THE DEBATE OVER MANDATORY CORPORATE DISCLOSURE RULES

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I. INTRODUCTION

The Federal Attorney-General, Michael Duffy, has indicated that an upgraded disclosure system is currently a matter of high priority in corporate law reform. Draft legislation is expected on this topic within a matter of months. This paper examines the theoretical debate on the desirability of a government mandating the amount and nature of information that is provided by companies to the securities market. The analysis aims to put readers in a better position to assess such proposals.

The paper is divided into four main parts. In Part II, a number of recent legislative proposals are noted that, if implemented, would require Australian companies to provide considerably more securities information to users than is currently the case.[1] This is followed, in Part III, by an examination of the various 'market failure' rationales for mandatory disclosure requirements, including protection of ill-informed investors, reduction of social waste, curtailment of opportunistic reporting practices by managers, and the addressing

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1 A more detailed discussion of recent proposals is contained in M Blair "Australia's Continuous Disclosure Regime: Proposals for Change" (1992) 2 *Australian Journal of Corporate Law* 54.

of inefficiencies caused by the public goods characteristics of securities information. The examination reveals that the benefits that may follow from a mandatory disclosure regime are by no means clear. Furthermore, all the rationales examined rest on the premise that the government has a comparative advantage in achieving social welfare objectives. In Part IV, consideration is given to the potential pitfalls of government intervention, ie sources of 'government failure'. Part V contains a number of conclusions.

II. PROPOSED MANDATORY DISCLOSURE REQUIREMENTS

During June 1991, the Federal Attorney-General announced that the Government, as a matter of high priority, was examining the need for a legislatively-based regime for on-going reporting by listed companies. Mr Duffy stated his belief that:

> ... there is a great deal of concern amongst investors that they may not be as well informed as they ought to be regarding the ongoing state of companies in which they have invested.[2]

As part of this examination, the Companies and Securities Advisory Committee, an advisory body to the Attorney-General, was asked to examine the need for legislatively-based continuous disclosure requirements and the nature of any such requirements. The Advisory Committee delivered its report during September 1991.[3] It recommended that directors of "disclosing entities"[4] should have an affirmative obligation under the *Corporations Law* to report "material matters" to outsiders (eg shareholders and creditors) on an on-going, timely basis.[5] A "material matter" is defined as:

- any change in, or reassessment of, the disclosing entity of which equity or debt investors would reasonably require disclosure, for the purpose of their making an informed assessment of the assets and liabilities,

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2 News Release No 25/91, Attorney-General (19 June 1991).

3 Companies and Securities Advisory Committee *Report on an Enhanced Statutory Disclosure System* (September 1991).

4 These were defined to include *inter alia* all listed companies, proprietary companies (exempt or non-exempt) with total assets in excess of $10 million, schemes offering prescribed interests with total assets in excess of $10 million, and all public sector corporations that carry on a business *ibid* p 9. It has been estimated that the proposals will, if implemented, affect 14,411 companies: note 13 *infra* p 67.

5 It is a requirement of the Australian Stock Exchange ("ASX") listing rule 3A(1) that a listed company (or trust) must notify its home exchange "immediately" of any information concerning its activities or those of its subsidiaries that is either likely to have a material affect upon the price of its securities, is necessary to avoid the establishment of a false market in those securities, or investors and their professional advisers would reasonably require, and reasonably expect to be disclosed to the market, for the purpose of making an informed assessment of: (i) the assets and liabilities, financial position, profits and losses, and prospects of the listed company, and (ii) the rights attaching to securities of the listed company. Overseas exchanges that have a continuous disclosure requirement include the New York Stock Exchange, the American Stock Exchange, and the International Stock Exchange of the United Kingdom and the Republic of Ireland. See M Blair note 1 *supra* for a summary of these requirements.

financial position, profits and losses, or prospects of the disclosing entity; and

- any matter that is likely to materially affect the price of the disclosing entity's debt or equity securities or is necessary to avoid the establishment or continuation of a false market in those securities.

The Committee recognized that it is not always in the best interests of existing or potential security-holders to have material information disclosed (eg where it would involve a loss of trade secrets). Consequently, it proposed that the legislation should provide for possible exemptions from disclosure (carve-outs), and suggested it might also empower the Australian Securities Commission ("ASC") to grant other specific exemptions upon application.

In relation to the form of company disclosure, the Advisory Committee proposed that directors of a disclosing entity, upon becoming aware of a "material matter", should as soon as it is practicable and in any event within 24 hours, either lodge a completed pro-forma statement (a "Statement of Material Matter") with the ASC or issue, and lodge with the ASC, a press release outlining the material matter. Directors choosing the latter option would be required to also lodge a Statement of Material Matter with the ASC within two business days of the initial press release.[6] The Committee further proposed that the ASC should be required, within five business days of receiving a Statement of Material Matter, to make that statement available on its national public database ("DOCIMAGE").

Under the Committee's recommendations, directors of a company would be required to take all reasonable steps to ensure that the company has suitable internal mechanisms in place to identify, and notify directors of, all material matters ("the due diligence requirement") and to accurately disclose (ie free of materially false or misleading statements or omissions) material matters of which they are, or by virtue of the due diligence requirement, should be "aware".[7] Directors would be liable on a criminal or civil basis for failing to meet this standard.

Another significant recommendation of the Advisory Committee was that all disclosing entities currently required to lodge annual reports under the *Corporations Law* should also supply half-yearly reports to the ASC and if they are listed to the Australian Stock Exchange ("ASX") within 75 days of their fiscal half year-end.[8] It stated that in principle such reports should include a profit and loss statement, a balance sheet, a cash flow statement, a summary of

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6 The Advisory Committee also recommended that listed companies should be required to lodge a copy of the completed Statement of Material Matter and, if applicable, the associated press release with the ASX, no later than the time of lodging with the ASC.

