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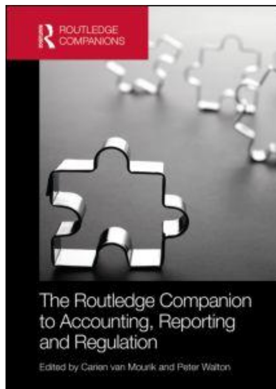

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Costs and Benefits of Disclosure

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Costs and Benefits of Disclosure

Ann Gaeremynck and Mathijs Van Peteghem

1. The relevance of disclosure

When judging the financial statements quality attention is usually paid to the two most relevant issues: measurement and disclosure. Over the years, questions related to disclosures have arisen. The fact that disclosures in the notes have significantly expanded has on the one hand led to questions regarding how meaningful such disclosures are, and has on the other hand raised serious concerns about the overall quality of the disclosures. Furthermore, the global financial crisis and the introduction of IFRS have contributed to the renewed interest in disclosure issues.

IFRS being a principles-based accounting framework has caused the emergence of additional disclosures in the financial statements. Some examples underline the relevance of those disclosures in this context. A first example, the impairment standard (IAS 36) stipulates that the circumstances under which an impairment is booked should be motivated in the notes of the financial statements (key assumptions used in the identification process, discount and growth rate of cash generating units, sensitivity analysis, etc.). This information is highly relevant to investors and allows a better judgment of how the value of the goodwill has been derived; the true and fair value of goodwill. A second example, IAS 40 *Investment property*, demands that the investment property valuation method (historical cost, market fair value, comparables or model fair value) is disclosed in the notes, but IAS 40 does not demand that the underlying parameters of the valuation process are specified, though they are highly relevant for decision making. A third example, transparency, requires recognized fair value estimates be supplemented with disclosures about reliability (Ryan, 2002; Barth, 2006; Bies 2005; Landsman, 2006; Blacconiere *et al.,* 2011). Disclosures about the reliability can be very diverse: disavowals of fair value disclosures in the notes (Blacconiere *et al.,* 2011) as well as disclosures on the underlying parameters used to value investment property to overcome problems with the estimation accuracy of the fair value measurements (Vergauwe *et al.,* 2012). Overall, disclosure has become more and more important in a US GAAP and IFRS context as measurement methods such as fair value demand more and more judgment from the preparer's side. The user's side should be informed about the judgments made to assess the reliability of the measurement choices made, which is a key characteristic in the decision process of different users. There is also a renewed interest in disclosure because of

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the financial crisis, especially in the banking sector (Goldstein and Sapra, 2012). Different national banks undertake annual stress tests to know whether banks have enough capital to absorb adverse economic conditions. The purpose of these stress tests is to discipline the market. However, the question has been raised whether the outcome of these stress tests should be disclosed as they may have adverse economic effects, such as sub-optimal economic decisions and excessive reactions of the public to bad news. As such disclosure can result in bank behavior which does not maximize firm value but maximizes the likelihood of passing the stress tests.

This short introduction illustrates the relevance of disclosures. The purpose of this study is not to give an overview of all disclosure studies published, which is a rather impossible task. Moreover, there are some very good reviews already published in the literature (Healy and Palepu, 2001; Core 2001; Leuz and Wysocki, 2008; Beyer *et al.,* 2010). This chapter discusses some issues which are relevant in all disclosure decisions:

- What is the role of disclosure?
- What are the costs of disclosure?
- How to disclose the information (form of disclosure)?
- When to disclose the information (timing of disclosure)?

2. The role of disclosure

It has been long recognized in the literature that disclosure fulfills a double role. First, disclosure fulfills an *ex ante* role to capital investors for informing them about firm value because of problems of asymmetry in information and of uncertainty. Second, disclosure also fulfills a stewardship role *ex post* in limiting agency problems between company insiders and outsiders.

Ex ante disclosure fulfills a role of solving asymmetries in information and uncertainty. A well-accepted rationale for disclosing information is that disclosures result in a decrease of the information asymmetries between company insiders and outsiders with positive effects on firm value. Asymmetries in information occur because management have privately held information about the profitability and the risk of future projects. Enhanced disclosure not only results in a decrease of the asymmetries in information but also helps firms to make better decisions. Disclosure serves as a monitoring mechanism (Lambert *et al.,* 2007). Therefore, more disclosure reduces uncertainty about the 'real' value of the firm. Disclosures which reveal private information to the market are typically labeled as efficient disclosures (Holthausen *et al.,* 1983; Holthausen, 1990; Healy and Palepu, 1993). If market participants do not receive any information, they will undervalue firms with good projects and overvalue firms with bad projects. Disclosing information can solve this potential market failure.

