5-6-1974

A Critique of The Rationale for Required Corporate Financial Disclosure

George J. Benston

A CRITIQUE OF THE RATIONALE FOR REQUIRED CORPORATE FINANCIAL DISCLOSURE*

by
George J. Benston
Professor of Accounting and Finance
Graduate School of Management University of Rochester
May 6, 1974

[Introductory note: Dr. George J. Benston was educated at Queens College (B.A.), New York University (M.B.A.) and the University of Chicago (Ph.D.). He also is a Certified Public Accountant. His writings span the fields of accounting, finance, economics and banking.

He is a consultant to banks, organizations, and various Federal agencies, including the Federal Reserve Board, the Comptroller of the Currency, The President's Commission on Financial Structure and Regulation, and the National Commission on Consumer Finance. Presently, he is preparing a study comparing financial disclosure in the United States and the United Kingdom for the Institute of Chartered Accountants in England and Wales.

In his lecture, Professor Benston will consider the rationale for government regulation of financial disclosure in a free society rather than simply assume that "more is better" as does the SEC, the AICPA, security analysts, and the financial press. He then will examine the benefits presumed to flow from mandated disclosure. This examination will include a review of the extant evidence on the need for and value of laws requiring financial disclosure. Some additional insight into the benefits and costs of government required disclosure will be obtained from a contrast of the regulatory agency system followed in the United States with the United Kingdom company laws.

Professor Benston's analysis is particularly timely in view of the extensions of disclosure currently sought by the SEC. He draws some possibly unorthodox conclusions from his analysis which might give those who believe "more is better" some reason to question the value to society of government regulation of disclosure.]

For many of us who grew up under Franklin Roosevelt, learned our accounting or worked in the financial markets since the early 1930's, it's hard to conceive of a world without the SEC. Somehow it seems as though disclosure always was required, and that until it was required it didn't really exist. It is very hard, I think, for financial analysts to conceive of a world in which the 8-Ks, 10-Qs, and 10-Ks aren't available or in which the Securities Act of 1933 doesn't mandate prospectuses. Almost without questioning, many accountants, analysts, comptrollers, the financial press, stockholders and potential investors assume that were it not for government required financial disclosure and the SEC the market for securities would be unregulated and hence unfair and inefficient. So it seems anachronistic to question the desirability of government required disclosure.

Nevertheless, we should question the desirability and efficacy of government intervention in the securities markets, or anywhere else for that matter. This assertion is based on my belief that we are, or at least want to be, a free society. In such a society, one presumes that government ought not require anything of its citizens unless some overriding aspect of the public interest commands it, some benefit that offsets the cost imposed on private individuals. Thus we must determine what are those benefits and what are the costs. In the analysis that follows, I emphasize "what are the benefits" more than "what are the costs" because, if it turns out that the benefits aren't very great and if it seems the costs are great, the question essentially is answered. However, if it turns out that the benefits are considerable, we must then measure how great the costs are and delineate the distributive effects of requiring disclosure on different groups in society. Until we make these calculations and unless the benefits from required disclosure clearly exceed the costs and the distributive effects either are negligible or are in accordance with our ethical precepts, I suggest that government mandated financial disclosure should be repealed or at least not expanded.

WHY SHOULD FINANCIAL DISCLOSURE BE REQUIRED?

The preliminary question is, "why should financial disclosure be required?" I must emphasize that voluntary disclosure is not questioned, though this is an interesting question for research and analysis. However, only disclosure made in accordance with government mandate (that is, in accordance with the Securities Acts of 1933 and 1934) requires justification, since one can argue that such a requirement is contrary to the basic tenets of a free society. In a free society, contracts among private individuals ought to be freely determined. If a person wants to buy the stock of a corporation that discloses financial data, such is that person's right. If a person does not want to buy the stock of a corporation that does not disclose, that also is her right. Therefore, we should ask that government mandated disclosure be justified before it is imposed.

Several reasons can be adduced to justify interference with people's right to enter freely into security purchase contracts. I'll simply list five of these and then discuss them: (1) the obligation of government to provide for the enforcement of contracts; (2) a concept of fairness or equity in dealings among people; (3) improved efficiency of resource allocation; (4) administration of government and employees' and the public's right to know; and (5) political considerations. Each of the reasons is first explained and then the evidence that supports or is contrary to the reason is marshalled.

