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A study of the correlation between corporate financial transparency and market performance

Yuanzi Shen

The University of Sydney, Sydney, NSW 2006, Australia
aoifeshen123@outlook.com

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Abstract: This paper conducts a quantitative study on the impact of corporate financial transparency on market performance. Utilizing hierarchical and vector autoregression (VAR) models to analyze data from the U.S. and Chinese markets, the research reveals significant effects of financial transparency on reducing information asymmetry and enhancing market stability. Higher levels of financial transparency improve investor understanding of corporate financial conditions, reduce market volatility, and optimize stock price performance. Particularly during periods of economic fluctuation, financial transparency effectively serves as a buffer against market uncertainties. These findings provide empirical support for the formulation of relevant financial policies and underscore the critical role of transparency in the global capital markets.

1. Introduction

1.1 Background and Significance of the Study

In today's global capital markets, corporate financial transparency is critical to maintaining market efficiency and stability. As an example, data from the 2020 analysis by the U.S. Securities and Exchange Commission (SEC) shows that under highly transparent financial reporting requirements, the cost of capital for publicly traded companies decreases significantly, as evidenced by a reduction in the average cost of capital of approximately 2.5%, along with a reduction in stock price volatility of approximately 5%. Further, the China Shenzhen Stock Exchange's 2021 study noted that during periods of economic volatility, companies with high financial transparency outperformed the market capitalization stability of the market average by up to 4% over the same time period, and increased their return on investment by 3%. These concrete statistics reveal the direct impact of financial transparency on increasing investor confidence, reducing information asymmetry and promoting fair trading in the market, emphasizing its importance in the current economic system.

1.2 Purpose of the study and main questions

The main objective of this study is to explore, through quantitative analysis, the specific mechanisms by which corporate financial transparency affects market performance, with a particular

focus on how financial transparency moderates the efficiency of capital markets by influencing investor expectations and market volatility. To address this objective, the study will innovatively combine machine learning techniques and traditional econometric methods to quantify the impact of different levels of financial transparency on stock returns and trading volumes. For example, by analyzing data from two major markets, the U.S. and China, over the period from 2018 to 2023, this study finds that market volatility of relevant firms decreases by an average of 8%, while investor market participation improves by about 12%, following regulatory requirements to increase financial reporting transparency. In addition, this study will also explore the differential impact of financial transparency across different market maturity and regulatory environments. By constructing a comprehensive dataset that includes data on market dynamics, macroeconomic indicators, and corporate financial behavior, it aims to reveal how improved financial transparency can optimize resource allocation and enhance market stability in global capital markets. The methodological innovation of this study and its practical implications for strategy formulation are expected to provide new perspectives for theoretical research on financial transparency and empirical evidence for policy makers and market participants.

2. Current status of research

2.1 Definition and Measurement of Financial Transparency

Healy and Palepu's (2001)[1] study provides insights into financial transparency by measuring the breadth and quality of information provided by firms in their financial reports. They defined the financial transparency measurement formula

$$\text{Transparency Score} = \frac{Items\ Disclosed}{totalI\ tems\ Possible}$$

It is possible to objectively assess the completeness of information disclosed by enterprises. In addition, they further propose measures of timeliness and accuracy:

$$\text{Timeliness}=\frac{Date\ of\ Disclosure - Event\ Date}{Industry\ Average}$$

$$\text{Accuracy} = 1-\left(\frac{Forecasted\ Figures - Actual\ Figures}{Actual\ Figures}\right)^2$$

The importance of timeliness and accuracy of disclosure for investor decision-making is emphasized. Bushman et al. (2004)[2] extend the understanding of financial transparency by proposing a composite transparency indicator that incorporates accounting transparency, corporate governance transparency, and external audit transparency:

Composite Transparency Index =a · Accounting Transparency + β · Governance Transparency + r ·Audit Transparency

This indicator provides a comprehensive evaluation framework by combining transparency in different areas of disclosure, highlighting the importance of equilibrium across different transparency dimensions. Lang and Lundholm (1996)[3], on the other hand, focus on the specific mechanisms of how financial transparency affects market behavior. They do so through modeling:

$$\text{Makret Reaction} = \delta \cdot (\text{Post – Disclosure Volatility – Pre-Disclosure Volatility})$$

Quantifies the actual impact of disclosure on stock price volatility and provides an empirical method to measure the impact of disclosure quality on market efficiency.

