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Original Paper

A Cost-Benefit Analysis of Mandatory and Voluntary Corporate Disclosure

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Abstract

Disclosure is important for corporate financing and business activities, as explained by Signalling Theory and Principal-Agent Theory. Corporate disclosure can be divided into voluntary and mandatory. Driven by the pursuit of maximising economic benefits, companies are motivated to opt to disclose voluntarily, notwithstanding the self-interest of managers and the dilemma of free-riding reduces the incentives and role of such disclosures. This inherent limitation of voluntary disclosure mechanisms has catalysed the widespread adoption of mandatory disclosure requirements. However, a simplistic discussion of the advantages and disadvantages of voluntary versus mandatory falls short of providing a conclusion. To address this gap, this study incorporates a cost-benefit analysis framework from law and economics. The effectiveness of mandatory disclosure, conceptualized as a form of governmental intervention in economic activities, hinges on the balance between its implementation costs and the derived benefits. The value of mandatory disclosure is related to regulatory effectiveness, which in turn influences the costs borne by companies in meeting disclosure requirements and the challenges faced by investors in utilising disclosed information.

Keywords

Mandatory Disclosure, Voluntary Disclosure, Cost-Benefit Analysis

1. Introduction

In the information age, company disclosures, including both financial and non-financial information, are inextricably linked to their operational activities. This information plays a key role in allocating resources and wealth, and its distribution amongst market participants significantly impacts the fairness and efficiency of the capital market. In well-developed capital markets, institutional investors require clear corporate disclosures. Companies, aiming to enhance reputation and build trust, often provide information voluntarily (Rogers & Stocken, 2005). According to the signalling theory by Myers and

Majluf, which revises the Modigliani-Miller (MM) Theory, the optimal choice for companies is to disclose all private information voluntarily (Myers & Majluf, 1984). However, in reality, the distribution of information is highly imbalanced, characterised by a severe asymmetry between companies and investors, and uneven in the amount of information accessed by investors with different sized portfolios. This disparity presents a conundrum in capital markets regarding the choice of voluntary or compulsory disclosure. The natural formation and development of capital markets have primarily been based on voluntary disclosure. Even in the relatively mature capital markets of the United States, mandatory disclosure was formally established by the Securities Act of 1933. As a form of market intervention, the justification for mandatory disclosure requires careful consideration. Efficiency is a fundamental legal goal (Coase, 1960), so its necessity should depend on two aspects: whether voluntary disclosure is insufficient to address the problems and whether the benefits of mandatory disclosure surpass its costs (Posner, 1981). Although existing literature has already extensively discussed the strengths and weaknesses of both mandatory and voluntary disclosure from various perspectives, such discussions become inconclusive since every argument has two sides. Therefore, this essay adopts a new approach by viewing the strengths of mandatory disclosure through the weaknesses of voluntary disclosure and introduces a cost-benefit method to analyse the strengths and weaknesses of mandatory disclosure from a holistic perspective. This essay will first analyse the function of corporate disclosure and then discuss the weaknesses of voluntary disclosure in fulfilling these functions, forming the basis for assessing the necessity of mandatory disclosure. Furthermore, the discussion extends to a cost-benefit analysis of the mandatory disclosure, exploring the ability of its strengths to compensate for the weaknesses of voluntary disclosure and whether the costs brought by its weaknesses are outweighed by its strengths.

2. Literature Review

Corporate disclosure is a crucial tool for linking companies and investors. Milgrom (1981) argues that disclosure can effectively alleviate information asymmetry and enhance financial transparency. Guay et al. (2016) further support this view, demonstrating that information disclosure can reduce the adverse effects caused by a noisy information environment. This role profoundly affects both the liquidity and capital costs of a company. Botosan (1997) finds a negative correlation between information disclosure and the cost of capital. Sengupta (1998) also identifies a similar negative correlation with debt costs. Botosan and Plumlee (2002) extend this to equity costs. Moreover, information disclosure can enhance the governance of a company. Bushman and Smith (2001) underscore disclosure providing essential accounting information for governance mechanisms, including management incentives, board supervision and creditor monitoring. Keim’s (1978) empirical study reveals a negative correlation between the concentration of ownership and the quality of corporate disclosures, indicating that disclosure weakens the ability of major shareholders to exploit minorities. During their research, Deumes and Knechel (2008) find that when agency conflicts are intense, management tends to disclose more information to achieve an information equilibrium between themselves and their principals. Furthermore, Ullman (1985) demonstrates that a higher quality of disclosure leads to a greater proportion of corporate debt, resulting in more effective creditor governance. Beyond financial information, the disclosure of Corporate Social Responsibility (CSR) information can also reduce information asymmetry between companies and the market (Hung, Shi, & Wang, 2013), lower financing costs (Dhaliwal et al., 2014) and enhance intangible assets such as company reputation (Duff, 2016).