THE OBLIGATION OF GOVERNMENT TO ENFORCE CONTRACTS -- REDUCTION OF FRAUD AND MISREPRESENTATION

In general the government's obligation to provide for the enforcement of contracts is a consequence of its police power and the rule of law. In carrying out its judicial responsibilities, the government has an interest in reducing the probability of fraud by making its discovery and prosecution easier. Then the cost to the government of enforcing contracts would be lower. But, one should ask, why is disclosure necessarily related to fraud? If a company announced: "We're not telling you anything, we do not intend to tell you anything, and if you don't like, it, buy shares in another company", then one need not invest in this company. If disclosure is not promised, its absence is not fraud.

Nevertheless, we must recognize the existence of implied contracts that a given society tends to expect the government to enforce. Specifically, investors expect corporate management to act in a fiduciary capacity, to operate the enterprise in the interest of the shareholders rather than in the interests of management. Of course shareholders can agree to a contract that allows corporate management to operate the enterprise any way they wish. But such contracts are rare; it is difficult to imagine shareholders knowingly agreeing to unrestrained selfserving behavior by management. Rather when management is found appropriating corporate resources or writing selfserving contracts, investors seek redress in the courts or appeal to the legislature for subsidies to offset their loss. Thus government might find prevention of fraud and misrepresentation preferable to having to mediate disputes.

The question to be answered is whether or not required disclosure is necessary or desirable for reducing fraud and misrepresentation. A preliminary consideration is whether or not fraud and misrepresentation is a serious problem worthy of government intervention. Unfortunately, it is difficult to know how much fraud there is at any time, since unless it is discovered, it is not recorded. Nevertheless, it is useful to examine evidence on financial statement fraud before 1933 and 1934, when the federal Securities Acts were enacted. For this purpose, I reviewed all the evidence I could find including the many volumes of Senate hearings that preceded the Securities Acts and the published legal cases. Fortunately, a survey of the cases dealing with the accountants' liability prior to 1934 was published in 1935 by Wiley Rich.(1) This study reveals very few cases in which fraud or gross negligence was alleged against public accountants before the passage of the Securities Acts. The Senate hearings also reveal virtually no instances of fraud or misrepresentation with respect to financial statements. However one reason for the dearth of cases may have been the difficulty of suing accountants for fraud because of the rule of privity, under which the courts held that an accountant's statements were prepared for the corporation and, in general, only the corporation had the right to sue. So it is possible that there was fraud but it was not revealed by the court cases (although this does not explain the lack of claimed fraud at the Senate hearings).

The Securities Acts changed the legal situation considerably. Now it is relatively easy to sue accountants and others for fraud. The plaintiff does not even have to prove she ever saw the financial statements, but simply that the statements contained a material misstatement. And then the accountant has to prove that she was justified in believing the figures given to her by management or that the plaintiff experienced no damages. Nevertheless, almost no cases are reported filed against accountants until the 1950's. Had fraud in financial statements been a serious problem before the Securities Acts were enacted, it seems probable that some accountants would have been sued after 1934, unless the incidence of fraud suddenly disappeared (which is hard to believe). So I conclude (although I cannot be absolutely certain) that there was very little fraud or serious misrepresentation in published financial statements prior to 1934.

Nevertheless, one should explain why the general public seemed to believe that financial statements often were fraudulent or misleading if these were, in fact, not serious problems before the early 1930's. I suggest that this folklore is due to several sources. One is the writings of journalists and a crusading economist, William Z. Ripley. In his work (most notably *Main Street* and *Wall Street*) he excoriated financial accountants and corporations for misrepresentative financial statements. The cases he refers to, though, date from the 1910's and the early 1920's. Virtually no cases are mentioned in the middle 1920's and later. Thus the Securities Acts may have been designed, in part, to solve a problem of an earlier decade that was no longer a problem by the time the legislation was enacted.

The second source of the belief that financial statements were misleading is unrealistic expectations about the meaningfulness of accounting numbers. Indeed, I suggest that complaints about the "quality" of financial statements heard today, as well as before 1933, are based on the belief that accountants could produce "meaningful" statements, but they won't. Thus people complain about misrepresentation because there are various ways of recording depreciation, sales, purchases and acquisitions of other corporations, etc., among which management and accountants can pick and choose. However, the problem basically is that accountants cannot report the wealth embodied in shares and the change in that wealth (income) unambiguously because there is no theoretically correct way to measure these variables. It is not that accountants are not doing their jobs; rather it is not possible for anyone to measure value objectively. That is what the securities markets are all about -- it is there that investors' subjective estimates of the present value of future expected cash flows are compared and acted on. Consequently, people expect more from accountants than can possibly be provided.