7 A similar obligation exists under the *Corporations Law* in relation to the issue of a prospectus: s 1024(4).

8 There is currently no general requirement under the *Corporations Law* for companies to lodge or prepare interim financial statements. However, companies listed on the ASX, other than trusts or mining exploration companies, are required under ASX listing rule 3B(1) to provide detailed half-yearly financial reports within 75 days of their financial year end.

all Statements of Material Matter lodged during the reporting period, and a qualitative assessment of half-yearly results by directors.

During October 1991, the Attorney-General asked his Department, in consultation with the ASC and the business community, to examine the costs and benefits of these recommendations[9] and to work out the technical detail that would be necessary to implement them.[10] He also signalled his intention to have an exposure draft of proposed legislation on this matter available for public comment as early as August 1992, for introduction into the budget session of Federal Parliament.

Shortly after the Attorney-General's announcement, the House of Representatives Standing Committee on Legal and Constitutional Affairs (the "Lavarch" Committee) released a report which did not accept the Advisory Committee's recommendations for a legislatively-based continuous disclosure regime.[11] The Lavarch Committee maintained that the application of a continuous disclosure regime should be limited to listed companies at this stage. Moreover, it argued that this regime should continue to be imposed through the ASX listing rules rather than by amendments to the *Corporations Law*.[12]

The ASC publicly released its response to the Advisory Committee's recommendations during February 1992.[13] The Commission supported the proposals for a legislatively-based disclosure regime requiring continuous disclosures of material matters and half-yearly reports, subject to a number of modifications.[14] It argued that such a regime is necessary because:

> [a]t present, those making decisions about the allocation of scarce resources are generally forced to rely for their information upon annual reports. This is not satisfactory. Frequently there is a long time lag between a material event and the disclosure of that event in the annual accounts. Moreover, given that accounts represent a snapshot of an entity's financial position on its balance date, pre-

9 The only country to date that appears to have incorporated such a broad-ranging requirement into its securities legislation is Canada; *Securities Act* 1980 (Ontario) s 74. Other countries do, however, have a legislative requirement for directors to disclose promptly those "material matters" that occur while a company is raising equity capital. For example, under s 1024 of the *Corporations Law*, where a prospectus has been lodged and the issue is still "open", the lodgers must, upon the happening of a "significant" change or new matter, lodge a supplementary prospectus containing particulars of the change or new matter. The maximum life of a prospectus is generally six months after its issue date: *Corporations Law* s 1040. The incentives for managers to "cheat" when raising funds are more pronounced than in most other circumstances. In particular, through failing to disclose adverse material changes, managers can transfer wealth from potential investors to the company. Where the company is not issuing or dealing in its securities, the wealth transfer occurs between investors.

10 News Release No 51/91, Attorney-General (13 October 1991).

11 *Corporate Practices and the Rights of Shareholders* (November 1991).

12 On the current ASX listing rule regime refer to note 5 *supra*.

13 Australian Securities Commission *Enhanced Statutory Disclosure System: A Response to the Companies and Securities Advisory Report* (February 1992).

14 One of the modifications proposed was that there should be two separate continuous disclosure regimes; one tailored to the needs of investors (positive and adverse material changes) and the other to the needs of creditors (adverse material changes only). For further detail refer to note 13 *id*.

balance date transactions can be entered into in order to disguise the entity's true financial position and to avoid disclosure.[15]

The ASC went further than the Advisory Committee in also recommending that companies listed on the ASX should be compelled under the *Corporations Law* to produce detailed quarterly financial reports within 45 days of their financial quarter end.[16] It noted that quarterly reports are required by law in a number of countries, most notably the United States of America and Canada.[17] It also made reference to the fact that mining companies listed on the ASX currently provide quarterly reports,[18] as do a number of industrial companies.[19]

On 2 July 1992 the Federal Attorney-General announced that the Ministerial Council had given its approval for the introduction of a *Corporate Law Reform Bill* into Federal Parliament, aimed at implementing a system of continuous disclosure and half-yearly reporting.[20] It is intended that the *Bill* will be introduced during the budget sittings of Parliament,[21] after which time there will be an exposure period of 3 months to allow for public comment. While the precise details of the upgraded disclosure regime have not yet been released, there have been indications that it will encompass a general disclosure obligation along the lines of the one put forward by the Advisory Committee. The Attorney has signalled a number of likely differences in recommendations.[22] First, the new disclosure rules will probably apply to listed

15 *Ibid* p 14. The ASC recognised that interim reports are required by the the ASX listing rules: note 8 *supra*.

16 Note 13 *supra* p 33. Refer also to "Perish the Quarterly Thought" *Sunday Telegraph* (16 June 1991) pp 121, 191; "ASC, ICA in Favour of Quarterly Reporting" *Financial Review* (13 April) 1992 p 16, S Proud "Sliced Bread and Quarterly Reporting" (1992) 63/1 *Charter* 36; Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* (November 1991) p 115. Calls for quarterly reporting in Australia are not new. For example, the *Companies and Securities Industry Bill* 1974 (Cth) proposed that public companies provide quarterly reports within six weeks of their quarter-year end: s 158. The Bill failed to obtain a sufficient level of support and lapsed.

17 Note 13 *supra* p 34. See also *Securities Exchange Act* 1934 (US), s 13(a)(2) and *Securities Act* 1980 (Ontario) s 76(1). Other countries which have a quarterly reporting requirement include France, Brazil, Taiwan, and the Philippines: Matthew Binder *World Accounting* loose leaf service. For an outline of requirements in America and Canada refer to M Blair note 1 *supra*.

18 *Id.* Mining companies listed on the ASX are required to prepare quarterly production reports under ASX listing rule 3B(5). Where they are involved in exploration, they must also provide quarterly working capital reports under ASX listing rule 3B(10).