According to a Financial Accounting Standards Board research report in 2001, many industry-leading firms voluntarily disclose information to communicate better with their investors. The reliability of voluntary disclosure remains a contentious issue because of no limitation in its scope, extent or frequency. Southworth (2009) notes that the lack of transparency in the information production process often results in deficiencies in voluntary disclosure. Healy and Palepu (2001) emphasise that the effectiveness of voluntary disclosure in addressing information asymmetry and misallocation of resources depends on its quality. There are also risks that managers might misuse voluntary disclosures to confuse investors by reducing financial transparency. Lang and Lundholm (2000) observe that optimistic news increased whilst pessimistic news decreased in the year preceding equity refinancing. This trend reversed after refinancing and those companies that increased their voluntary disclosure six months before equity refinancing experienced a significant stock price drop after issuing shares (ibid). Jo and Kim (2007) also state that companies that suddenly increased their voluntary disclosure frequency before equity refinancing and then significantly reduced it were more likely to engage in earnings manipulation. Furthermore, the motivating factors for voluntary disclosure can also be negatively influenced (ibid). Burks et al. (2018) discover that increased competition within an industry is associated with higher levels of voluntary information disclosure.

The limitations of voluntary disclosure have led to the widespread adoption of mandatory disclosure. Li and Yang (2016) demonstrate the complementary relationship between mandatory and voluntary disclosures in the context of adopting IFRS for mandatory reporting. Gigler and Hemmer (1998) argue that mandatory disclosure can provide a guarantee of the credibility for voluntary disclosure and deter managers from false reporting due to the risk of subsequent exposure, thereby enhancing the quality of voluntary disclosures. Sansing's (1992) single-stage game model shows that mandatory disclosure can ensure that managers disclose some credible information. Whilst mandatory disclosure has solved some issues of voluntary disclosure, its effectiveness is also controversial. Coffee (1984) advocates that mandatory disclosure can enhance transparency and efficiency in markets characterised by information asymmetry and failures. Easterbrook and Fischel (1984) believe that mandatory disclosure aligns with market goals in incentivising companies to disclose information needed by investors. The study by La Porta et al. (2006) also highlights that the mandatory disclosure and private enforcement are the main functions of securities law. Conversely, Coase (ibid), Stigler (1963) and Benston (1973) argue that false statements, insider trading and fraud in the securities market should be adjusted by contract law and tort law, or resolved through private enforcement. The securities law is ineffective and harmful as government regulation increases transaction costs and interferes with market mechanisms. Benson (1973) further finds that continuous mandatory disclosure did not benefit investors (ibid). Moreover, mandatory disclosure can also affect market competition equality. The cost of mandatory disclosure is the same for large and small enterprises, meaning that smaller enterprises face higher per-unit disclosure costs, potentially disadvantaging or even ousting them from the market (Easterbrook & Fischel, 1984).