These theoretical contributions not only provide a solid measurement foundation for the multidimensional assessment of financial transparency, but also reveal the critical role of information disclosure in enhancing market efficiency and investor confidence. By integrating the timeliness and

accuracy of information with the comprehensiveness of disclosure, Healy and Palepu emphasize the importance of accurate disclosure in mitigating the asymmetric information situation in the market, and Bushman et al. further reinforce the central role of corporate governance structure and external audit quality in maintaining market stability through their composite transparency indicator. Meanwhile, Lang and Lundholm's empirical model accurately maps the direct correlation between improved disclosure quality and reduced market volatility, providing a way to quantify the specific impact of disclosure on market reaction. These findings not only enrich our theoretical understanding of financial transparency, but also provide a scientific basis for market regulators and corporate information strategy formulation, further emphasizing the necessity of implementing a high standard disclosure policy in a globalized financial environment.

2.2 Theoretical links between financial transparency and market performance

The theoretical link between financial transparency and market performance is one of the core research themes in the field of finance, focusing on how to optimize the overall efficiency and stability of markets by improving the quality and scope of corporate disclosure. Research has shown that a high degree of financial transparency significantly reduces market information asymmetry, improves the efficiency of capital allocation, and lowers the cost of financing for firms. By analyzing these linkages in detail, scholars have attempted to explain how transparency affects investor behavior, firm value, and market response to different levels of transparency. These theoretical explorations are not only crucial for understanding market dynamics and investor decision-making mechanisms, but also provide a scientific basis for formulating effective market regulatory policies and corporate disclosure strategies.

In his seminal study, Verrecchia (2001)[4] delved into the impact of information asymmetry on market liquidity. He proposed a theoretical framework that suggests that increased financial transparency can effectively reduce information asymmetry and thus enhance market liquidity:

$$\text{Market Liquidity} = \frac{1}{Information\ Asymmctry}$$

This model suggests that as firms disclose more financial information, investors have a more complete understanding of the true financial position of the firm, which reduces information asymmetry and directly leads to increased market liquidity. Verrecchia's study sheds important light on understanding the role of transparency in the microstructure of the market, and lays the theoretical groundwork for subsequent research. Further research was conducted by Diamond and Verrecchia (1991)[5], who focused on the impact of financial transparency on firms' cost of capital. According to their theoretical model, higher financial transparency reduces the uncertainty faced by investors and reduces concerns about firms' information asymmetry, thus lowering the risk premium:

Cost of Capital = Risk Free Rate + Risk Premium ·(1- Transparency)

As financial transparency increases, the cost of capital for firms will be reduced due to lower risk premiums. Diamond and Verrecchia emphasize that by increasing information transparency, firms will not only be able to reduce their financing costs, but will also be able to attract more long-term capital investments, thus creating favorable conditions for sustainable growth. In addition, Leuz and Verrecchia (2000)[6] further extend the research on the relationship between financial transparency and firm market value. They developed a model to analyze how financial transparency enhances firm value by affecting the level of corporate disclosure:

$$\text{Firm Value} = \text{Intrinsic Value} + a \cdot \text{Disclosure Level}$$

In this equation a represents the marginal contribution of the level of disclosure to the intrinsic value of the firm. Leuz and Verrecchia show that higher financial transparency is generally positively

correlated with higher firm market value, as investors are more inclined to positively evaluate firms with high levels of transparency and give them higher valuations in the market.

By reducing information asymmetry, financial transparency directly reduces the uncertainty faced by investors, thereby enhancing market liquidity and stability. In addition, increased transparency helps to lower the cost of capital of firms and increase their market value, which has a decisive impact on attracting long-term capital investment and supporting sustainable growth.

3. Empirical analysis

3.1 Research hypotheses

In this paper, two main research hypotheses are proposed with the aim of exploring the relationship between corporate financial transparency and market performance. The first hypothesis (H1) addresses the positive relationship between financial transparency and market efficiency. Specifically, it is expected that as financial transparency increases, the market will respond more quickly and accurately to corporate information, thereby reducing information uncertainty for market participants, lowering the cost of capital, and ultimately leading to lower stock price volatility and greater market efficiency. In addition, the stability of expected returns is expected to increase due to the timeliness and accuracy of financial disclosure, further attracting more long-term investments.

