategies when they are not prompted to take the perspective of a reasonable investor than when they are. As noted in the research method section, after making their disclosure judgment, participants were asked to rate the importance of evidence items in making their disclosure recommendations. We use these importance ratings to calculate a mean importance rating for evidence supportive of disclosure and for evidence non-supportive of disclosure for each experimental condition. We calculate a mean importance rating by first classifying the evidence items between supportive and non-supportive of disclosure at the median of participants' evidence evaluations of the 20 evidence items, resulting in ten evidence items as supportive of disclosure and ten items as non-supportive of disclosure. We then calculate the mean importance rating for type of evidence (supportive of disclosure versus non-supportive of disclosure) by experimental condition (see Table 3).

Smith, 1996; Lord et al., 1979) and rate evidence that supports their preferred beliefs as methodologically superior and of higher quality (Koehler, 1993). Individuals also overestimate the quality, relevance and importance of viewpoint-consistent information compared to viewpoint-inconsistent information (Ditto & Lopez, 1992; Ditto, Scepanisky, Munro, Apanovitch, & Lockhart, 1998).

For our study, this would suggest that managers will be more likely to adopt biased information processing strategies when they are not prompted to take the perspective of a reasonable investor than when they are. As noted in the research method section, after making their disclosure judgment, participants were asked to rate the importance of evidence items in making their disclosure recommendations. We use these importance ratings to calculate a mean importance rating for evidence supportive of disclosure and for evidence non-supportive of disclosure for each experimental condition. We calculate a mean importance rating by first classifying the evidence items between supportive and non-supportive of disclosure at the median of participants’ evidence evaluations of the 20 evidence items, resulting in ten evidence items as supportive of disclosure and ten items as non-supportive of disclosure. We then calculate the mean importance rating for type of evidence (supportive of disclosure versus non-supportive of disclosure) by experimental condition (see Table 3).
conditions place importance on both types of evidence in reaching their final disclosure recommendation.

5. Experiment Two

We conduct an additional experiment to establish that our results are robust to the way managers are prompted to consider the perspective of a reasonable investor. In Experiment One, we ask participants to “step into the shoes of a reasonable investor” when making materiality judgments. We then ask participants to make a disclosure judgment based on “whether you believe a reasonable investor would require disclosure of a revised earnings’ forecast at this time”. In Experiment Two, we use an indirect approach for the operationalization of the reasonable investor prompt variable. This indirect approach is intended to reduce possible demand effects. Specifically, we employ a 1 x 3 between-subjects design. Our first two conditions (consistent with Experiment One) are no prompt and prompt (here labeled ‘RI prompt’) plus we add a new manipulation of the reasonable investor prompt condition (referred to as ‘RI rating’). In the RI rating condition we ask the participants to rate whether the disclosure would influence a reasonable investor’s decision to buy or sell the companies’ securities and then ask participants to make a disclosure judgment based on “whether you believe disclosure of a revised earnings’ forecast is required at this time”. Consistent with H1 in Experiment One, we expect that the likelihood of managers recommending disclosure of a probable negative change in earnings expectations will be greater in both prompt conditions compared to the no prompt condition.

5.1. Participants

Fifty-nine finance managers participated in the experiment. Participants were recruited over a five month period through professional accounting associations, industry contacts and university networks.21 Participants were promised confidentiality of information and an AS$40 (approximately US$37 at the time) gift voucher for their participation. The participants had an average rating of 4.31 (median = 4, range 1–10) in terms of their familiarity with making CD decisions. In response to whether they had been involved in making similar types of CD decisions, 40 percent reported one to ten times, while 60 percent had not made the continuous disclosure decision. However, these participants have the requisite background to make CD decisions.22

5.2. Design and case materials

As discussed above, the no prompt and RI prompt conditions in Experiment Two are identical to Experiment One. Similar to both these conditions, participants assigned to the RI rating conditions are instructed to assume the role of company secretary, assess a potential disclosure matter and provide to the board of directors a recommendation on whether the information should be disclosed. They are reminded of the ASX requirement “to consider whether a reasonable person would expect the information to have a material effect on the price or value of the entity’s securities when making continuous disclosure decisions”.

Prior to providing a disclosure recommendation, participants in the RI rating condition are asked to “rate the likelihood that this specific disclosure matter would influence a reasonable investor’s decision to buy or sell securities in GSL at the current market price”. Participants then provide a recommendation to the Board of Directors based on “whether you believe disclosure of a revised earnings forecast is required at this time”. Thus, both the no prompt and the RI rating condition were both asked “whether you believe the information should be disclosed”.

The task and procedures are identical to Experiment One except for the following two changes. First, participants are not asked to rate the importance of each evidence item following their disclosure recommendation. Second, as the focus of Experiment Two is to establish the results in Experiment One are robust to the way managers are prompted to consider a reasonable investor’s perspective, all participants are assigned to the unknown condition of the firm’s prior disclosure policy.