3. Functions of Disclosure

3.1 Signalling Theory

Signalling Theory explains the motivations behind company disclosure. According to the Efficient Market Hypothesis, market prices reflect the discounted values of past, present and even future events (Fama, 1970). In this market, stock price movements are indicated by high-quality information disclosure, and investors can make their respective decisions with a rational perspective. The MM Theory emphasises that corporate investments should be exclusively driven by available investment opportunities in an ideal and frictionless market (Modigliani & Miller, 1958). In practice, however, company investments deviate from these ideal estimates, indicating problems with investment efficiency which are largely caused by information asymmetry (Roychowdhury, Shroff, & Verdi, 2019). Information asymmetry can be categorised into ex-ante and ex-post asymmetry. The adverse selection model focuses on ex-ante asymmetry, where disadvantaged investors seek higher capital returns due to a lack of information about companies, leading to financing constraints for companies unable to meet the investment demand (Myers & Majluf, 1984). The moral hazard model emphasises ex-post asymmetry, such as managers with information advantages engaging in inefficient or excessive investments for personal benefits (Jensen, 1986). In a market with serious information asymmetry, it is hard for investors to search for information amongst thousands of companies to make their decisions, resulting in adverse selection and moral hazards (Mirrlees, 1971).

Signal Transmission is an effective way of addressing the moral hazard and adverse selection issues. This theory, proposed by Spence in 1974, is designed to achieve the equilibrium of market information supply and requires entities with information advantages to enable the active transmission of relevant information to all those who are at a disadvantage. The Pricing Model of neoclassical economics assumes perfect information, and if it does not, market mechanisms will fail to achieve optimal resource allocation (Asimakopolus, 1978). Information asymmetry is a subset of imperfect information, referring to incomplete and unevenly distributed information. Capital relates to scarce resources in competitive capital markets. To prevent the undervaluation of corporate value and reduce financing costs, high-quality companies should disclose more to enhance transparency and distinguish themselves from other types of companies (Grossman, 1981). Non-financial disclosures such as CSR reports can also serve the same role (Dhaliwal et al., 2011). Furthermore, exposing non-compliant behaviours of companies through timely and comprehensive disclosure can effectively prevent moral hazard practices. Therefore, reducing information asymmetry as well as improving information transmission between companies and the markets can enhance investment efficiency.

3.2 Principal-Agent Theory

Corporate disclosure plays a crucial role in minimising agency costs between managers and investors and ensuring fairness amongst all investors. According to Coase's (1993) theory of firms, a company is essentially a collection of contracts established amongst stakeholders, which need costs to become established and maintained. The relationship between shareholders and managers is an example of these contracts (Cheung, 1983). Both parties are rational economic people and seek to maximise their benefits in the theoretical assumptions. However, their goals differ; i.e., shareholders aim for maximising the company value, whilst creditors aim for reliable operations for payback and managers for higher compensation and leisure (Jensen & Warner, 1988). Consequently, managers may not always behave in the best interests of the shareholders due to information asymmetry, which allows them to prioritise their own interests above those of the shareholders, generating agency costs (La Porta et al., 1997). Therefore, shareholders need to monitor managers to prevent conduct that might harm their interests, which incurs additional costs. Since external shareholders find difficulty in monitoring managers directly, they actually rely on contracts, the enforcement of which is costly and can affect returns and the managers' compensation (Jensen & Meckling, 1976). This encourages managers to form an active disclosure to reduce these monitoring costs (ibid). The enhanced communication brought forth by disclosure helps in setting up contracts more efficiently and thus reduces their cost. It also promotes stronger trust between managers and stakeholders, contributing to the long-term stability. Furthermore, disclosure creates a fair environment where all investors, big or small, have equal access to information, ensuring balance and fairness in the capital market (Viccaro, 2002).