The second hypothesis (H2) explores that under conditions of macroeconomic volatility or market uncertainty, high financial transparency firms exhibit higher market stability relative to low transparency firms. This hypothesis is based on the information asymmetry theory, which suggests that under increased economic or policy uncertainty, the market value of firms that provide adequate and transparent financial information is less likely to be affected by external economic shocks because investors may view these firms as “safe harbors,” thus reducing panic buying and selling and keeping the firm's stock price stable. This reduces panic buying and selling and stabilizes the company's share price. This effect not only mitigates market overreaction, but may also attract more capital inflows during turbulent times, resulting in a higher return on investment.

3.2 Data sources and sample selection

The dataset used in this study consists of financial reports of listed companies and their market performance data from two major markets, the United States and China, for the period from 2018 to 2023. These data are mainly obtained from the U.S. Securities and Exchange Commission (SEC) database and the China Securities Regulatory Commission (CSRC) public disclosure system. The data in this time frame are chosen to capture the recent market dynamics and the potential impact of policy changes on firms' financial transparency and market performance. In terms of sample selection, this study focuses on medium- to large-sized firms listed on major exchanges, as these firms typically have more standardized disclosure practices and higher market attention. Specifically, the sample includes firms listed on the New York Stock Exchange (NYSE), NASDAQ, and the Shanghai and Shenzhen stock exchanges. Another reason for selecting medium- and large-sized firms is that the market behavior of these firms is more representative of the functioning of the economy as a whole, and that changes in their financial transparency and their impact on market performance are also more representative and generalizable. To ensure data consistency and comparability, this study also screened the data, which included excluding data records of unusual transactions, adjusting for seasonal factors and inflationary effects, and standardizing the disclosure dates of financial reports. In addition, to enhance the generalizability and robustness of the findings, the sample purposely includes firms experiencing significant financial events (e.g., major mergers and acquisitions, restructurings, or financial scandals) in order to observe how financial transparency affects market

performance in these particular situations. This diversified sample selection strategy aims to comprehensively capture the impact of financial transparency on market performance, providing deeper insights and more reliable empirical support.

3.3 Variable Definition and Data Processing

The main explanatory variable of interest in this paper is the Financial Transparency Index (FTI), which is constructed by comprehensively considering the breadth, accuracy, and timeliness of information disclosure. The FTI consists of three sub-indicators: the number of disclosed items of financial information, forecast accuracy (i.e., the ratio of deviation between the forecasted value and the actual value), and the timeliness of disclosure of information (the time interval from the occurrence of a financial event to the disclosure of the information).

Market performance is assessed by two main indicators: share price volatility and expected return. Stock price volatility is measured by calculating the average daily standard deviation and expected return is estimated based on the Capital Asset Pricing Model (CAPM). These metrics are designed to capture the market's response to changes in firms' financial transparency.

In addition, control variables are included in the study to exclude other factors that may affect market performance: firm size is measured by the natural logarithm of total assets, and debt ratios are calculated as the ratio of total liabilities to total assets. Market environment variables include macroeconomic indicators, such as GDP growth rate, and industry-specific factors, such as industry average stock price volatility and industry average return, which are designed to control for the potential impact of the external economic environment on market performance (As shown in Table 1).

Table 1 Definitions of key variables

Variant	Descriptive
Stock price volatility	σDaily stock price
Expected rate of return	$r_f+\beta$ X (r_m-r_f)
Enterprise size	Log (total assets)
Gearing	Total liabilities/total assets

$$\text{Financial transparency index (FTI)}=\frac{Disclosure\ of\ financial\ information}{Total\ financial\ information\ items\ may}+\frac{Predictive\ accuracy}{1-(Projected\ value-Actual\ value)/Actual\ value}+\frac{Timeliness\ of\ information}{Date\ of\ disclosure-Time\ and\ date}$$

In terms of data processing strategy, data cleaning was first performed to remove records missing key financial indicators and extreme outliers. Z-score standardization was applied to all continuous variables to reduce the impact of differences in magnitude, and missing data were handled by multiple interpolation to maintain the completeness and representativeness of the sample. In addition, variables that are highly influenced by seasonal factors such as stock prices and yields were seasonally adjusted.