The positive market reactions to more disclosure have been extensively illustrated in the literature (Welker, 1995; Healy *et al.,* 1999; Leuz and Verrecchia, 2000; Verrecchia, 2001). Providing value relevant information to otherwise uninformed investors enhances firm visibility and investors' willingness to invest in the firm (Diamond and Verrecchia, 1991; Chang *et al.,* 2008), facilitates the placement and trading of shares at fair prices, improves the market liquidity and lowers the cost of capital (Diamond and Verrecchia, 1991; Kim and Verrecchia, 1994; Botosan 1997; Piotroski 1999; Botosan and Plumlee 2002). Furthermore, evidence also exists that investors punish firms for insufficient disclosure (Welker, 1995; Leuz and Verrecchia, 2000; Lambert *et al.,* 2007) as they want to "price protect" themselves against potential losses from trading with better informed market participants. Along the same lines, Gelb and Zarowin (2002) document a positive relation between voluntary disclosure and stock price informativeness, indicating the

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importance of providing sufficient information to investors. Francis *et al.* (2007) focus on the complementary role of disclosure and earnings quality and attribute the reduction in a firm's capital cost more to improved earnings quality than to increased disclosure. Firms with high earnings quality typically also have more expansive voluntary disclosures (Francis *et al.,* 2007).

The rationale to disclose information because of possible asymmetries in information does not only apply to shareholders but also to debtholders. Debtholders lend money to a firm to give that firm the possibility to invest in new projects. The interest rate charged will reflect general market uncertainty as well as firm-specific risks. Enhanced disclosure allows lenders to gain increased insight in a borrowing company, thereby reducing uncertainty and asymmetries in information. Consequently, if a firm discloses more, debt holders will charge a lower interest rate to the firm with also a direct positive effect on firm value (Sengupta 1998; Chen *et al.,* 2002). A remark which especially concerns debtholders is that incentives to publicly disclose information typically apply to public debt and not to private debt (such as loans granted by banks). All the necessary information to supply a loan can be provided in private meetings without the risk of having specific costs linked to the disclosure, such as proprietary costs (see Section 3.1 below).

However, *ex post* disclosure also fulfills a stewardship role with the purpose of decreasing agency costs. Agency costs arise for different reasons. First, agency costs arise because the suppliers of capital are not the same persons as the ones responsible for managing the funds provided (Shleifer and Vishny, 1997). Management has the ability to make decisions that are in their own interests, possibly expropriating investors' funds and harming shareholders (Jensen and Meckling, 1976). Furthermore, management can withhold bad news for the owners because of opportunistic reasons (e.g. management compensation or career concerns). In an environment with separation of management and ownership, disclosure fulfills a monitoring role in evaluating management performance and strategy (Lambert *et al.,* 2007). If the information is truthfully disclosed, the likelihood that company insiders realize private benefits of control is smaller, which will positively impact firm value. Investors anticipate the existence of these possible agency problems by demanding a premium which increases the firm's cost of capital (Lang and Lundholm 1996) and which has a negative effect on the market liquidity (Verrecchia, 2001).

A typical example of a setting where disclosure can fulfill a stewardship function is the disclosure of executive compensation. Performance-based compensation schemes are a central part of corporate governance practices and allow for a strong link between executive remuneration and performance. This offers incentives to the management to maximize firm value. However, since performance is mostly defined using accounting numbers, managers are tempted to manipulate earnings in order to inflate remuneration. Shareholder monitoring is particularly relevant in this setting, but outside monitoring may also prove useful. Consequently, more recently regulators have started requiring firms to disclose executive remuneration as firms do not disclose them on a voluntary basis (Liu and Taylor, 2008; Hitz and Werner, 2012).

However, the specific characteristics of the environment will also influence the type of stewardship role disclosure fulfills. In a European setting, where the majority of the shares are typically held by a single shareholder, the agency problem is of a fundamentally different nature. The principal-agent problem of dispersed ownership is no longer a concern due to the increased monitoring of majority shareholders (Shleifer and Vishny, 1986) while a new agency problem is introduced: a principal-principal problem. This encompasses conflicts between majority and minority shareholders, where the former abuse their power at the expense of the latter (Young *et al.,* 2008). With a controlling shareholder, the fundamental governance problem is

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not opportunism by executives and directors at the expense of public shareholders at large but rather opportunism by the controlling shareholder at the expense of the minority shareholders (Bebchuk and Weisbach, 2010). Majority ownership most likely implies too much shareholder involvement, where the controlling shareholder enjoys private benefits of control and uses its voting power and influence on management to extract even more benefits (Claessens *et al.,* 2002; Renders and Gaeremynck, 2011). These benefits include the appropriation of corporate resources by the majority shareholder or related-party transactions at unconventional transfer prices. The value generated by these transactions is not shared among all the shareholders in proportion of the shares owned, but is enjoyed exclusively by the party in control (Dyck and Zingales, 2004). In this setting, disclosure is even more important when a controlling shareholder is present. Minority shareholders have no influence on firm policies or practices and are largely dependent on the information made available by the management. Enhanced disclosure, whether disclosed on a voluntary or regulatory basis, provides them with the means on which to base their judgment. This allows them to signal shareholder expropriation or other power abuse by the majority shareholder.