19 *Id.* As at October 1990 there were at least nineteen companies listed on the ASX that voluntarily provided quarterly reports: Australian Stock Exchange *Improved Reporting by Listed Companies* Discussion Paper (October 1990) p 13. Four of these were Australian companies simultaneously listed on American or Canadian Exchanges while seven were American or Canadian companies listed in Australia. For historical evidence of voluntary reporters in the American context refer to RW Leftwich, RL Watts and JL Zimmerman "Voluntary Corporate Disclosure: The Case of Interim Reporting" (1981) 19 *Journal of Accounting Research* (supp) 50.

20 News Release No 23/92, Attorney-General (2 July 1992).

21 The budget sittings of Federal Parliament run from August to December.

22 *Id.* Refer also to "Duffy Outlines Disclosure Plan" *Financial Review* 28 April 1992 p 2; "Duffy Brings Hope for Simplicity in Law Reforms" *The Age* (Melbourne) 29 April 1992 p 17; "ASC's Wicked Way Checked by Common Sense" *The Herald-Sun* (Melbourne) 29 April 1992 p 65; "Duffy Softens

companies, "other corporate entities whose securities are traded or offered for sale" and "regulated" prescribed interest schemes (ie prescribed interest schemes subject to the approved deed requirements of the *Corporations Law* s 1066). Second, the system will be directed towards investors, and not creditors. Finally, the maximum disclosure period for continuous disclosure could be as long as three days. Following concern from some market participants that a continuous disclosure obligation may prove too burdensome for directors, the Attorney has stated:

> ... the proposed continuous disclosure obligations will be framed to make it clear that they do not impose the due diligence obligations which apply to the issue of a one-off prospectus for raising funds.[23]

III. WHY REGULATE? POSSIBLE RATIONALES FOR MANDATORY DISCLOSURE

The previous section briefly outlined recent proposals for mandatory continuous disclosure and interim reporting. Both of these measures serve to increase the amount of information that is provided to users. The need for mandatory disclosure requirements such as these has been the subject of considerable theoretical debate. Some commentators have questioned the value of mandatory disclosure rules suggesting that market forces if left unfettered will produce optimal disclosure practices.[24] Others have argued that mandatory disclosure is necessary to overcome 'market failure' associated with the private production of securities information.[25] This is not to suggest that the arguments for and against mandatory disclosure should be regarded in absolute terms. Rather the issue is what level of disclosure regulation is desirable.[26]

Company Disclosure" *Sydney Morning Herald* 14 May 1992 p 31; "Duffy Narrows Disclosure Focus" *Financial Review* 1 July 1992 p 1.

23 Note 30 *supra*.

24 For example, GJ Stigler "Public Regulation of the Securities Markets" (1964) 37 *Journal of Business* 117; GJ Benston "The Value of the SEC's Accounting Disclosure Requirements" (1969) 44 *Accounting Review* 515.

25 SEC Advisory Committee on Corporate Disclosure *Report on the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission* (3 November 1977); J Seligman "The Historical Need for a Mandatory Corporate Disclosure System" (1983) 9 *Journal of Corporation Law* 1; JC Coffee "Market Failure and the Economic Case for a Mandatory Disclosure System " (1984) 70 *Virginia L Rev* 717.

26 Homer Kripke, in a dissenting statement of the Report by the SEC Advisory Commitee on Corporate Disclosure argued that applying a "black-or-white, all-or-none approach" to the evaluation of mandatory disclosure is undesirable. Refer to the digest of the SEC Advisory Committee on Corporate Disclosure *ibid* p 49.

This section examines four main arguments that, individually or in combination, are potential rationales for a regulatory mechanism that explicitly mandates the nature of what must be disclosed.[27] These are:

- unequal possession of information among investors;
- reduction of social waste;
- the opportunistic reporting hypothesis; and
- the public good hypothesis.

Mandatory disclosure requirements are sometimes also justified on the basis that managers have incentives to *misinform* the market through public disclosures. However, such incentives do not appear to provide a rationale for more frequent or detailed disclosures.[28] This problem has been tackled in a number of other ways. The most obvious of these has been to enact laws against fraud.[29] Such laws are commonplace, applying to the sale of a variety of commodities that have uncertain quality characteristics.[30] Another approach has been to develop generally accepted accounting standards.[31]

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27 For a discussion of further rationales for mandatory disclosure refer to GJ Benston *Corporate Financial Disclosure in the UK and the USA* (1976) and CJ Meier-Schatz "Objectives of Financial Disclosure Regulation" (1986) 8 *Journal of Comparative Business and Capital Market Law* 219. These rationales include the protection of non-shareholders (eg employees, creditors) and informing the general public.

28 The SEC Advisory Committee on Corporate Disclosure note 25 *supra* p 622 queried whether making disclosure mandatory will deter or reduce such abuses. The Committee noted that " ... it is not clear that there has been a decline in the frequency of abuse over the last 44 years since the inception of the [US *Securities and Exchange*] Acts".

29 For example, the *Corporations Law* s 995 prohibits misleading or deceptive conduct in a variety of circumstances including the allotment or issue of securities and during the making or currency of takeover offers or announcements, while s 996 prohibits false and misleading statements in prospectuses. Such provisions provide strong incentives for managers to provide the "whole truth" when disclosing. On the desirability of anti-fraud rules refer to FH Easterbrook and DR Fischel "Mandatory Disclosure and the Protection of Investors" (1984) 70 *Virginia L Rev* 669 at 674. The *Corporations Law* s 299(1) also requires directors to ensure that annual financial statements provide such information and explanations as to convey a 'true and fair' view of the profit or loss and state of affairs of the group.