In addition, some decisions by accountants that are perfectly reasonable *ex ante* may seem deliberately misleading *ex post*. For example, *ex ante* an exchange of land for a long-term note may properly be recorded as a sale if it appears that the note will be collected. But if it turns out that the note isn't collected, the exchange should not have been recorded as a sale because nothing of value was received. But the accountant doesn't know that until after the fact. And, should the note be good but the accountant chose not to record the transaction until it was collected, someone might complain that she didn't inform shareholders that their investments were more valuable than they were previous to the transaction.

The problem is made even more difficult by the use of the historical cost basis for recording assets. As a consequence, reported costs and profits are a function of the original cost of an asset written off or sold as much as of contemporary economic events. To reduce manipulation by management, accountants insist on pre-determined (though essentially arbitrary) rules to control how the original cost of assets are expensed (such as straight-line depreciation of fixed assets and first-in, first-out expensing of inventory). Nevertheless, managers still can control the amount of profits reported in many situations. For example, where the enterprise owns a number of economically identical or similar assets (such as securities or parcels of land) that were purchased for different amounts, management can choose which one to sell and thus determine the reported profit.

In any event, is there any evidence that the Securities Acts, as administered by the SEC, have reduced fraud or misrepresentation or even improved the "quality" of reported financial data? If one reads the SEC's dockets, it appears as though most small-time securities hucksters have been or are being charged with violations or subjected to stop orders. Nevertheless, investors would be well advised to take the traditional warning, *caveat emptor*, seriously. Indeed, there is reason to believe that in some respects the SEC has made fraud easier, not more difficult. Their concern with financial statements, which leads them to promulgate strict rules on what may and may not be reported, tends to give many investors the impression that approved practice (which in many instances cannot be other than misleading, either by commission or ommission) is correct and useful.

More important, though, is the tendency of the SEC to act as though it were a "blue skies" agency. This was not the intention of the Securities Acts. As President Roosevelt put it, "This proposal (the Securities Act of 1933) adds to the ancient rule of caveat emptor the further doctrine 'let the seller beware.' It puts the burden of telling the whole truth on the seller." But the SEC has restricted severely what the seller can say. Appraisal of assets, estimates of future sales and profits, and other "soft" information may not be included in a prospectus. Disclosure as such is not allowed. Rather, in 1938, the SEC declared in ASR (Accounting Series Release) 4: " ... where financial statements filed ... are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate *despite disclosures* in the certificate of the accountant or in footnotes to the statements provided the matters involved are material" (italics added). More recently, ASR 115 indicates that companies whose statements show inadequate working capital after a new issue is floated will not be accepted for registration. Consequently, despite the "red herring" warning required on prospectuses that the SEC has not and does not approve securities, it is not unreasonable for investors to assume (and for dishonest securities salesmen to claim) that an SEC registered prospectus has been given a sort of "Good Housekeeping" seal of approval. (After all, many issues are rejected -- those allowed must be O.K.). In addition, the "boiler plate" pessimistic descriptions of competition, prospects, etc., make it easy for unscrupulous salesmen to claim: "No company could be that bad -- the SEC makes you say that -- but here's the real, inside story." Thus, investors should not assume that the "bad old days" have passed. Rather, as SEC Chairman Ray Garrett, Jr. observed recently: "We have had cases of fraud and mismanagement and disregard of investor interest that rival anything known to the men of 1933 who set about to construct a system that would make the world safe for small investors ... "(2) Considering such frauds as Equity Funding and Home Stake Production (among others), the investor would do well not to forget the pre-SEC warning, *caveat emptor*.