In an environment where disclosure fulfills a stewardship role, different mechanisms can help to encourage disclosure such as the institutional setting as well as the quality of firm governance. Of particular importance is the board of directors (Adams *et al.,* 2010) and especially the audit committee in disclosure settings. Better-governed firms are found to make more informative disclosures (Beekes and Brown, 2006). In the literature extensive evidence is found that well-functioning boards and especially audit committees can encourage disclosures (Ho and Wong, 2001; Cheng and Courtenay, 2006). In a context of IFRS adoption, Verriest *et al.* (2013) find that firms with stronger governance have a higher degree of voluntary disclosure, comply more fully with the minimum disclosure requirements set in the IFRS standards, and use IAS 39's carve-out provision less opportunistically. Finally, when studying the relationship between disclosure and governance, it may not be ignored that both can be substitutes. As an illustration, disclosure as well as a well-functioning remuneration committee can both avoid excessive compensation being paid to management.

3. Costs of disclosures

Even if everyone is convinced that more disclosure creates benefits, increased transparency by disclosing more information leads to more indirect as well as direct costs for the company. Because of the existence of costs, independent of whether disclosure fulfills a stewardship or signaling role, full disclosure of all the private information will not occur in practice. In the case of voluntary disclosure, the assumption is that managers will disclose information if they expect that the benefits from doing so outweigh the costs. In the case of mandatory disclosure, while firms have less discretion over the decision itself, they determine the quantity (e.g. the number of lines), the nature (e.g. good or bad news or neutral) of the information or more qualitative characteristics disclosed. In this decision, costs as well as benefits will determine those characteristics of the information disclosed.

When investigating the costs of disclosure, there are different types of disclosure costs. First, there are the direct costs of collecting, processing and publishing the information (e.g. organizing a conference call or organizing the internal reporting system in such a way that the information is available, for example segmental reporting). Direct costs of preparing disclosures are related to firm size as well as to the characteristics of the reporting environment (e.g. listed or not). It is well accepted that in some institutional settings, where the difference between local

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GAAP and IFRS is big, the introduction of IFRS standards resulted in a substantial increase of the direct reporting costs. If a firm is cross-listed in the US, firms have to disclose a Form 20-F, which demands additional costs.

Second, there are also indirect costs such as proprietary, verification and litigation costs. Indirect costs explain disclosure practices although the specific setting and the accounting issue studied will determine the relative importance of each category. While proprietary costs can be highly important for issues such as segmental reporting, litigation costs can influence risk reporting strategies and verification costs can impact the level of detail as well as frequency of voluntary earnings' forecasts releases.

3.1 Proprietary costs

Proprietary costs arise when information disclosure results into competitively sensitive information to the market (Verrecchia, 1983; Wagenhofer, 1990; Feltham and Xie, 1992; Depoers and Jeanjean 2010). Competitors may use this information to obtain a competitive advantage towards the disclosing company. IFRS 8 is a typical example of competitive sensitive information. If segments are identified on a very disaggregated level, the disclosure of the profits by segment can attract entry in the market and it can harm the competitive position of the firm. However, in a situation of losses and bad market prospects it can also deter entry in that market segment. Using confidential plant-level data Bens *et al.* (2011) show that proprietary costs of separately reporting segment information influence the level of aggregation in external reporting. The higher the level of proprietary costs, the higher the level of aggregation. Likewise, Botosan and Stanford (2005) find evidence that managers conceal profitable segments which operate in industries with a low degree of competition as compared to their primary operations. However, Berger and Hann (2007) test the proprietary costs hypothesis for withholding information relating to segmental reporting and find only mixed empirical evidence. The proprietary cost rationale is only significant in a minority of models and is non-robust to other specifications.

Notice that proprietary costs are not only applicable to the competitive market position but also to other markets such as the labor market. Scott (1994) provides evidence that the propensity to disclose pension plan related information was negatively associated with measures capturing labor market power. Disclosing the wages of top managers results in a higher employee turnover of a firm's top management as they more often get good job offers by headhunters.