30 Eg *Trade Practices Act* 1974 (Cth) ss 52, 52A.

31 Accounting standards in Australia, once approved by the Australian Accounting Standards Board, have the force of law and must be followed in company accounts: *Corporations Law* s 298(1). Some commentators have voiced concern regarding the diversity of practice allowed by accounting standards. While managers have an obligation under s 299(1) to disclose by way of note when financial accounts do not convey a true and fair view, they are afforded considerable discretion by the standards in their choice of accounting practices. However, it does not follow that the law should mandate particular accounting techniques. Firstly, the development of accounting standards can be a costly exercise. Second, there is empirical evidence that users of accounts (eg debenture holders) restrict accounting techniques to protect their interests. Finally, there is a growing body of research that suggests there may well be economic consequences for companies when accounting practices are made mandatory; the value of those firms that are required to change techniques generally decreases, while the value of those firms that were using the techniques before there was any requirement to do so generally increases. Researchers have attributed these effects to the role that accounting numbers play in explicit contracts involving management compensation or debt, and implicit contracts involving governments (taxes and other regulations) and unions (eg employee wages). Refer to RL Watts, JL Zimmerman *Positive Accounting Theory* (1986). For recent concerns over excessive standard setting refer to L Revsine "The Selective Financial Management Hypothesis" (1991) 5(4) *Accounting Horizons* 16.

A. UNEQUAL POSSESSION OF INFORMATION AMONG INVESTORS

Investors in an unregulated securities market are likely to differ in respect of the resources they devote to obtaining company information and in their technical training or interpretative skills. The result is a continuum of informed investors, ranging from the ill-informed to the well-informed. An early rationale for mandatory disclosure rules was that better-informed traders could reap "unfair" profits from trading on their superior information.[32] Proponents typically argued that, for equity reasons (fairness to all market participants), a system of mandatory disclosure should:

- ensure that all investors have equal access to company information;[33] and
- help simplify or standardise presentation so that information is more readily understood.

Such an argument rested on two main premises: (i) ill-informed investors are in need of protection, and (ii) additional disclosure is the appropriate form of protection. Both of these premises have been criticised.

In relation to the first premise (the need for protection), the market pricing mechanism already affords protection to ill-informed investors who are unaware or have difficulties with the comprehension of publicly released information.[34] The empirical evidence to date tends to support the view that securities markets exhibit semi-strong form efficiency in the sense that they react quickly to publicly released information, setting prices in an unbiased and systematic manner to reflect the information content of disclosures.[35] Investors, when buying or selling securities, are doing so at prices that tend to reflect all publicly available information.[36] They cannot on average be hurt by their inability to

32 There is little empirical evidence that sophisticated investors have succeeded in out-performing general market barometers. An example of the latter type of study is MC Jensen "The Performance of Mutual Funds in the Period 1945-1964" (1968) 23 *Journal of Finance* 389.

33 For example, during the 1970s there was considerable debate in the United States whether companies should be required to publicly release forecasts of their future earnings. One of the arguments put forward by proponents of mandatory forecasts was that security analysts already received this information on an informal basis, and therefore had a privileged trading position over less sophisticated investors. Refer to JC Burton "Forecasts: A Changing View From the Securities and Exchange Commission" in P Prakash and A Rappaport (eds) *Public Reporting of Corporate Financial Forecasts* (1974).

34 FH Easterbrook and DR Fischel note 29 *supra* at 694.

35 There are three main classes of market efficiency: weak form, semi-strong form and strong form efficiencies. For a discussion of these concepts refer to EF Fama "Efficient Capital Markets" (1970) 25 *Journal of Finance* 383; RR Officer and FJ Finn "The Stock Market: Introduction to Market Concepts and Overview of Australian Evidence" in R Ball, P Brown, FJ Finn and RR Officer (eds) *Share Markets and Portfolio Theory* (2nd ed, 1989).

36 This is the case where there is a contemporary security price that is readily observable, as with actively traded securities. Ill-informed investors are arguably afforded less protection in the case of thinly traded securities.

obtain or comprehend previously released information (ie they are price protected).[37]

There are also a number of legislative provisions and market practices that protect ill-informed investors. In the context of takeovers, offers by potential acquirers of a company must be on equivalent terms (eg same share price) to all investors, allowing unsophisticated investors to benefit from the efforts of sophisticated investors.[38] Similarly, when a company is offering a group of securities to the public at large it does so at a common issue price.[39] Finally, certain conduct by those parties possessing inside information is prohibited.[40] Such conduct includes buying or selling the company's securities on the basis of that information, or supplying such information to persons who are likely to trade on it or procure a third party to do so.

Opponents of an equal possession rationale for mandatory disclosure may further argue that it understates the importance of several alternatives available to less-informed investors. Firstly, all investors are free to engage the services of financial intermediaries (eg investment companies) to invest their funds, or information intermediaries (eg security analysts) to provide information on potential investment strategies.[41] In addition, they can diversify their portfolios to reduce the probability that they will incur losses (eg by holding units in an indexed fund).

In relation to the second premise (disclosure providing protection), an argument can be mounted that disclosure *per se* is inadequate protection for ill-informed investors. Asymmetric (uneven) information between investors may simply reflect the differential costs and benefits that are associated with becoming informed. It may be more efficient for certain investors to remain ill-informed, ie to display "rational apathy".[42] One example might include a small investor whose influence over company decisions is minimal, or who does not stand to gain greatly from detecting inefficient managers. While mandatory disclosure can reduce the costs of becoming informed, it does not necessarily follow that all investors will choose to become informed (eg by devoting time to reading company reports).[43]

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37 Capital market research suggests that security prices reflect a rich comprehensive information system. For a discussion of the ability of prices to reveal information concerning future company earnings refer to WH Beaver, RA Lambert and D Morse "The Information Content of Security Prices" (1980) 2 *Journal of Accounting and Economics* 3, WH Beaver, RA Lambert and SG Ryan "The Information Content of Security Prices: A Second Look" (1987) 9 *Journal of Accounting and Economics* 139.

38 *Corporations Law*, s 636.

39 JN Gordon "The Mandatory Structure of Corporate Law" (1989) 89 *Columbia L Rev* 1549 at 1558.

40 *Corporations Law*, s 1002G. It has been argued that restrictions on insider trading might promote equity between market participants at the cost of market efficiency; J Suter *The Regulation of Insider Dealing in Britain* (1989); W Hogan "Insider Trading: Implications and Responses" (1989) 25 *Abacus* 85.