4. Weakness of Voluntary Disclosure

4.1 Fraud and Concealment

Corporates may abuse the right of voluntary disclosure, intentionally releasing false or misleading information that harms investor interests. Both Signalling Theory and Principal-Agent Theory view the decision-makers of corporate disclosure, who are mainly managers, as rational individuals seeking to maximise utility and disclosing information to enhance company value (Douglas, 1986). However, this premise overlooks the significance of corporate control transactions and is overly optimistic about the alignment of interests between company management and shareholders (Coffee, 1984). The lure of insider trading and leveraged buyouts can motivate management to obtain ownership at discounted prices, possibly leading them to disclose false or misleading information for personal gain (Hafzalla, 2007). Investors cannot discern or verify the truthfulness of information that managers disclose voluntarily, especially without strict standards like those for mandatory disclosures. Moreover, anti-fraud rules can partially prevent fraudulent disclosure, although they are insufficient for addressing the non-disclosure issues. As a result, companies under voluntary disclosure might only reveal positive information whilst hiding the negative. Empirical research shows that companies which voluntarily disclose their earnings forecasts are usually those which have performed better, whilst those with poorer profitability and investment returns are less likely to disclose such information voluntarily (Penman, 1980). These weaknesses create rent-seeking opportunities for managers. According to the Folk Theorem of game theory, as long as the present value of the cost of ending a long-term cooperative relationship is higher than the expected benefit of current fraud, repeated long-term games can regulate opportunistic behaviour in market transactions (Osborne & Rubinstein, 1994). However, it is possible that the one-time benefits of fraud for managers outweigh the long-term costs of a damaged reputation. This will be more likely to occur in markets characterised by frequent personnel and ownership changes, where managers may not be repeated game players. Therefore, the opportunistic behaviour tendency of managers can lead to significant moral hazard problems.

To price securities effectively, investors require uninterrupted access to comprehensive and accurate information (Fama, 1970). If managers conceal or manipulate information that is crucial for investors'' decision-making, both investors and society suffer losses. This also undermines the value of information and renders the incentive signalling mechanism ineffective. Therefore, voluntary disclosure becomes a tool for information fraud, allowing managers to provide false information (Healy & Palepu, 2001). In times of poor corporate performance, managers will imitate the signals of a successful company, releasing misleadingly positive performance information to hoodwink the market temporarily. In a highly competitive market where short-term survival is crucial, the outcome of a single-period competition may lead to 'the bad always beats the good'. Companies disclosing false information could survive on short-term gains, whilst those disclosing true information might face bankruptcy due to overly negative market reactions (Richardson et al., 2006). Managers no longer disclose relevant information both unconditionally and voluntarily, yet manipulate disclosure from the perspective of maximising their own interests. When this happens, voluntary disclosure further deepens the information asymmetry rather than resolving it.

4.2 External Effects

Information is a public good, and its production and use have strong externalities, leading to the free-rider problem (Pigou, 2017). Although the supply of information is determined by demand, suppliers cannot pass on the production costs to demanders since all users can access it without any cost, resulting in a lack of incentives for supplying (Coffee, 1984). This often leads to an information undersupply as the market mechanisms malfunction. Once corporate information is disclosed, it becomes accessible to all, including legal users like investors and creditors, as well as free-riders, including competitors. These free-riders might use the information against the firm without any cost (Jin, 2005). Whilst companies are inclined to satisfy the market's broad information demands, they also need to consider whether the cost of providing this exceeds the increase in company value through resolving the adverse selection issues (Gao & Liang, 2013). If disclosing certain information harms the company's competitive position, to prevent free rides by competitors, the company might be reluctant to disclose valuable information, such as details about products or investment projects. As a result, the amount of information will be less than optimal under voluntary disclosure (Verrecchia, 1983).

5. Cost-Benefit Analysis of the Mandatory Disclosure

5.1 Unpredictable Benefit

The benefit of mandatory disclosure is that it helps consumers to make well-informed decisions, thus improving the welfare of society. Theoretically, mandatory disclosure can compensate for the weaknesses of voluntary disclosure, enhancing information accuracy and mitigating external effects. The goals and requirements of mandatory disclosure are designed to ensure that the disclosed information is reliable, accurate, complete and timely. As is often pointed out in Securities Law textbooks, the establishment of a modern securities regulatory system based on mandatory disclosure aims to promote openness and transparency in the securities market and prevent fraud against investors by companies (Loss, Seligman, & Paredes, 2023). Additionally, according to the theory of public goods, the most effective solution to the free-rider problem is through the government provision and its comprehensive coordination (Ostrom, Schroeder, & Wynne, 2009). The public good nature of information implies that the marginal cost of repeated use is almost zero; therefore, theoretically, once information is produced, it should be made freely accessible to as many people as possible. Mandatory disclosure enforced by the government compels firms to disclose more information and encourages analysis institutions to generate additional insights, thereby enhancing the overall efficiency of information supply. Consequently, this can partially help to address the issues related to a lack of motivation for voluntary disclosure by managers and the general inadequacy of information supply.