3.2 Verification costs

Disclosure of information can only fulfill its role of decreasing asymmetries in information when it is reliable, truthful and free from manipulation (Ball *et al.,* 2011; Crawford and Sobel, 1982). Consequently, if a firm wants to disclose additional information truthfully to the market, the firm has to spend additional resources to verify this information. Therefore, another important, albeit indirect, cost factor of disclosing information identified is the verification cost. This is the cost of establishing credibility by enhanced financial statement verification (Ball *et al.,* 2011). In this context, the most important verification mechanism is provided by the internal and external audit function. Firms have incentives to invest substantially in their auditor as larger and more qualified audit firms will in general be more expensive but the market values high quality audits (Francis and Wang, 2008). This results in accurate and reliable disclosure. The external auditor is complemented by the internal audit function. Accordingly, Prawitt *et al.* (2009) find evidence of a positive relation between internal audit quality and earnings informativeness

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as proxied by the level of earnings management. Firms have an incentive to invest in the audit as it contributes to the credibility of the information provided, which has a positive effect on the stock price (Lundholm and Myers, 2002). Finally, empirical evidence shows that verification costs will also be smaller in circumstances where disclosure does not relate to measurement issues (Ball *et al.,* 2011).

Firms can also employ other verification mechanisms than the audit function to provide credibility to the information provided. An external appraiser report for the measurement of the investment property provides credibility to the measurement of the investment property (Vergauwe *et al.,* 2012). Another example is an evaluation of corporate environmental practices by experts. This will signal an open information policy to investors and enhance disclosure credibility (Darnall *et al.,* 2009).

3.3 Litigation costs

Associated with the verification costs is another category of indirect disclosure costs, being the litigation costs. A firm incurs litigation costs when third parties file complaint and sue for damages on the basis of insufficient or misleading disclosure. The legal proceedings entail real expenses on representation and damages, as well as a loss of reputation. Karpoff *et al.* (1998) document these effects relating to environmental violations and find a loss in market value of equity almost equal to the legal penalties following the violation. In this setting, reputational concerns are of secondary importance. Conversely, a law suit encourages firms to decrease the provision of disclosures for which they may later be held accountable (Rogers and Van Buskirk, 2009). Finally, in studying the relationship between litigation costs and disclosure, it is important to notice that an endogenous relationship exists between disclosure and litigation as is also the case for proprietary costs.

4. Types and timing of disclosures

Next to the disclosure decision itself, costs and benefits also influence the types of disclosures made. Characteristics of the information studied in previous literature are the quantitative versus the qualitative as well as the nature of the information provided.

4.1 Types of disclosure

Qualitative versus quantitative information

Whether disclosure is of a quantitative or qualitative nature, depends to a large extent on the event to which the disclosures relate. If disclosures relate to foreign currency risk, it is obvious that quantitative information about the risk can be provided. The exposure to credit risks also allows quantitative disclosures. Notice that quantitative disclosures can always be supplemented with qualitative information but the opposite is often more difficult. Furthermore, although one would expect investors to attach more value to quantitative aspects, qualitative disclosures as well can have a non-negligible impact. Another class of highly relevant non-quantitative disclosures made are environmental, by which the firm aims to promote its environmental awareness. Aerts and Cormier (2009) state that environmental legitimacy is mainly about perception, and this perception is significantly and positively affected by the extent and quality of environmental disclosures in the annual report and press releases. Relating to environmental disclosures, Cho and

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Patten (2007) acknowledge firms' use of disclosure as a legitimizing tool towards society. Aerts and Cormier (2009) apply the same reasoning to media legitimacy. Media legitimacy is found to strongly influence the public opinion on a company (Carroll and McCombs, 2003). Accordingly, Botan and Taylor (2004) emphasize the importance of information issues for corporate reputation. Another example where qualitative information is highly relevant is corporate social responsibility (CSR), which has recently emerged as a topic of increased interest to practitioners and academics (Lindgreen and Swaen, 2010). CSR is a way to introduce ethics into the organizational structure, whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis (European Commission, 2011). In practice, CSR disclosure appears limited. Holder-Webb *et al.* (2009) find that firms tend to keep most of the CSR information private. As a possible explanation, the authors suggest investors do not take this information seriously without assurance as to its quality. The importance of verification and reliable data is stressed. The disclosure on CSR is also related to the strength of corporate governance settings (Aguilera *et al.,* 2006). Firms with higher CSR are associated with higher disclosure (Gelb and Strawser, 2001), as well as less risky stocks (Becchetti and Ciciretti, 2009).

