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Mandatory disclosure and asymmetry in financial reporting ☆

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ABSTRACT

This paper examines the demand for disclosure rules by informed managers interested in increasing the market price of their firms. Within a model of political influence, a *majority* of managers chooses disclosure rules with which *all* firms must comply. In equilibrium, disclosure rules are asymmetric with greater levels of disclosure over adverse events. This asymmetry is positively associated with the informativeness of the measurement and increasing in the level of verifiability and ex-ante uncertainty of the information. The theory also offers implications about the relation between mandatory and voluntary disclosure, when both channels are endogenous.

This study develops a rationale for the existence of asymmetric financial reporting rules mandating disclosures of unfavorable economic events. This characteristic is shared by a broad set of accounting rules, generally referred to as impairment accounting; impairments are an archetype for many existing measurement rules as illustrated by impairment tests, lower of cost or market or contingent liabilities. Moreover, beyond pure impairment accounting, the asymmetric reporting of bad news is a key institutional fact that permeates the very foundations of financial reporting, from the going-concern opinion issued by an external auditor to the stricter enforcement by courts of law over material omissions of adverse events.

Recent literature has provided a categorization of decision problems for which asymmetry is or is not optimal for decision-making, but no definitive explanation for its ubiquity in financial reporting policy. Skeptics argue that there is no universal solution to all decision-theoretic information design problems, as perhaps best summarized by Demski's (1973) impossibility theorem. Here, we take a different path from that of the decision-theoretic approach. Rather than asking what measurement best solves any individual production or contracting problem, we assume that observed policies respond to the *collective* demands of managers and examine which disclosure rules emerge from a process of political compromise. In a parsimonious model, we demonstrate that collective choice can lead to disclosure rules that are generally asymmetric and

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always require the disclosure of certain adverse (below-median) news. Further, such rules need not be preferred for decision-making purposes.

We develop a baseline model which includes as few elements as necessary and then expand this baseline to include several additional institutional facts. In the baseline model, the economy is composed of managers privately informed about future cash flows and selling shares of their firm in a competitive market. We assume that managers' behavior is motivated by the short-term market price, that managers are the only interest group exerting influence to push for certain disclosure rules, and that firms' shareholders (or other parties) do not exert influence. Each manager is endowed with one unit of influence – hereafter, one vote – and the disclosure rule that is implemented reflects the preferences of the majority of managers. We assume that all firms must disclose in accordance to what was agreed to in the vote. We therefore refer to these disclosures as mandatory – and any minority of managers that did not support the rule, or might lose from it, cannot opt out or ignore the rule. Implementing disclosure rules entails a cost incurred by all firms.

Then, we extend the baseline model to incorporate other important characteristics of the environment. We consider the determination of disclosure rules when managers can voluntarily provide additional information. The asymmetry of mandatory disclosure rules extends to this environment but we show that voluntary disclosure tends to substitute for mandatory disclosure. Contrary to most voluntary disclosure models, non-disclosure can lead to a positive market reaction because bad news is subject to mandatory disclosure. We also consider a setting where an "outside party" (e.g., investors, a standard-setter, uninformed managers, managers with a long-term horizon, etc.) can offset some of the influence exerted by informed managers. The asymmetry extends to this setting, and we show that influence by an outside party weakly reduces disclosure. In addition, the baseline results are robust to variations in the assumptions, such as settings in which managers are imperfectly informed about future transactions affected by the rule or in which real operating decisions are made conditional on the disclosure.

Our assumptions comport with a few stylized facts of the rule-setting process in accounting. First, in the US, the authority to enact a new accounting standard lies with Congress and the Securities and Exchange Commission. Furthermore, Congress often takes an active role in shaping accounting policy; during the period 1976–2000, for example, the Financial Accounting Standards Board was involved in eighteen Congressional hearings (Beresford, 2001). Second, Congress is a political body, subject to various influences and pressures by interest groups. Managers of reporting firms form an important example of such an interest group and may represent the point of view of their current shareholders. For example, Beresford (1988) notes that, "*for most of our projects, the preparer community tends to be the most vocal in expressing opinions about the various issues*" (p. 5) and Zeff (2002) similarly remarks that "*preparers in the U.S. are well-organized and constitute a powerful lobby*" (p. 44). Third, final standards emerge from a process of political compromise, which may not benefit unorganized interest groups or groups whose interest lies in the minority. Implementing disclosure rules is mandatory for all publicly traded firms, and a public firm cannot opt out and write its own rules even if doing so is in the best interest of its shareholders. There are open questions as to whether this is the best format for a standard-setting institution (Dye and Sunder, 2001; Bertomeu and Cheynel, 2013) which we cannot answer here.

We emphasize that this paper does not intend to offer a general theory of standard-setting and note several caveats. We focus the model on the market price impact of a new rule. This has the benefit of focusing the model on trade-offs discussed in the extensive disclosure literature, but also comes with the limitations inherent to this family of models. In particular, we cannot discuss issues that pertain to stewardship problems as, for example, in the case of standards about compensation measurement or regulatory capital ratios. In addition, the model focuses on influence by parties interested in increasing the short-term stock price. We do not offer here a game-theoretic model in which a standard-setter plays a political game to stir political forces toward a preferred outcome (see Amershi et al., 1982 and Bertomeu and Cheynel, 2013 for models of active standard-setting). Hence, our baseline model does not predict the relatively recent trend toward fair-value accounting.[1]

We provide next a sketch of the formal intuition and develop the complete argument in subsequent sections. Firms' outcomes are drawn from a known distribution, and a disclosure rule defines the outcomes that must be made public. A Condorcet equilibrium disclosure rule is defined such that no majority of firms' managers would be willing to change that rule to a proposed alternative. Consider an existing policy enforcing disclosures of some favorable events but not of other less favorable events. There is, in such a policy, a mass of non-disclosers who support any *new* policy that increases the non-disclosure market price. Such a new policy can be designed as follows: reclassify a small fraction of favorable events "disclosed" in the existing policy as "not-disclosed" in the new policy. Because these events are favorable, the reclassification will increase the non-disclosure market price and, therefore, it will be supported by all non-disclosers in the old policy. The fact that only a *small* fraction of events is reclassified is key in this construction of a new policy: managers whose events have been reclassified might oppose the new policy but, because only few of them have been reclassified, they do not have the votes to overcome the preference of all non-disclosers.

An equilibrium policy, when it exists, must then require disclosure of relatively unfavorable economic events. In fact, we show that the equilibrium rule maximizes the non-disclosure market price and, in the complete analysis, further show that

[1] Yet, our model does allow researchers to understand why, overall, managers may oppose fair-value accounting. (This opposition is particularly prominent in the comment letters submitted by the banking industry, where fair-value is most widely applied). It is also the case that, in both US GAAP and international standards, fair-value measurements are often optional (for many classes of non-financial tangible assets) or explicitly forbidden (for most current assets and intangibles) and do not constitute the largest portion of balance sheets, even for primarily financial firms (Laux and Leuz, 2010).