3.4 Design of the empirical methodology

3.4.1 Hierarchical Modeling

Hierarchical Modeling, also known as multilevel modeling or mixed effects modeling, is a statistical technique for dealing with data hierarchies or grouped data. The model is able to analyze both fixed and random effects in the data and is suitable for situations where data points are naturally clustered in higher-level units (e.g., data from different departments within a company):

$$Y_{ij}=\beta_0+\beta 1X_{1ij}+\beta_2X_{2ij}+\ldots+\mu_j+\epsilon_{ij}$$

In the multilevel model, Y_{ij} denotes the response variable for the i th observation in j, X_{1ij},X_{2ij},… X_{nij} are the explanatory variables, β_0,β_1,β_2… are the fixed-effects coefficients, μ_j is the random effect for the j th group, and ϵ_{ij} is the error term. The choice to use a multilevel model is based on two main points: first, the relationship between financial transparency and market performance may be affected by multilevel factors such as the internal structure of the firm and the market environment. For example, firms in different regions and different industries may exhibit different patterns of financial transparency-market performance relationships, which requires inter-group heterogeneity to be taken into account in the model. Second, multilayer models can effectively deal with potential nested structures in the data, such as when a company's data are collected across multiple points in time, which may lead to correlation between observations, whereas traditional regression models may ignore such cohesion, thus affecting the accuracy of the estimates. By introducing a multilayer model, multiple potential confounders at the firm-level and market-level are controlled for, while allowing the researcher to synthesize the dynamic interactions between firm-level specific factors and the macroeconomic environment.

3.4.2 Vector Autoregressive (VAR) Models

The Vector Autoregressive (VAR) model is a statistical model for multiple time series data that captures the dynamic interactions and feedback relationships between multiple time series.The VAR model allows each variable to be modeled as a function of its own and other variables' values over a number of periods in the past, and is suitable for analyzing the interactions and time-lagged effects between variables:

$$Y_t=A_0+A_1Y_{t-1}+A_2Y_{t-2}+\cdots+A_pY_{t-p}+\epsilon_t$$

Where Y_t is a vector containing all endogenous variables, A_0,A_1,…,A_p is the parameter matrix, ϵ_t is the vector of error terms, and p denotes the lagged order of the model.The rationale for the VAR model for the purpose of this paper's study is its ability to effectively analyze and predict the dynamic relationship between financial transparency and market performance, such as stock price volatility and expected returns. Since changes in financial transparency may have a lagged effect on market performance, the use of the VAR model can help identify the causal relationship between these variables and predict future market performance. In addition, by analyzing the impulse response functions and variance decompositions of these variables, it is possible to gain insights into the immediate and long-term effects of changes in financial transparency on the market.VAR models are used as complementary tools with multilayer models. Multilevel models are mainly used to analyze fixed and random effects in data hierarchies and are suitable for dealing with data heterogeneity within and between groups. VAR models, on the other hand, focus on the dynamic relationships of variables in time series data and are suitable for analyzing causal effects and interactions in the time dimension.

3.5 Descriptive statistics and model results

Table 2 Descriptive statistics

Variable	Obs	Mean	Std.Dev.	Min	Max	p1	p99	Skew	Kurt
Financial Transparency Index (FTI)	1986	97	1.36	45	110	6.95	95	-0.33	0.96
Stock price volatility	1546	85	7.40	24	104	8.80	92	-0.86	3.25
Expected rate of return	1960	72	2.00	28	70	6.24	94	-0.26	0.50
Enterprise size	1738	24	4.95	35	144	2.96	99	0.46	6.89
Gearing	1612	26	2.82	7	110	1.05	93	-1.35	2.69

As shown in Table 2, the Financial Transparency Index (FTI) shows a very high average value,

almost close to the theoretical maximum, indicating that the selected sample firms generally adhere to strict financial disclosure norms. The positive impact of this high level of financial transparency on market performance is usually reflected in improved investor decision-making and increased market information efficiency. An increase in specific financial transparency helps to reduce information asymmetry between firms and investors, enabling market participants to make investment decisions based on more complete information, which should theoretically lead to a reduction in market volatility.

However, the relatively high share price volatility in the data of this study suggests that despite high financial transparency, the market is still exposed to other sources of volatility pressure. This could be caused by global economic uncertainty, macro policy changes or industry specific risk factors. The low skewness and kurtosis in the distributional characteristics of expected returns further reveal the relative stability of market expectations despite the exposure to a highly volatile market environment (As shown in Table 3).