While the costs of qualitative information (e.g. verification costs, proprietary costs) are lower, the benefits will also be smaller as the information is less precise (Danckaert *et al.,* 2008). Furthermore, where quantitative information is less subject to discretion and often verified by an independent auditor, qualitative disclosure is largely at the discretion of management and not verified by an independent external party. Finally, disclosure can result in increased litigation, where not only the disclosure itself but also the nature as well as the quantitative character of the news is relevant (Beyer *et al.,* 2010).

Nature of the news

The reaction of investors to news will depend not only on the precision but also on the type of information being released, i.e. whether disclosures made contain good or bad news for the company. Previous studies that have examined the relation between disclosure and stock price reactions conclude that good news disclosures are associated with positive stock price responses (Lang and Lundholm, 2000; Henry, 2008; Demers and Vega, 2008; Davis *et al.,* 2008). Moreover, Skinner (1994) finds that stock price reactions to bad news disclosures are larger in absolute value than stock price reactions to good news events.

4.2 The timing and the way to disclose the information

Next to the disclosure decision itself as well as the type of disclosures made, costs and benefits also influence the timing (early or late) and where to disclose the information (in the annual report, the MD&A (Management Discussion and Analysis) analysis or by using another means).

The timing of disclosure

Sengupta (2004) shows that the reporting lag is shorter for firms with larger benefits (i.e. a greater investor demand for information) and larger costs (i.e. greater litigation costs). To avoid litigation costs, firms make not only high quality but also timely disclosures (Lang and Lundholm, 1993; Sengupta, 2004; Kothari *et al.,* 2009b). Furthermore, the nature of the news also influences the timing although the evidence is mixed. Skinner (1994, 1997) documents that firms

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with bad news are more likely to pre-disclose compared to those with good news. On the contrary, empirical evidence (Givoly and Palmon, 1982; Chambers and Penman, 1984; Kross and Schroeder, 1984; Begley and Fischer, 1998; Kothari *et al.,* 2009b) also shows that managers are successful in withholding much of the bad news from investors until it becomes inevitable that the bad news will be released. Managers' tendency to withhold bad news is lower for firms with high litigation risk, but higher for managers with greater career concerns (Kothari *et al.,* 2009b). While litigation costs are highly relevant for the timing of the disclosures made, proprietary costs do not influence the timing of disclosures. The frequency of the segment disclosures made does not depend on the level of proprietary costs (Botosan and Harris, 2000).

The form of disclosure

a) The annual report

Disclosures can be done in different ways: in the annual report, in the MD&A analysis or by using another means (such as conference calls). The annual report of a company is the primary instrument to disclose information to shareholders. Firms are required by law to provide an overview of the annual accounts as well as several other disclosures related to environmental issues, firm risks, corporate governance in the notes, etc. The importance of a firm's annual report cannot be exaggerated. The annual reports have therefore been extensively regulated to force firms to disclose a number of items which they would not have disclosed on a voluntary basis. The quality of disclosure matters as well as the quantity (Beretta and Bozzolan, 2012). Furthermore, evidence also shows that despite regulation, firms still aim to obscure negative news to investors. S. Li (2010) finds firms with lower earnings to have more complicated annual reports which are less accessible to the reader. Firms with persistent positive earnings have easier to read annual reports. They therefore appear to misuse discretion allowed for by the legislation to mitigate the adverse consequences of bad news. While everyone is convinced about the value of regulated information (e.g. earnings, disclosures about the valuation methods), not everyone is convinced about the value of voluntary disclosures in the financial statements. Although Banghøj and Plenborg (2008) acknowledge the use of voluntary disclosure in reducing information asymmetries, they do not find that voluntary information in the annual accounts is relevant to investors. This could mean that investors are not capable of incorporating this voluntary information in the firm value estimates.

The impact of information can also differ depending on the form in which it is disclosed. The primary difference between these forms is the verification and reliability of information. Among the various forms, the balance sheet and profit and loss accounts have the most authority, since these have been thoroughly inspected by an external auditor. This involves an objective expert opinion on the reliability and truthfulness of the firm's financial situation. Hence, investors largely base their judgment on the information found in the audited financial statements. Balance sheet and profit and loss account are intertwined: value relevance of one aspect is complemented by the other (Black and White, 2003). A correctly valued balance sheet offers a constraint to managerial discretion in manipulating the financial data (Barton and Simko, 2002). Recognizing the importance of the balance sheet, managers voluntarily include these data in quarterly earnings announcements to inform investors when current earnings are less informative or future earnings are more uncertain (Chen *et al.,* 2002). Therefore, balance sheet disclosures are more prevalent among younger firms and those operating in high tech industries, since these firms face increased uncertainties. They are also more likely for firms reporting losses, with larger forecast errors, engaging in merger and acquisitions and with more volatile stock returns (Chen *et al.,* 2002).