The effectiveness of mandatory disclosure depends on a fragile chain of causation (Ben-Shahar & Schneider, 2016). If any link in this chain fails, the intended objectives will not be met. The entire process spans from the production to the use of information. Initially, regulators must establish appropriate disclosure standards and scope, and companies required to disclose must then follow these guidelines, ensuring that the information is accessible, comprehensible and usable for an audience with varied features and abilities. However, this chain is actually already broken in practice (Georgiev, 2017). Firstly, regulators may not find the optimal level of mandatory disclosure, leading to information overload. Public goods are naturally subsidised and cost-free, so consumers often overestimate their needs. Regulators tend to expand the scope of mandatory disclosure because they have inherent inertia and do not have to bear the cost of disclosure, thereby the function and required amount of mandatory disclosure are overestimated (Ben-Shahar & Schneider, 2014). Secondly, the mandatory disclosure system does not address the problem of information fraud and companies may still manipulate the data, leading to false or misleading disclosures. Companies can avoid disclosure requirements in various ways, such as disregarding laws, dressing up disclosures in rhetoric, burying important details in fine print, or intentionally overwhelming the investors with information overload (Ben-Shahar & Schneider, 2016). Research has found that the number of words indicating uncertainty (e.g. “approximate”, “uncertain” and “indefinite”) and weak modal verbs (e.g. “might”, “possible” and “contingent”) in corporate annual reports are significantly positively correlated with the volatility of stock returns in the following period (Loughran & McDonald, 2011). Additionally, the semantic ambiguity in IPO prospectuses is strongly associated with more volatile earnings performance in the 60-day period following the offering (Loughran & McDonald, 2013). The situation is more severe in China, where accounting information fraud is common. Data as of April 2017 shows that amongst 707 penalised listed companies, the primary reasons for violations were related to disclosure, including “false or seriously misleading statements” and “inaccurate or untimely financial forecasts” (Jia, 2017). Statistics show that those penalised companies have a higher rate of repeated offenses and shorter intervals between them (Ye, 2022).

Finally, the impact of mandatory disclosure on targeted investors is also unclear. On the one hand, the similarity of mandated disclosures across companies reduces the value of this information for investors. According to the Signalling Theory, signals must be distinctive and not easily imitated. However, the conformity and standardised nature of mandatory disclosures often fail to meet these criteria, rendering them less effective as market signals or as tools for investor decision-making. Moreover, mandatory disclosures are usually imposed by a government with legal force and complemented by industry norms that set additional standards regarding the type and format. Beyond the requirement for their own operational efficiency, companies also need to establish legitimacy by aligning with the expectations of stakeholders within their industry (Campbell, 2007). Hence, the coercive isomorphism based on the threat of corporate survival and the normative isomorphism based on gaining industry approval lead to a gradual isomorphism in corporate behaviour (Scott 2013). This results in a convergence in the disclosure frequency and characteristics, which further reduces the diversity of the analysts’ predictions (Lang & Lundholm, 1996). As a consequence, the information becomes less helpful as a reference for investors to make investment decisions. On the other hand, the recent increasing regulatory demands for more comprehensive disclosures have led to an information overload, which makes investors neglect important information. The increasing complexity and volume of information raise the processing burden for users and may sometimes exceed their analytical capacity. If the cost of incorporating information into valuation models and investment decisions exceeds the benefits, investors might choose to forgo the information (Bloomfield, 2002). Additionally, the abundance of information makes it challenging for investors to discern critical information and identify whether such information is deliberately concealed, potentially impairing decision-making abilities (Impink, Paananen, & Renders, 2016).