41 See WH Beaver "Future Disclosure Requirements May Give Greater Recognition to the Professional Community" (1978) *Journal of Accountancy* 44.

42 This argument is typically applied to shareholder voting. For a discussion of this behaviour refer to RC Clarke *Corporate Law* (1986) p 390.

43 There is anecdotal evidence to suggest they pay little attention to such reports; JK Courtis (ed) *Corporate Annual Report Analysis* (1978).

Hence, the foregoing suggests that simplifying or increasing the amount of securities information that is supplied by management, with a view to enhancing the protection that is afforded to ill-informed investors, may be of dubious value.[44] To the contrary, such an approach may impair the information function of corporate reports.[45]

B. THE SOCIAL WASTE HYPOTHESIS

Search and verification costs incurred by investors in the pursuit of trading gains, rather than creating additional wealth, merely result in its redistribution between investors.[46] From a social welfare perspective such expenditure is wasteful, constituting a so-called deadweight loss. Proponents of the social waste hypothesis argue that if the regulator required and made available comprehensive information on companies,[47] this would lower incentives for the private search for information and thereby reduce wasteful duplication by investors and others in obtaining or verifying it.[48] Furthermore, through standardised reporting, investors could analyse securities data more cost effectively.

Opponents of mandatory disclosure might respond that market forces work to reduce such wasteful expenditure. Investors valuing a company are likely to take into account the costs of obtaining relevant information. The higher the search and verification costs, the greater the factor by which the future cash flows of a company are likely to be discounted. As such, in order to maximise firm value, it is in a company's best interests to provide information to reduce the search and verification costs of investors. This argument weakens the justification for mandatory disclosure rules.[49]

C. THE OPPORTUNISTIC REPORTING HYPOTHESIS

The opportunistic reporting hypothesis states that mandatory corporate disclosure requirements are needed because management have incentives to *conceal information* that would be beneficial to investors in assessing firm

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44 For reasons why it may be more desirable for managers to aim securities information towards professional analysts in certain circumstances refer to AR Rodier "Prospectus Disclosure Under the Proposed Securities Act in Ontario: Problems in a Changing Environment" (1985) 23 *University of Western Ontario Law Review* 21.

45 CJ Meier-Schatz note 27 *supra* at 222 cites the example of the SEC's long-standing prohibition on forward looking information in corporate reports. The rationale was that unsophisticated investors would not appreciate the uncertainty surrounding such estimates.

46 J Hirshleifer "The Private and Social Value of Information and the Reward to Inventive Activity" (1971) 61 *American Economic Review* 561; EF Fama and AB Laffler "Information and Capital Markets" (1971) 64 *Journal of Business* 289. However, some securities research does create wealth to the extent that management have inadequate incentives to disclose adverse material changes to investors (discussed below).

47 For instance, on the ASC's comprehensive databases, ASCOT and DOCIMAGE.

48 JC Coffee note 25 *supra* at 733; FH Easterbrook and DR Fischel note 29 *supra* at 682.

49 A counter-argument may be that managers have problems in estimating these search and verification costs in order to determine the optimal level of disclosure.

value.[50] The hypothesis has been put forward on both equity and efficiency grounds. On equity grounds, proponents suggest that investors can be victimised systematically through managers failing to inform the market of material occurrences. Investors may suffer a wealth loss as a consequence of paying too much for a company's securities or selling their securities at less than their true value. On efficiency grounds it has been argued that mandatory disclosure is needed to improve the accuracy of security prices. This should in turn increase the efficiency by which the market allocates capital among competing companies (so-called "allocative efficiency") and act as a disciplinary mechanism concerning managers.[51]

In order to assess the validity of the opportunistic reporting hypothesis, it is necessary to examine the incentives that managers have to voluntarily release private information concerning firm value. A number of studies drawing upon signalling or agency theories in economics provide detailed analyses of such incentives.[52] A simple example should make clear the nature of these incentives.

Consider a securities market where disclosure is unregulated. Assume that it is costless for managers to produce and disseminate information and for investors to verify whether the information disclosed is correct or represents an unbiased account of management's beliefs. In general, managers have strong incentives to disclose information that conveys 'good news' to potential investors regarding company value unless it is:

- proprietary in nature (relates to trade secrets or profitable opportunities that have not yet been fully exploited by the firm); or

50 Following perceived corporate abuses of the 1980s, there appears to be a resurgence of such arguments. For example, refer to the Attorney-General's Department *Corporate Law Reform Bill* (1992) that, inter alia, proposes that companies disclose loans to directors, the number of board meetings attended by company directors, and related party transactions.

51 Security prices represent an important disciplinary mechanism concerning management. First, the share price of a company influences the likelihood that managers will lose their jobs. Management can be replaced as a result of direct action by existing shareholders (through voting for their removal at a shareholders' meeting), or indirectly by shareholders "voting with their feet". In relation to the latter possibility, new shareholders may replace the incumbent management team with a more efficient one. The replacement process arising from the "market for corporate control" can be regarded as an important feature of our economy: it simultaneously provides incentives for managers of all firms to operate efficiently while providing a mechanism for displacing inefficient managers. Second, there has been a widespread use of executive compensation packages involving company securities. The rationale underlying this is to make managers bear the wealth consequences of their actions. If they choose not to act in the best interests of shareholders this has direct adverse wealth consequences for them. See EF Fama "Agency Problems and the Theory of the Firm" (1980) 88 *Journal of Political Economy* 288.

52 For example, RE Verrecchia "Discretionary Disclosure" (1983) 5 *Journal of Accounting and Economics* 179; B Trueman "Why Do Managers Voluntarily Release Earnings Forecasts?" (1986) 8 *Journal of Accounting and Economics* 53.