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Another important aspect of firm disclosure are the notes found in the annual report. In the notes, a company provides clarification on several items in the financial statements as well as explains the firm's financial and operational performance. Issues treated are various and contain information on debt, corporate governance, risks and uncertainties facing the firm, environmental disclosures, etc. The notes offer management an opportunity to decrease information asymmetries and inform stakeholders on matters which it finds relevant. However, lack of verification may threaten the perceived reliability of these disclosures. Next to the notes where those disclosures about the valuation choices are made, the most well-known element added to the balance sheet and the profit and loss account is the Management Discussion and Analysis (MD&A). In the MD&A, management has to state its view on the company's operations as well as future prospects. This is a source of useful information and is part of a firm's overall disclosure quality (Clarkson *et al.,* 1999; Cole and Jones, 2004). In a recent study, Brown and Tucker (2011) find the primary users of the MD&A-schedules to be investors rather than analysts and also document stagnation in MD&A content. This suggests firms tend to 'copy and paste' the schedule with only minor changes between years, which results in only a limited usefulness towards investors. However, the tone changes between subsequent MD&A filings do have an impact. Management's tone change adds to portfolio drift after taking into account accruals and earnings surprises (Feldman *et al.,* 2010). The incremental value of the information conveyed by the tone change is stated to depend on the strength of the firm's information and disclosure environment. F. Li (2010) confirms the importance of tone in the MD&A, as well as the limited use analysts make of these schedules. MD&As are also evidenced to have an impact on a firm's cost of capital, stock return volatility and analyst forecast dispersion (Kothari *et al.,* 2009a).

The reason why the relevance of the annual report is often questioned is its timeliness. Annual reports are only issued within some months after the year-end. This means some (possibly outdated) information is aggregated and jointly disclosed towards investors. New bad news disclosures made at the time of the annual report issue can result in a sudden shock in stock prices. The gap between the financial year end and the issue of financial statements is influenced by proprietary costs, information cost savings and relative good or bad news (Leventos and Weetman, 2004). The timeliness of information also has an impact on litigation costs: less timely disclosure of negative earnings news increases firms' litigation consequences (Billings, 2008). When restatements are involved, the gap considerably widens (Badertscher and Burks, 2011). Gigler and Hemmer (2001) relate the timeliness of disclosure to a firm's accounting policy in a theoretical framework. Overall, annual reports may provide insufficient or untimely disclosure to investors. This explains why large firms opt for quarterly reports as well. However, the issue or verification arises in this setting, since these statements are not subject to a statutory audit in most countries.

b) Conference calls

A common practice used in larger firms to overcome the problems of the timeliness with the annual report is the use of conference calls. The role of these conference calls is to communicate important information to investors and stakeholders by the use of digital meetings. Information is then disseminated on a more frequent basis, resulting in reduced information asymmetries. The information disclosed by conference calls is also evidenced to contain new and material information for market participants (Frankel *et al.,* 1999). Consequently, firms regularly holding conference calls are found to display low information asymmetries and have a lower cost of capital as compared to firms with a less open disclosure policy (Brown *et al.,* 2004). Furthermore, conference

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calls result in a significant reduction of analyst forecast error (Kimbrough, 2005) and more informative earnings (Kohlbeck and Magilke, 2002).

There are different types of conference calls. Bushee *et al.* (2003) distinguish between 'open' and 'closed' conference calls. Whereas closed conference calls contain only a limited number of participants (major investors, important stakeholders, invited professionals, etc.), open conference calls allow all parties, including analysts, unlimited access to the call. The authors find open conference calls to be associated with a large number of shareholders, lower institutional ownership, lower analyst following and higher average share turnover. Open conference calls result in fast and wide information disclosure and are upcoming standard practices, matching advances in technology, regulatory and market pressures (Skinner, 2003). Closed conference calls on the other hand are found to be subject to managerial opportunism in respect to the analysts involved: favorable and prestigious analysts have higher participation probabilities than unfavorable and less prestigious analysts (Mayew, 2008). This managerial opportunism can also manifest itself in deception and manipulation at the conference call (Larcker and Zakolyukina, 2010).

Conference calls are an important means of increasing disclosure frequency towards investors and allow firms flexibility and discretion in determining the content of new information. However, discretion also offers scope for opportunism. In order to minimize credibility issues, firms may incur verification costs to enhance disclosure reliability in conference calls.