5.2 Multiple Cost

Regulatory costs of mandatory disclosure include the costs which regulators bear in gathering information for policy making and the rent-seeking costs brought about by government failure. Compared to the companies and investors themselves, it is harder for regulators to know which information is the most useful and beneficial for mutual cooperation between companies and investors. Given the situations of different industries, companies and projects vary, their disclosure design should also differ and a one-size-fits-all approach may lead to efficiency losses. For instance, foreign competitors of listed companies may use disclosed information to gain a competitive advantage, thus intensifying competition to the rest of the industry with a competitive disadvantage. Just as in the United States manufacturing industry, the mandatory disclosure is mostly to blame for its recession (Glaeser & Omartian, 2022). Therefore, regulators require additional information search costs to achieve the socially optimal level of disclosure, where the marginal social benefit equals the social marginal cost. Furthermore, the opportunistic nature of government intervention behaviours creates costs. Government regulation can be malevolent and rent-seeking in the absence of an effective constraint-handling mechanism. The regulators have the power to decide whether the disclosure satisfies the requirements, indirectly incentivising market participants to engage in rent-seeking activities that could bring financial convenience, such as paying bribes to the government or other authorised intermediaries in order to avoid regulation.

Mandatory disclosure also increases costs for companies. The disclosure will weaken the information feedback effect which shows that stock prices can provide valuable information to management about which they are unaware and can utilise to make company decisions (Ye, Zheng, & Zhu, 2023). Although managers have a wealth of information about their companies, they may be inefficient at collecting information that is incentive incompatible with the information possessors or is hard to standardise or interpret (Rajan & Zingales, 2004). Markets have competitive advantages in generating certain types of information compared with companies, hence the production of private information remains crucial (Hayek, 2000). Whilst mandatory disclosure increases overall market information, it makes investors less willing to seek and produce information, generally reducing the amount of information available for managers to make decisions (Pinto, 2023). For growth-focused companies, where future investments are vital and the stock price feedback effect is significant, the increased cost of private information can lead to a loss of value by suppressing stock price feedback (Gao & Liang, 2013). Under mandatory disclosure, the value loss from lack of choice may outweigh the benefits of solving adverse selection issues, thereby reducing efficiency, which could have been avoided. Moreover, overly detailed and specific disclosure requirements in mandatory disclosure may expose companies to external opportunists (such as plaintiff lawyers and competitors) who seek to leverage litigation or other means for their own gain, necessitating significant costs for the companies involved (Francis, Philbrick, & Schipper, 1994).

6. Conclusion

Disclosure is an essential circumstance for corporate financing and business activities. Its function can be explained by Signalling Theory and Principal-Agent Theory. Companies signal information about their real situation through disclosures to mitigate information asymmetry, reducing financing costs and enhancing investment efficiency. Additionally, interest conflicts exist between management and investors. Disclosures could provide more information about management conduct to reduce investor monitoring costs and also create a fair way for investors to access information, thereby balancing the status between management and all stakeholders.

Corporate disclosure can be voluntary or mandatory. As entities pursuing the maximisation of economic benefits, companies are motivated to disclose voluntarily. However, managers may not always be rational and might conceal negative news or disclose false information for self-interest, exacerbating information asymmetry. Moreover, the public good nature of information encourages free-riding, satisfying investor needs whilst also making it available to competitors, potentially harming the company's competitive position and reducing the incentive for voluntary disclosure.

The weaknesses of voluntary disclosure have prompted the global adoption of mandatory disclosure. As a means of creating government intervention in the economy, the effectiveness of mandatory disclosure depends on whether its implementation costs are lower than the benefits. Mandatory disclosure is designed to enhance information accuracy and alleviate the external effects of public goods. However, its real value is determined by regulatory effectiveness, the reliability of the disclosed information and its impact on investors. The expected benefits of mandatory disclosure are uncertain. The disclosure requirements set by regulators are not necessarily efficient, and potential fraudulent activities might not be prevented. The information similarity and overload also combine to make it hard for investors to use. Furthermore, its implementation comes with costs. These are the costs for the regulators of gathering information for policy-making as well as the costs of rent-seeking due to government regulatory failure. Corporates may face reduced efficiency due to diminished information feedback effects and the financial burdens of increased litigation.

This essay attempts to move beyond the endless debates over certain strengths and weaknesses in previous research and comprehensively evaluates mandatory disclosure by combining both from a cost-benefit analysis. However, due to the lack of empirical research support, this essay cannot provide precise cost-benefit conclusions. Future research could consider more factors such as the safe harbour system and discuss them based on the practical data, thereby enabling corporate disclosure to serve companies, investors and society better.

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