If a Company Says It’s Ethical, Investors Might Want to Be Skeptical

A new study finds the use of ‘trust’ words is correlated with a variety of negative outcomes

By Lisa Ward
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Companies using ‘trust words’ are about 15% more likely to receive a comment letter from the SEC.

ILLUSTRATION: ROB DOBI
Certain words that many companies use in their annual reports—words like ethical, integrity and responsibility—are meant to convey trustworthiness.

But new research suggests that companies that use such words in annual filings known as 10-Ks are associated with a variety of negative outcomes.

Use of the words in annual statements, for instance, was correlated with a decreased interest in the stock of the company in question, the study found. In the first 48 hours after earnings were announced, stock prices increased on average about 1.15% for companies that didn’t use the words in their report. In comparison, stocks of companies that did use them increased only about 0.11% in that two-day period.

Basing their findings on 21 words that seek to evoke a sense of trustworthiness, the authors also found that companies whose annual filings included the words tended to pay about $100,000 more in auditing fees than firms eschewing the words. Academic researchers often track auditing fees as a way to better understand corporate risk, where higher auditing fees often suggest more risk.

SEC is calling

Companies using trust words were also about 15% more likely to receive a comment letter from the Securities and Exchange Commission asking them to clarify information on their annual report than companies that didn’t use trust words. The SEC often uses comment letters to communicate its concerns with the annual report.

“Companies likely use trust words to project a positive image and better manage information within the annual report, but it seems that no one is really fooled,” says Gopal Krishnan, a professor of accounting at Bentley University in Waltham, Mass., and one of the study’s co-authors.

The authors used a computer program to search for the 21 words in the annual filings of 3,595 companies between 1995 and 2018. In their sample, 1,659 firms used trust words and 1,936 didn’t.

Correlation or causation?

The authors said they didn’t study causation—that is, whether using trust words resulted in less trust. Instead their study simply found that companies with negative outcomes were the ones most likely to use trust words.

The authors also evaluated companies’ performance when it comes to social responsibility, focusing on five areas: community, diversity, employee relations, environment and product. Once again, they found that companies that didn’t use trust words had better corporate responsibility assessment.

The takeaway, according to Myo Jung Cho, a professor of accounting at Pace University’s Lubin School of Business and the paper’s other co-author, is that rather than convey a company’s virtue, trust words may instead act as a red flag, highlighting potential pitfalls for investors and regulations.

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