5. Regulation and its impact on disclosure

Given the possible benefits of disclosure the question can be raised whether disclosure should be regulated or mainly remain voluntary. An extensive overview of the pros and cons of disclosure regulation can be found in Leuz and Wysocki (2008), who make the interesting statement that disclosure regulation is demanded when non-disclosures create externalities that make disclosures in fact socially desirable. If we look to the recent financial crisis, one could argue that regulation of risk disclosures in the financial statements of banks are socially desirable as non-disclosure has resulted in serious financial distress and the need of financial aid by the government.

While it has been shown theoretically that firms are motivated to provide voluntary disclosure if the benefits outweigh the costs (Healy and Palepu, 2001), the benefits and costs of mandatory disclosures are far from clear (Bushee and Leuz, 2005) and have been heavily debated in the past (e.g. Coffee, 1984; Easterbrook and Fischel, 1984). In an environment with low costs of disclosure and few benefits to retaining private information, disclosure should not be extensively regulated. An equilibrium is likely to occur where all firms except the worst one will disclose the relevant information (Milgrom, 1981). However, the costs of mandatory disclosures are not always low and therefore regulation is sometimes needed to force firms to reveal the private information. Regulatory pressures may also have an impact on voluntary disclosure (Baginski *et al.,* 2002). Fernandes *et al.* (2010) provide an illustration on the market impact of loosening disclosure requirements.

An example that regulation is not without cost but has significant capital market effects is the introduction of IFRS. Given the globalization of the capital markets, the introduction of IFRS is likely to lead to more transparent and more comparable financial statements between firms of different countries. S. Li (2010) shows that the extent to which IFRS adoption increases financial disclosure, using the number of additional disclosures required by IFRS (GAAP in 2001) compared to local GAAP, influences the capital market benefits of the IFRS introduction. The

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reduction in the cost of equity is significantly greater among mandatory adopters in countries with a large increase in disclosures than in countries with a small increase in disclosures. This result is consistent with increased disclosure being one of the possible mechanisms behind the cost of equity effect of IFRS adoption (S. Li, 2010).

The introduction of IFRS in the EU and many other jurisdictions is also a clear example that regulation shifted from a local to a more international level. The institutions of accounting regulation have changed with the increasing worldwide adoption of International Financial Reporting Standards (IFRS). For many jurisdictions this event replaced government regulation with that of the IASB as a private standard setter (Wagenhofer, 2011). However, in the US next to the accounting standards, there is also substantial federal regulation (e.g. SOX) and stock market regulation (SEC regulation). That stock market regulation can be effective in enhancing disclosures is exemplified by Form 20-F. Cross-listed firms on NYSE are subject to specific disclosure requirements (Adhikari and Tondkar 1992; Salter 1998), which exceed mandatory reporting requirements demanded by the accounting standards, such as the business and industry risk disclosures. These requirements not only affect the disclosure quality of cross-listed firms in the US market with an improved market liquidity but also create spillovers to the annual report of the cross-listed firm in the home market (e.g. Danckaert, 2012).

Whether additional disclosures demanded by accounting standards or by other regulatory bodies result in increased disclosure, depends to a large extent on the enforcement regime. Empirical evidence shows that not all countries implement the standards equally rigorously (Leuz and Wysocki, 2008). Leuz *et al.* (2008) point out that a country's legal and institutional environment affects firms' financial reporting incentives and hence influences financial statement quality. Most prior literature finds that firms operating in countries with strong legal enforcement disclose more information than firms operating in a weak legal environment (Vanstraelen *et al.* 2003; Brown and Tucker 2011; Hope 2003; Fogarty *et al.* 2006). S. Li (2010) also finds that mandatory adopters in countries with weak enforcement mechanisms and a small increase in disclosures from mandatory IFRS adoption actually experience an increase in their cost of equity, consistent with more discretion afforded under IFRS having a detrimental effect to shareholders when the standards are not properly enforced. Furthermore, in a US context, the SEC views enforcement of financial disclosure requirements as an essential element in a reliable financial accounting regime and a central part of the SEC mission (e.g. Levitt 1998; Paredes 2009). That SEC enforcement activities are effective is shown in a study on executive compensation regulation (Cassell *et al.,* 2011). While firms reviewed by the SEC corrected all the identified disclosure defects, firms not reviewed by the SEC exhibited little change in their compliance levels. This finding is consistent with the SEC's conclusion (Parratt, 2009) that non-compliance with the new regulations persists until defective disclosures are publicly identified in SEC reviews. Although SEC enforcement can improve quality of executive disclosure compensation, neither negative media attention nor a focused SEC enforcement action seems to be effective in disciplining CEO compensation (Cassell *et al.,* 2011).