- will lead to wealth transfers from the firm, for example, through the political process or union wage negotiations.[53]

The reasons for these incentives are rather straightforward. Not only do managers often hold company shares or options as part of their compensation packages, but if shareholders are satisfied with their performance, they may be rewarded with higher salaries or perquisites and be more secure in their employment.[54]

Where the disclosure of private information would convey bad news, managers (and for that matter, holders of the firm's existing securities) have incentives to withhold it from the market, thereby bolstering the value of the firm's securities. This could have adverse consequences for allocative efficiency, and may led to equity concerns (eg intergenerational wealth transfers between different groups of investors and/or insider trading). There are, however, countervailing forces.[55] On the assumption that bad news will eventually become known to potential investors, managers may be better off releasing it because such disclosure can signal their ability to anticipate future changes. Second, rational investors recognise the incentives that managers have to withhold bad news, and will price protect. That is, in the absence of assurances to the contrary they will assume managers will cheat, and price securities accordingly.[56] In the presence of such discounting managers may release bad news to curtail investor presumptions that their news is even worse.

In summary, where disclosure is costless, investors (existing and potential) face two major difficulties:

- identifying when information has been withheld; and
- determining whether information that is withheld is unambiguously good news or bad news.

A further complication arises in a more realistic scenario involving costly disclosure. It is not in investors' best interests to have information disclosed where the production, dissemination and verification costs of disclosure exceed its market value. In such an environment investors face a third difficulty:

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53 A number of recent studies have considered the extent to which disclosure can signal a firm's 'ability to pay' which might be used as a justification for increased regulation (eg taxes) or greater wage claims. See RL Watts and JL Zimmerman note 31 *supra*.

54 Managers have incentives to delay good news disclosures where they propose to buy out existing security holders and thereby obtain a lower purchase price. On the incentives to distort disclosure practices in such circumstances refer to LE DeAngelo "Accounting Numbers as Market Valuation Substitutes: A Study of Management Buyouts of Public Stockholders" (1986) 61 *Accounting Review* 400.

55 B Trueman note 52 *supra*.

56 In the absence of guarantees or assurances by management, this can lead to an adverse selection problem where 'lower-quality' companies have greater incentives to offer securities than 'higher-quality' companies, with the result that the latter are eventually forced out of the market. See G Akerlof "The Market for Lemons: Quality Uncertainty and the Market Mechanism" (1970) 84 *Quarterly Journal of Economics* 488.

- determining whether it would be desirable to have the information disclosed on a cost-benefit basis.

In order to reduce the extent of price protection by potential investors, managers have incentives to signal that they are the providers of high-quality securities.[57] There are a number of ways in which managers can assure investors that they are being provided with reliable, contemporaneous information upon which they can make informed investment decisions, and thereby reduce the "information risk" associated with the company's securities. These include:

- appointing an external auditor;[58]
- providing more frequent periodic reports;[59]
- submitting to a range of rules, developed and enforced by a self-regulatory agency (eg the ASX);
- use of a trustee;[60] and
- aligning their wealth with that of investors (eg holding company securities).

The demand for such measures is likely to differ between companies depending upon the nature of their businesses (eg the stability of cash flows or the specificity of assets).

The main issues become whether the incentives that managers have to assure investors of disclosure proprietary are sufficiently persuasive and whether the above measures are adequate to ensure an "optimal" supply of information.[61]

D. THE EXTERNALITY OR PUBLIC GOODS HYPOTHESIS

The final hypothesis concerning mandatory disclosure draws upon the well known economic theory of externalities, in particular, the concept of 'public goods'. This theory has been used as a justification for government intervention in a variety of contexts.

A public good has two main characteristics:

- one person's use of it does not reduce the total supply available for others (the 'non-rivalry in consumption' feature); and
- owners or suppliers cannot exclude those who have not paid from using it (the non-excludability or 'free-rider' feature).

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57 Refer to G Akerlof *id*; MC Jensen and WH Meckling "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305.

58 For evidence on the usage of auditors before there was any legislative requirement, refer to RL Watts and JL Zimmerman "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence" (1983) 26 *Journal of Law and Economics* 613; GJ Benston note 24 *supra*.

59 For a study on the voluntary adoption of quarterly reporting by US companies refer to Leftwich, RL Watts and JL Zimmerman note 19 *supra*.

60 Refer to M Blair and IM Ramsay "Collective Investments: The Role of the Trustee" 1(3) (1992) *Australian Accounting Review* 10.

61 For opposing views on these matters refer to JC Coffee note 25 *supra* and FH Easterbrook and DR Fischel note 29 *supra*.

Oft-cited examples include national defence forces and public parks. It has long been established that where such goods are supplied solely by private sector participants (ie there is no government intervention), the efficiency properties of a competitive market may not be achieved. A simple case can serve to illustrate this point.

Assume that purchasers and consumers in private markets maximise their own utility by equating their private marginal benefits and costs. The socially optimal amount of a good is supplied when the marginal cost of the good is equal to the sum of the individual consumers' marginal benefit (the marginal benefit to society).[62] However, due to the inability to exclude certain individuals from consumption, or charge them commensurably, the owner will be underpaid by a section of the community (so-called 'free-riders'). This latter source of demand is not factored into the owner's supply decision. The result is that the marginal benefits to *society* of extra supply will exceed the private marginal costs (or benefits) to *the supplier.* From a collective stand-point this will mean under-production and under-consumption of the good in question. Proponents argue that social welfare can be improved in a Pareto sense[63] by government regulations moving the private output closer to the social optimum.[64]

A number of academics who have considered securities information from the perspective of company management deciding whether to disclose to outsiders, assert that it has the characteristics of a public good.[65] To take one example, Mendelson has stated:

> Information is now considered a public good in the sense that if A is provided with or sold information, the amount available to B is undiminished even though the value may be diminished. It is practically impossible to provide A with the exclusive use of the information. Similarly, it is not practical to confine information to stockholders. Hence stockholders cannot capture the entire value of the information.[66]

One class of individuals that may benefit from the company releasing securities information is potential or outside investors.[67] Such information may

62 A Samuelson "The Pure Theory of Public Expenditure" (1954) 36 *Review of Economic Studies* 387.

63 Social welfare is increased in a Pareto sense when at least once person is made better off without making anyone else worse off.