FAIRNESS (EQUITY) IN DEALINGS AMONG PEOPLE

Fairness (equity) is a difficult concept to define operationally. For some people, a transaction or contract is "fair" when they make a "reasonable" profit, whether others gain or lose. Few would say a transaction is "fair" should they end up with less than they began or even less than they expected to gain. Therefore, many people feel cheated when the price of a security in which they invest drops soon after their purchase. They ask who is responsible? Perhaps the investors should have done more research, but failed to exercise prudent care. Perhaps the sellers mislead them by knowingly giving them false information. Or perhaps no one is responsible; it's just a consequence of unpredictable events. Regardless of the actuality, should something *appear* to have been "unfair," those adversely affected look to government for a redress of what they think are "wrongs." As with fraud, it might be less expensive for government to require disclosure, if the disclosure has the effect of improving perceived fairness in the market, than to mediate disputes.

Also as with fraud, before mandated financial disclosure is accepted as a cure for "unfairness" we should determine whether the security markets were unfair before the Securities Acts were enacted and whether the Acts, as administered by the SEC, have made the markets more fair. First "fairness" must be defined operationally. One definition used by economists is that the market is a "fair game" (Eugene Fama's phrase) if all available information is reflected completely by the price of a security. (In the semi-strong form, a fair game market is one in which all publicly available information is impounded into share prices). In this event, the market price of shares is unbiased. While the price of a share may not be "correct" (in the sense that in the light of subsequent, presently unknown events, one would not offer or sell the share for the amount paid or received), at the time of the transaction there is no more likelihood for the market price of the security to be higher than lower were additional information known. Thus should one buy a share of General Motors stock for $49, the economic effect of a plant that burned or an invention completed yesterday would be impounded into that market price. Therefore, the investor would not buy at a bargain or sell at a loss, had she but known what others know.

Of course, it is not possible that everything can be known by everyone at the same time: information cannot come to the market instantaneously, somebody must know something before somebody else. Therefore it is not likely that financial statements can be the sole or perhaps even the primary means by which the market approximates a "fair game." Nor is it desirable that financial statements be the sole source of information about corporations. Consider an extreme situation, where information is known only as it is published in the financial statements. In this event the market price of shares would be "unfair" on all except the days when statements are published because between the dates of the financial statements something happened and whoever buys or sells at that time wouldn't know about it. So it would be most unfortunate for investors if financial statements were the *sole* means of transmitting information.

But published financial statements might improve the transmission of information. What is the evidence? There have been quite a few statistical studies of share price movements and the relationship between share prices and published financial statements. I will only summarize the principal findings, since the literature is quite large.(3) First, there are studies that speak to the question of how well the stock markets operate. Unfortunately, one cannot ever know whether the markets are what Eugene Fama calls "the strong form of the efficient markets hypothesis," that is whether all information is impounded into share prices because we can't determine when information is known or even what, exactly, is or is not "information." Nevertheless, we can say that if the successive price changes or any combinations of successive price changes are statistically independent, the prices follow a random walk (the weak form of the efficient markets hypothesis). Consequently, knowledge of past price change patterns does not enable one to predict what the next change will be. Nor can a trading rule, such as those proposed by chartists, allow one to do more than break even, gross of transactions costs. A market characterized by price changes that follow a random walk is consistent with a market in which all information is fully impounded into share prices. (I must emphasize that this statistical property of share prices does not *prove* that all information is reflected by share prices; it is just *consistent* with this belief). Quite a few studies have been published on the manner in which prices change in the securities markets in the United States and United Kingdom. All of these studies show that the market follows what can be described as a random walk. These studies include U.S. data from the New York Stock Exchange before as well as after passage of the Securities Acts, over-the-counter data, and U.K. data from the (London) Stock Exchange where considerably less disclosure is required than in the U.S. None of these studies indicates that the behavior of share price changes is affected by the degree or extent of government required disclosure. Specifically, successive share price changes of U.S. companies followed a random walk before and after passage of the Securities Exchange Act of 1934, with respect to companies before and after passage of the '34 Act that did and did not disclose sales prior to 1934; similar findings are reported for U.K. companies, who are not required to disclose nearly as much as are U.S. companies.

Another aspect of "fairness" is the absence of manipulation of share prices. In a booklet, *A 25 Year Summary of the Activities of the Securities and Exchange Commission*, the SEC claims that operators of the more than 100 pools that operated during 1929 were able to manipulate share prices because investors were unable to obtain reliable financial information. First, one should consider that pools are successful if people believe rumors about impending "great developments." Financial statements, which refer to the past, should have little effect on the ability of manipulators to spread rumors. Second, I reviewed the financial statements of the more than 100 pools operated in 1929 through 1932.(4) All of the companies whose shares were included in the pools' manipulations published financial statements. The major item not published was sales. However, almost the exact proportion of these companies published sales figures as did the New York Stock Exchange listed companies whose shares were not included in pool manipulations. Thus the fact and extent of financial disclosure appears to be unrelated to share price manipulation.