In the debate on whether disclosure should be regulated or not, it is important to highlight that, whatever disclosure issue is considered, it can never be fully regulated. A certain part always remains voluntary. An accounting standard or a stock exchange can demand that certain information is disclosed but can never fully regulate the tone of the news, the precision of disclosures given or the extent (the number of lines) designated to the news. Those issues are especially relevant for qualitative more than quantitative disclosures. However, the tone of the news also reveals private information. Firms with bad environmental performance are more likely to use optimistic language in their environmental disclosures (Cho *et al.,* 2010). Furthermore, these qualitative characteristics of information are useful for the capital market.

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Even for a regulated item such as credit risk, Danckaert *et al.* (2008) find that the stock market reaction, the decrease in the market spread, is larger when the credit risk information is more precise, i.e. whether the firm elaborates the actions that have been taken to limit the risk, the risk is expressed in monetary items or information is given how the risk is expected to evolve in the future. Taken together, even in a setting of regulated information, the whole picture can never be fully regulated.

6. Conclusion

The preceding sections have offered an initial understanding of the value of disclosure in the current economic environment. Firms face a trade-off between costs and benefits when deciding upon the level of disclosure. When the costs exceed the gains, this will lead to a suboptimal amount of information disclosed to investors and stakeholders. The resulting information asymmetries produce agency costs and inefficiencies, since lack of information impedes investors' decisions and transparent markets. Towards investors, firm disclosure is the primary source of information. Hence, they predominantly rely on firms' self-reported data. Since firms are themselves responsible for the content and extent of disclosure, reliability issues may arise. Investors will not find all information equally credible. Verification costs may then be incurred to enhance disclosure credibility and stimulate investors' knowledge of the organization.

In deciding upon the optimal disclosure level, firms have a choice between a wide range of options in tailoring disclosure to their specific needs. Annual reports are compulsory and extensively regulated, but a variety of additional schedules and mediums allow more flexibility. The core source of information remains the quantitative data found in the financial statements and the notes, since these are verified by an external auditor and are considered reliable and less prone to manipulation. However, additional qualitative oriented disclosures constitute an almost equally important source, albeit managerial discretion is high in respect to environmental disclosures, conference calls, press releases, etc. These disclosures are made on a more voluntary basis and allow firms to increase disclosure frequency, thus being more informative to investors. Interim reports, earnings announcements and conference calls serve the same purpose.

Despite a positive appreciation of disclosure by investors, the stock market exhibits a strong negative reaction when the voluntary disclosure contains bad news – measured by adverse earnings announcements – as opposed to a positive reaction for good news disclosures (Skinner, 1994). Comparable results are obtained concerning unexpected bond downgrades by Goh and Ederington (1993). The nature of the news may therefore influence corporate disclosure decisions. Important information may be withheld when disclosing the information would entail adverse consequences for the firm. Regulation can constrain this risk of managerial opportunism by imposing legal requirements, but this is at the expense of flexibility. However, complete regulation is impossible. Companies will always have some leeway in applying the rules and complementing regulatory disclosure with voluntary information. Regulation should therefore focus on key data aspects and verification costs, as to stimulate firms to provide a minimum of objective disclosure to investors.

Lastly, when studying disclosure issues, the economic and regulatory situation will highly determine which disclosure issues are the most in the picture. A regulatory topic related to disclosures is the convergence issues related to IFRS 8. Although FASB and the IASB spend a lot of time on the convergence project between IFRS and US GAAP standards, whether convergence has been successful or not is an open question. However, if we want to realize a

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global framework for financial reporting, this is a highly relevant topic. An example of how the current financial crisis determines relevant disclosures is the disclosure of stress tests done on financial institutions (Bischof and Daske, 2012). Disclosure of the stress tests will encourage appropriate behavior by the financial institutions as well as by the regulatory agencies, which have to disclose the tool used to apply the stress tests. However, in the studies investigating the stress disclosure test, next to the direct costs of disclosures some 'new' endogenous costs are identified. Banks could probably take the short profit maximizing investment decisions to pass the stress test instead of maximizing the long-term value, which illustrates that more disclosure is not always a good thing. Furthermore, those disclosures could also lead to instability of the financial market (Goldstein and Sapra, 2012). Allowing for flexibility may mediate these problems.

This chapter has made clear that disclosure practices cannot be considered in isolation. One has to link the form, time and content of disclosure to firm-level determinants and market reactions, taking into account the costs and benefits as perceived by the firm for each of these decisions. Disclosure practices therefore largely differ between firms and will continue to do so despite regulation. However, a minimum level of disclosure towards investors is warranted to establish an environment characterized by low information asymmetries.

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