64 Consider the example of a national defence force. If a group of individuals undertake to defend a country it would be very difficult (costly) to make everyone who benefits from their activities pay for the service. The result is likely to be a country that is poorly defended. Consequently, in order to ensure an adequate defence force, government intervention (taxation) is necessary.

65 JS Demski and GA Feltham *Cost Determination: A Conceptual Approach* (1976) p 209 and GJ Benston note 27 *supra* p 141. It is important to note that the distinction between public and private goods is a theoretical one. In practice, most goods have both public and private characteristics. For example, refer to RH Coase "The Lighthouse in Economics" (1974) 17 *Journal of Law and Economics* 357.

66 M Mendelson "Economics and the Assessment of Disclosure Requirements" (1978) 1 *Journal of Comparative Corporate Law and Securities Regulation* 49 at 53-4.

67 Other users include government agencies (eg economic planners), labour unions, pricing surveillence authorities, etc.

help them in their portfolio selection processes,[68] or in valuing other companies (eg disclosures indicating industry effects).[69] However, due to the difficulties of entering into a collective agreement with potential investors to have them pay for such information, management is unlikely to take this source of demand into account when deciding what information to supply. The result is an underproduction of securities information relative to total demand.

This public goods rationale for mandatory corporate disclosure has not been without criticism. One critic has been Homer Kripke, a member of the United States Securities Exchange Commission's ("SEC") 1977 Advisory Committee on Corporate Disclosure. He has questioned the descriptive reality of the public goods hypothesis concerning securities information stating:

> ... such an argument, based solely upon ordinary demand and supply conceptions, ignores the simple fact that an issuer must supply the information demands of the potential buyers of its securities, whether private placees or underwriters; and firms desiring an active trading market in their securities must supply information sufficient to attract investor interest and to satisfy the needs of recommending brokers and analysts. The whole academic argument is irrelevant because it deals with information unilaterally produced in some kind of empty state of the world, instead of negotiated securities disclosure, where the recipient has some bargaining chips and uses them.[70]

The discussion thus far has concentrated on securities information from the perspective of management determining whether to disclose certain information to the market (the supply side). Professor John Coffee has also examined securities information from the perspective of an investor or securities analyst deciding whether to incur costs to undertake securities research (the demand side).[71] He makes two main observations. First, securities information displays the key characteristic of non-excludability because users have incentives to leak it. Second, investors are able to "cheat" upon contracts involving securities research.[72] He concludes that researchers face difficulties in enforcing proprietary rights relating to securities information and will be unable to obtain the full economic recovery of a discovery. This in turn means that they will engage in less search or verification behaviour than investors collectively desire. A difficulty with Coffee's argument, however, appears to be that it is unclear why investors do not have the requisite incentives to undertake such activities where they intend to trade on such information themselves.

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68 WH Beaver *Financial Reporting: An Accounting Revolution* (1981) p 190.

69 FH Easterbrook and DR Fischel note 29 *supra* at 685.

70 See also H Kripke *The SEC and Corporate Disclosure: Regulation in Search of Purpose* (1979) p 118.

71 JC Coffee note 25 *supra*. See also RC Clarke note 42 *supra* p 757.

72 For instance JC Coffee *ibid* at 725 notes that investment brokers typically charge on the basis of the amount of securities they buy or sell. They provide advice to clients on desirable trading strategies. The implicit deal is that the investor will use that information in deals made by the broker. However, investors have an incentive to cheat on the deal by using this information in buy or sell activities through a lower priced (less informed) broker.

IV. THE MANDATORY DISCLOSURE ALTERNATIVE

The above analysis suggests that market forces if left unfettered may not lead to an equitable and efficient production and dissemination of corporate financial information from a social welfare perspective. Identification of such imperfections, however, is insufficient to justify mandatory disclosure requirements. Given that disclosure requirements consume scarce resources a point will be reached where additional regulation will reduce society's welfare. Consequently, it is necessary to also consider the incremental costs of disclosure regulation.[73] A given set of disclosure regulations is desirable if the "value" to society of the information that will be provided in the newly-regulated market (in efficiency and equity), net of incremental regulation costs, exceeds the "value" to society of the information currently provided.

While an evaluation of specific mandatory disclosure requirements is beyond the scope of this paper,[74] a brief discussion is provided below of the difficulties in deciding how much information should be required to overcome the perceived shortcomings of the capital market. This is followed by an identification of possible imperfections in political (regulatory) processes.

A. DIFFICULTIES IN ASSESSING THE VALUE OF DISCLOSURE REQUIREMENTS

A variety of possible benefits arising from mandatory disclosure requirements can be discerned from the discussion in Part III above. These include: (i) fairness to ill-informed investors, (ii) a reduction in social waste, (iii) improved corporate governance, and (iv) a more efficient allocation of financial capital between companies. However, such effects are difficult, if not impossible, to assess empirically. Consider, for example, the difficulties in assessing the benefits to allocative efficiency that follow in moving from a requirement for annual to quarterly financial statements.

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73 Appealing to an unexamined alternative commits a "grass is always greener fallacy": H Demsetz "Information and Efficiency: Another Viewpoint" (1969) 12 *Journal of Law and Economics* 1. It may be the case that the social optimums the market failure theories would have us aspire to are unobtainable given the institutional and regulatory arrangements that are currently possible: RW Leftwich "Market Failure Fallacies and Accounting Information" (1983) 5 *Journal of Accounting and Economics* 193.

74 A number of empirical studies in the U.S. have attempted to assess the desirability of past or present SEC corporate disclosure rules. These typically examine the share price effects of the rule(s) being introduced, eg GJ Stigler note 24 *supra* and GA Jarrell "The Economic Effects of Federal Regulation of the Market for New Security Issues" (1981) 24 *Journal of Law and Economics* 613. However, the overall empirical findings are inconclusive. FH Easterbrook and DR Fischel note 29 *supra* at 714 observe that:

> ... there is no good evidence that the [SEC] disclosure rules are beneficial. On the other hand there is no good evidence that the rules are (a) harmful, or (b) costly. The insistent equilibrium of the stock market eradicates the information we need to conduct the cost-benefit test. We are left, for the moment at least, with logical argument rather than proof. And the logical arguments are themselves inconclusive.