IMPROVED EFFICIENCY OF RESOURCE ALLOCATION

The third reason for required disclosure, improved efficiency of resource allocation, is a major argument underlying the Securities Acts in the United States. If resources flow to those uses where the marginal rate of return is the highest, the nation benefits. Required disclosure, it is assumed, is necessary to permit investors to make such resource allocation decisions. It is argued that corporations would not voluntarily supply all of the information desired by investors because non-shareholders (including competitors) cannot be charged for the information and cannot be prevented from obtaining it. Consequently, management who operate corporations to maximize the wealth of shareholders would publish less than the optimal amount of information. In addition, the amount of resources devoted to processing and interpreting financial data might be reduced were the data available in some standard form, such as 10-Ks and S-1s.

The quality of the data reported also is expected to be better as a consequence of government supervision. Some critics believe that many corporate managers and their hired accomplices, the CPAs, do not provide data of sufficient quality (or quantity) to allow shareholders to judge the managers' performance. Government mandated reports of the managers' stewardship, these critics claim, would result in more efficiently managed corporations.

The validity of this reason for requiring disclosure rests on the belief that the data given in financial statements are both useful and sufficiently timely for investors' decisions. Although the validity of this belief cannot be determined definitively, there is considerable reason to doubt that traditional accounting statement do, or even can, serve this purpose. The meaningfulness of financial statement data has been questioned in a large number of articles and books by critics who point out that such practices as the historical cost basis of recording assets and liabilities, arbitrary rules for allocating assets to products and expense, non-capitalization of intangible assets such as advertising, research and development and goodwill, etc., reduce the value of financial statements for resource allocation decisions. At the present time, we have little research evidence that validates or invalidates these criticisms. We do know, however, that government intervention with financial disclosure has resulted in few changes in the type of information disclosed. Indeed, the SEC has prevented changes by considering financial statements that use current market or price level adjusted figures, reappraisals of assets, capitalized goodwill, etc., as unacceptable. While innovations and improvements in financial reporting may not have occurred had the SEC not enforced traditional, conservative practices, it is fair to say that the agency has not used its resources to develop or support research on better methods of reporting economic events.

The claim has been made, though, that financial statements are more reliable as a consequence of government regulation of disclosure. It is true that the SEC has been a positive force in improving auditing procedures somewhat. The 1936 Interstate Hosiery Mills Inc. and other cases and the recent moves by the SEC to require peer review of the audit procedures, working papers, quality control, etc., of some large CPA firms probably have resulted and will result in more effective auditing practices. However, there is little evidence that poor audits and deliberately misleading or grossly unreliable financial statements were more prevalent before creation of the SEC. Thus, there appears no more reason to conclude that government regulation of financial reporting has improved or worsened the quality of financial data available to investors.

However, there is little doubt that the quantity of data disclosed by corporations is greater as a consequence of government regulation. The amount of data required by Regulation S-X and for various filings far exceeds that published by most (perhaps all) corporations before the SEC was established. But is this detailed data useful to investors or are they simply more costly for corporations to produce? While this question cannot be answered definitively, some statistical studies on the relationship between published financial reports and share prices are enlightening.

Tests of changes in share prices at or about the time financial statements are published can provide us with insights into the use to which investors (on the whole) put the statements. If the numbers revealed in the statements provide investors with information we would expect share prices to change as this information caused investors to alter their previously formed expectations. The validity of the tests is, of course, dependent on the validity of the method used to estimate what information was expected before the statements were published, on the expectation that the effect of the information published is captured in fairly rapid changes in share prices, in an adequate specification of other factors, etc.. Since one cannot be certain that all of these requirements were met, the tests cannot be said to be conclusive. Nevertheless, they are instructive.

I published the first of these statistical tests in which the "market model" was used to account for the effect on share prices of changes in the market as a whole. This paper is available elsewhere and the method is now fairly commonly used and described in a large number of papers.(5) Other researchers have used several versions of the model and all have reached the same conclusion.(6) The share price change associated with the publication of financial statements is inconsistent with the belief that investors find that financial statements provide them with previously unknown or with useful information, at least with respect to the reporting corporations.(7) In addition, several studies have been made on the relationship between share prices and changes and differences in reporting practices (such as shifts from accelerated to straight-line depreciation and deferred vs. flow-through treatment of deferred tax liabilities).(8) These studies also are consistent with the hypothesis that market participants either are not fooled by the effect of different accounting practices on net income or disregard the financial statements.