6. Results-Experiment Two

As manipulation checks, participants were asked to indicate the degree to which they made the recommendation based upon their beliefs of a reasonable investor on a 10-point scale (1 = “not at all” to 10 = “very much”). Participants in the RI prompt condition had an average rating of 7.84 (s.d. 2.218), participants in the RI rating condition had an average rating of 7.59 (s.d. 1.326) and participants in the no prompt condition had an average rating of 6.38 (s.d. 1.857). There were significant differences between the RI prompt and no prompt conditions (t = 2.332, p = 0.012, one-tailed) and between the RI rating and no prompt conditions (t = 1.879, p = 0.033, one-tailed). There were no significant differences between the RI rating and RI prompt (p = 0.443, two-tailed). Consistent with Experiment One, participants were also asked to indicate whether they thought of a particular type of investor when completing the task. Chi-square tests comparing the RI prompt and no prompt conditions and the RI rating and no prompt conditions found marginally significant effects (χ²(1) = 3.069, p = 0.09 and χ²(1) = 3.967, p = 0.06, respectively).

Consistent with H1 in Experiment One, we expect that managers are more likely to recommend disclosure of a negative change in earnings expectations when they are prompted to take the perspective of a reasonable investor than when they are not. Observed results are shown in Fig. 3 and descriptive and inferential statistics are presented in Table 5 comparing each of the alternative operationalizations of the reasonable investor prompt conditions to the no prompt condition.

The means for the no prompt, RI prompt and RI rating conditions are –1.67, 0.63 and 0.79, respectively. Planned contrasts in Panel C of Table 5 show significant mean differences in the disclosure judgment between the RI prompt and no prompt conditions (t = 1.920, p = 0.030, one-tailed) as well as between the RI rating and no prompt conditions (t = 2.036, p = 0.025, one-tailed).

21 Of those who received an invitation to participate in the study and requested a research packet, 65% returned the completed research materials.

22 While our participants were less experienced than those in Experiment One, they were still finance managers with sufficient experience to make CD judgments. Participants’ current position, familiarity with ASX LR3.1 and 3.1A and the number of times they had been involved in making similar CD decisions did not differ significantly (p > 0.10) across the three experimental conditions. Participants’ current position did not interact significantly with any of the independent variables in the study.

23 We also conduct an analysis using independent t-tests which show consistent results with our planned contrast tests. We find a significant mean difference between RI prompt and no prompt conditions (t = 1.725, p = 0.046, one-tailed) as well as between the RI rating and no prompt conditions (t = 2.036, p = 0.025, one-tailed).
regardless of which of our two operationalizations of the reasonable investor prompt manipulation we use. Consistent with Experiment One, we find that managers’ disclosure recommendations are more supportive of disclosing a negative change in earnings’ expectations when they are prompted to take a reasonable investor’s perspective compared to when they are not.

7. Discussion and conclusions

Our primary contribution is to show that managers are more likely to recommend disclosure of negative earnings information when they are prompted to take the perspective of a reasonable investor. This finding is robust across two alternative operationalizations of the reasonable investor prompt. We also show that the reasonable investor prompt has a larger impact when the firm’s prior disclosure policy is unknown than when it is known. While this latter result may appear counterintuitive, it is consistent with the psychological theory on motivated reasoning (e.g., Edwards & Smith, 1996; Kunda, 1990). In our additional analysis, our results suggest an important potential benefit of perspective taking is to reduce the biasing effects of directional preferences on their information processing strategies. Our analysis indicates that

Table 5
Experiment Two: ANOVA and planned contrasts for the effects of reasonable investor prompt on managers’ disclosure judgments.

Panel A: descriptive statistics for the effects of reasonable investor prompt on managers’ disclosure judgments

<table>
<thead>
<tr>
<th>Reasonable Investor Prompt</th>
<th>Disclosure Recommendation</th>
<th>Means</th>
<th>(Std. Dev.)</th>
<th>[n]</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Prompt</td>
<td></td>
<td>-1.67</td>
<td>(3.941)</td>
<td>[21]</td>
</tr>
<tr>
<td>RI Prompt</td>
<td></td>
<td>0.63</td>
<td>(4.487)</td>
<td>[19]</td>
</tr>
<tr>
<td>RI Rating</td>
<td></td>
<td>0.79</td>
<td>(3.660)</td>
<td>[19]</td>
</tr>
</tbody>
</table>

Panel B: ANOVA on Which Planned Contrasts are Based

<table>
<thead>
<tr>
<th>Source</th>
<th>SS</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>p</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reasonable Investor Prompt</td>
<td>76.670</td>
<td>2</td>
<td>38.335</td>
<td>2.348</td>
<td>0.105</td>
</tr>
<tr>
<td>Error</td>
<td>914.246</td>
<td>56</td>
<td>16.326</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>990.915</td>
<td>58</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Panel C: Planned Contrasts