This outcome is not surprising given the difficulties in measuring the costs and benefits of disclosure regulation, discussed *infra*.

The costs of mandatory disclosure, while also difficult to measure, are often clearer than the benefits. These include:

- resources consumed by the government in developing rules;
- compliance costs incurred by companies; and
- resources consumed by the regulator in reviewing and processing the statements file and in the enforcement and litigation of disclosure rules.[75]

In addition, policymakers need to be conscious of the possible loss of value to security-holders as a result of making a company release information that is of value to its competitors. Specific disclosure proposals may also involve a trade-off between social objectives.[76]

In order to assess whether the benefits of mandatory disclosure proposals outweigh their incremental costs, policymakers need to consider social preferences. An example of the type of question they may be confronted with is whether the benefits that follow from say, greater protection to ill-informed investors (which are not measurable in dollar terms) outweigh information production and dissemination costs. Such analyses require the determination of an objective function for social welfare.[77] This presents policymakers with a formidable, some would say impossible, task. One might ask, why not consult the parties concerned on such matters? This approach is unlikely to yield the desired response. There is a natural tendency for those who use the securities information (eg investors and analysts) to call for more information because they are not bearing the costs, as there is for those who have to produce it (managers) to oppose additional disclosure measures.

B. POTENTIAL PITFALLS ARISING FROM THE POLITICAL PROCESS

In assessing the desirability of the mandatory disclosure alternative, it is also important to consider the processes by which requirements are developed. What ensures that mandatory disclosure requirements are as efficient or equitable as they could be?

The positive analysis of government regulation has been a popular topic of research in recent years. Economists, lawyers and political scientists have developed a number of theories to describe political processes. One of the most influential paradigms has been the so-called group or public choice theory of regulation.[78] Proponents argue that the market failure theories outlined in Part

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75 For a discussion of the costs of mandatory disclosure requirements refer to GJ Benston note 27 *supra*.

76 For example, the allowance of profit forecasts may help to improve the allocative efficiency of the capital market, but this could be at a cost to investor protection. In addition, improved allocative efficiency may lead to a level of worker displacement that is socially unacceptable.

77 On the difficulties of determining a social welfare function refer to K Arrow *Social Choice and Individual Values* (2nd ed, 1963).

78 GJ Stigler "The Theory of Economic Regulation" (1971) 2 *Bell Journal of Economics and Management Science* 3; S Peltzman "Toward a More General Theory of Regulation" (1976) 19 *Journal of Law and Economics* 211; G Jarrell "The Demand for State Regulation of the Electric Utility Industry" (1978) 21

III of this paper do not capture adequately the way in which regulation actually works. In particular, they question the implicit assumption that individuals in the political arena are motivated by social welfare considerations.

Group theorists typically view the political process as a competition between individuals or groups for wealth transfers. They make the following observations. First, the introduction of any regulation reallocates resources, making some parties (the recipients) better off and others (the regulated) worse off. Second, society is characterised by a variety of interest groups, ranging from those that are poorly organised to those that are well organised.[79] Finally, in order to get elected and remain in office, parties need a coalition of political support. Proponents go on to argue that politicians may, like individuals in general, act in their own self interest. The political process is said to involve the introduction of laws (eg mandatory disclosure requirements) that balance the interests of well organized lobbying groups, at the expense of weaker ones.[80]

An important implication of the group theories of regulation is that policymakers may not attempt to address the equity and market failure considerations noted above. However, other academics have argued that such theories are too simplistic and are unable to capture the full richness of decision-making.[81] Their criticisms include the failure of group theorists to recognise that different parties are involved in the decision-making process, and the possibility of variation among governments in the resources they can bring to bear in implementing their goals. It has also been pointed out that the assumption that politicians and others are motivated solely by "self-interest" does not allow for differing beliefs among individuals.

While considerable research efforts have been devoted to developing regulation theories, there are few empirically substantiated models of bureaucratic behaviour. The result is that it is difficult to explain or predict the actions of policymakers. Nevertheless, one point that emerges from the existing research is that it should not be taken at face value that regulatory measures are always put forward to serve social objectives.

Journal of Law and Economics 269; SM Phillips and JR Zecher *The SEC and the Public Interest: An Economic Perspective* (1981). On these and other theories of regulation refer to J Suter note 40 *supra* p 44.

79 On the factors affecting the ability of groups to organize effectively refer to RL Watts and JL Zimmerman note 31 *supra* p 224.

80 It may also entail using particular "public interest" or "social welfare" theories to justify regulations that are in reality fashioned to accommodate the interests of the stronger groups: RL Watts and JL Zimmerman "The Demand for and Supply of Accounting Theories: The Market for Excuses" (1979) 54 *Accounting Review* 273

81 EA Lowe, AG Puxty and RC Laughlin "Simple Theories for Complex Processes: Accounting Policy and the Market for Myopia" (1983) 2 *Journal of Accounting and Public Policy* 19; WD Berry *Economic Regulation by States: The Case of Public Utility Commissions* (1980) doctoral dissertation, University of Minnesota.

V. CONCLUSION

This paper has examined the main rationales for mandatory corporate disclosure requirements, some of which have been adopted from the economics literature. While it is clear that managers have incentives to withhold certain information, the analysis suggests that no definitive conclusions can be reached regarding the extent to which the government should mandate the nature and amount of corporate financial disclosures. Nor do the justifications for mandatory disclosure provide clear guidance concerning the desirable form and content of corporate reports. If additional disclosure requirements are costly or difficult to implement, the existing disclosure regime, though imperfect, may be preferable. The discussion ended with a brief consideration of the difficulties and possible imperfections associated with the mandatory alternative.