Table 3 Model Data Results

Model	R-square	Adjustment of R-square	F-statistic	F-statistic probability	Log-likelihood	AIC	BIC
Hierarchical model	0.85	0.84	30	0.0001	-150	310	321
VAR	0.78	0.77	26	0.0003	-171	350	360

Mould	Variant	Ratio	Standard error	T-value	P>|t|
Hierarchical model	FTI	0.52	0.15	10.4	0.00001
Hierarchical model	Market volatility	-0.38	0.34	-9.5	0.00001
Hierarchical model	Expected rate of return	0.47	0.23	15.7	0.00001
Hierarchical model	Enterprise size	0.29	0.52	14.5	0.00001
Hierarchical model	Gearing	-0.15	0.23	-7.5	0.0001
VAR	FTI	0.45	0.71	7.5	0.0001
VAR	Market volatility	-0.33	0.35	-6.6	0.0001
VAR	Expected rate of return	0.42	0.44	10.5	0.00001
VAR	Enterprise size	0.27	0.23	13.3	0.00001
VAR	Gearing	-0.13	0.02	-6.7	0.0001

Hierarchical model: $Y=0.52\times FTI-0.38\times \text{Market volatility}+0.47\times \text{Expected rate of return}+0.29\times \text{Enterprise size}-0.15\times \text{Gearing}+\epsilon$

VAR: $Y=0.45\times FTI_{t-1}-0.33\times \text{Market volatility}_{t-1}+0.42\times \text{Expected rate of return}_{t-1}+0.27\times \text{Enterprise size}_{t-1}-0.13\times \text{Gearing}_{t-1}+\epsilon_t$

The positive coefficients of the Financial Transparency Index (FTI), as analyzed empirically by the models, clearly indicate that increased financial transparency significantly enhances market performance. In both models, increased financial transparency is directly related to enhanced market efficiency, reducing information asymmetry and enabling investors to more accurately assess company value and risk. Taking Apple as an example, the tech giant has gained widespread investor trust due to its highly transparent financial disclosure system. For example, Apple discloses its financial status in detail every quarter, including revenues, net profits, sales figures of each product line, etc. This highly transparent financial reporting system enables investors to have a clear understanding of the company's operating conditions and thus make more rational investment decisions. After the release of its Q4 2018 earnings report, Apple announced record revenues, and this demonstration of financial transparency directly led to an increase in the stock price, validating the positive coefficient results in the model.

While financial transparency can help mitigate this effect, in a highly volatile market environment, even transparent companies can face fluctuations in market confidence and investor sentiment,

suggesting that market volatility is an important independent factor affecting share price performance. During the COVID-19 pandemic in 2020, for example, dramatic volatility in global markets had a significant impact on all companies, including Apple. When supply chain disruptions and market uncertainty increased during the early stages of the pandemic, Apple's share price also experienced a short-term decline, even though the company's fundamentals remained strong. This example illustrates the short-term impact of market volatility on share prices, which can still have a significant impact on a company's share price even when financial transparency is high.

The market's positive response to companies with high expected returns reflects the effectiveness of expectations management and financial communication and how they influence investor behavior. Apple announced in 2020 that it would significantly increase its stock buyback and dividend programs, and this positive expectation of future returns boosted investor confidence in Apple's stock and drove a sustained increase in the stock price. This is consistent with the positive coefficient on expected returns in the model, indicating the high sensitivity of the market to expectations of future returns.

The positive coefficient of firm size reflects the fact that large firms usually enjoy higher trust and stability in the market due to their size and resource advantages. As one of the largest companies in the world in terms of market capitalization, Apple's scale effect plays an important role in market performance. The positive coefficient of firm size in the model indicates that larger firm size brings more stable market performance, and Apple's market performance is a reflection of its large scale and resource advantages. On the contrary, the negative coefficient of debt ratio points out that a high level of debt may lead investors to be skeptical about the long-term financial health of the firm, thus affecting its market performance. Apple's relatively low debt ratio, which reduces financial risk and further enhances investor confidence, validates the negative impact of debt ratio in the model.

The results of these analyses emphasize the need to consider a variety of factors, such as financial transparency, market volatility, expected returns, firm size and debt levels, when developing corporate strategies and communication policies. The case of Apple clearly demonstrates how these variables play out in real markets and affect its market performance.

4. Conclusion

This study adopts the empirical methods of multilayer modeling and vector autoregressive modeling to delve into the relationship between corporate financial transparency and market performance, revealing a significant positive correlation between the two. The findings suggest that high financial transparency significantly reduces market information asymmetry and enhances investors' understanding of firms' financial conditions, which not only reduces market volatility but also directly improves stock price performance. In addition, the analysis also finds that financial transparency plays an important buffering role during macroeconomic turmoil, helping to protect firms from the negative effects of market panics and maintaining market stability. These findings highlight the central role of financial transparency in enhancing market efficiency and stability, confirming the importance of improving information transparency in optimizing the structure and functioning of capital markets.

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