<table>
<thead>
<tr>
<th>Hypothesized Contrast</th>
<th>df</th>
<th>t</th>
<th>One-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>The likelihood of recommending disclosure is higher for managers in the RI Prompt condition than in the No Prompt condition.</td>
<td>56</td>
<td>1.796</td>
<td>0.039</td>
</tr>
<tr>
<td>The likelihood of recommending disclosure is higher for managers in the RI Rating condition than in the No Prompt condition.</td>
<td>56</td>
<td>1.920</td>
<td>0.030</td>
</tr>
<tr>
<td>• The RI Prompt is identical to the prompt manipulation used in Experiment One.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• The RI Rating is the new reasonable investor prompt manipulation tested in Experiment Two.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• The No Prompt is identical to the no prompt condition used in Experiment One.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This table presents descriptive and inferential statistics for Experiment Two where the dependent variable is the manager’s disclosure recommendation. Managers recommended on a 15-point scale whether disclosure of a revised earnings forecast is required at this time (−7 – clearly NOT REQUIRED TO BE DISCLOSED immediately to 7 – clearly REQUIRED TO BE DISCLOSED immediately, center point labeled “completely uncertain”).

Please cite this article in press as: Mayorga, D., & Trotman, K. T., The effects of a reasonable investor perspective and firm’s prior disclosure policy on managers’ disclosure judgments, Accounting, Organizations and Society (2015). http://dx.doi.org/10.1016/j.aos.2015.10.003
managers are more likely to rate evidence both supportive and non-supportive of disclosure as important in making their final disclosure judgment when they are prompted to take the perspective of a reasonable investor. In contrast, we find that managers rate evidence non-supportive of disclosure as more important in making their final disclosure judgment when they are not prompted to take a reasonable investor’s perspective.

Our findings have implications for regulators, accounting and auditing standard-setters and management. Regulators and standard-setters are continually faced with the difficult question of how much clarifying guidance and educational material to give to preparers, audit committees and auditors on financial reporting. For example, managers report that they often lack confidence in making materiality judgments, and that there is a lack of clarity around how it should be applied in practice (IASB, 2013), resulting in fear that not making a disclosure will be challenged by regulators (FRC, 2009). One of the Pozen Committee’s final recommendations was that the Financial Accounting Standards Board (FASB) and the SEC, supplement existing guidance to reinforce that those who evaluate the materiality of a financial statement error should “step into the shoes” of a reasonable investor when making such judgments (Pozen, 2008). IFRS (2014) has also suggested the need for additional guidance. Further, support for the guidance exists when grappling with Australia’s CD obligations, acknowledging that the reasonable person test can “give rise to some difficulty in practice for listed entities in assessing whether or not they have an obligation to disclose information” (ASX, 2013, p. 10) and now suggests that managers faced with a decision whether information is “market sensitive” ask themselves “would this information influence my decision to buy or sell securities in the entity at their current market price? (ASX, 2013, p. 10). Our findings suggest that prompting managers to ‘step into the shoes’ of a reasonable investor affects their disclosure recommendations.

With respect to management, our findings suggest that the benefits of considering the perspective of a reasonable investor are less when managers are aware of the firm’s prior disclosure policy than when it is unknown. This finding suggests that there are benefits of senior management considering a disclosure issue from the perspective of a reasonable investor prior to ascertaining the views of the board or a disclosure committee. While firms’ general disclosure preferences are often known (depending on turnover of Board members), not knowing the firms’ preference for a specific issue is not uncommon as many boards assess whether or not information needs to be disclosed in context rather than in isolation.

Our results should be interpreted in light of a number of limitations, which also suggest several opportunities for future research. First, consistent with most experiments which address possible changes to regulation, there is the potential for demand effects. However, we undertook a number of steps to reduce these demand effects including our between-subjects design, the richness of our case study and the fact that all participants are familiar with the need to consider the perspective of a reasonable investor. Second, our participants did not face actual rewards or penalties that exist in practice. Third, our case situation relates to managers’ disclosure recommendations (Pozen, 2008). IFRS (2014) has also suggested the need for additional guidance. Further, support for the guidance exists when grappling with Australia’s CD obligations, acknowledging that the reasonable person test can “give rise to some difficulty in practice for listed entities in assessing whether or not they have an obligation to disclose information” (ASX, 2013, p. 10) and now suggests that managers faced with a decision whether information is “market sensitive” ask themselves “would this information influence my decision to buy or sell securities in the entity at their current market price?” (ASX, 2013, p. 10).

The accounting profession is well entrenched in standards and the law, there are many ways it can be operationalized. Fifth, we use a strong version of the known condition of the firm’s prior disclosure policy in Experiment One. Sixth, for the participants in the prompt conditions this would be the first time a reasonable investor perspective would have been explicitly invoked prior to them making a disclosure recommendation. Consequently, results could change in a multi-period experiment as participants became more familiar with this form of judgment. Future research could also identify other environmental factors which enhance or reduce the benefits of perspective taking of a reasonable investor, and the situations under which these factors are important.

References


References

FRC. (2009). United Kingdom’s financial reporting council Louder than Words. Available at: https://frc.org.uk/getattachment/7d952925-74ea-4de6-b659-e924b2092f1a/Louder-than-words.aspx accessed 15.03.14.