Before a conclusion is drawn from these studies, I should mention the possibility that no relationship between share prices and financial statement data, when published, was found because investors learned the contents of the statements before publication from other sources. It can be argued that these other sources would not have existed or would not be trusted were it not for eventual government-required financial reporting. I tested this hypothesis, to the extent possible, by examining the effect of the SEC's requirement that sales figures be reported. Prior to passage of the Securities Exchange Act of 1934, 38 percent of the companies whose shares were listed on the New York Stock Exchange did not report sales. If the SEC's requirements provided investors with new information, one would expect a greater change in the share prices (up or down) or in the perceived riskiness of these companies, relative to the companies that previously reported sales arid relative to general market changes (which, at that time, were particularly important). But, the data reveal virtually no differences in the market prices or riskiness of the shares of the companies that newly revealed their sales compared to those who were unaffected by the SEC's disclosure requirement.(9)

Finally, does the availability of corporate financial data in fairly standardized form reduce the cost to investors of analyzing and using information about corporations and increase the efficiency with which corporations are managed? No studies that speak directly to this question have been published. However, several observations can be made that might provide a partial answer. First, there is little data to support the assumption underlying this question that published financial data in the form presently required by the SEC provide investors with "information." Second, the principal services that tabulate financial data, *Moody's* and *Standard and Poor's*, present little of the detailed data required by the SEC. Indeed, with the exception of sales (amount and by lines of business), the contents of these services are not much different now from what they were before 1933. Third, at least one measure of market efficiency, the random character of successive share price changes, does not indicate a more rapid impounding of information into share prices after than before passage of the Securities Acts. Nevertheless, one cannot be certain that some unmeasured improvements in the efficiency with which the security markets are operated and corporations are managed has not resulted from required financial disclosure. Thus far, though, no evidence has been presented that identifies and measures these benefits.

The evidence and reasoning, then, do not support the contention that government-required disclosure is used by investors in setting share prices. Does this mean that disclosure as such is not useful? The available studies do not answer this question directly. However, the studies do indicate that the current emphasis placed by the SEC and others on the value of published financial data for the efficient allocation of resources in the economy is, at the least, overstated and not demonstrated.

GOVERNMENT ADMINISTRATION AND EMPLOYEES' AND THE PUBLIC'S RIGHT TO KNOW

It has been argued that the economic affairs of a corporation are not solely a matter of concern between the owners and their hired managers, creditors, and the taxation authorities. Since privately-owned corporations control most of an industrialized nation's wealth, employ most of its citizens and produce most of the goods and services consumed, their efficiency and the way in which they use the resources "entrusted" to them is of concern to the general public. Employees also have a basic right to information about their employer. Without required disclosure, it is argued, shareholders would not demand as much information as the public would wish, because shareholders cannot capture the externality (a "better run economy") the information provides. In addition, government administration (such as breaking up monopolies and price control) may be more efficient were corporate financial data generally available.

Considering the last reason for required disclosure first -- more efficient government administration -- it is not clear that continuous financial reporting by all except the smallest corporations is the most efficient way to provide the government with needed information. Stratified random sampling not only would be less costly for companies, as a group, but would enable the government to collect the data needed to answer specific questions. The data disclosed in financial reports might not speak to the questions on which information is wanted.

In addition, the costs of and benefits expected from the data which corporations must provide should be calculated. For example, the Federal Trade Commission recently wants to require considerable information about sales and profits by individual products and product groups from large corporations. The benefits expected to be derived from these data are not at all clear. Presumably they are useful for determining whether monopoly practices exist in specific markets. However, to my knowledge, no studies have been reported which indicate whether these accounting data measure monopoly profits or how the data can provide the government with other than useless and potentially misleading information. Nor do I know of an analysis that shows that the estimated costs of providing and using the data exceed the expected benefits therefrom.

The contention that employees have a right to know their employer's financial data is based on the belief that corporations have as much responsibility to their employees as to their shareholders. The validity of this belief could be debated. As a minimum, the implications of dual responsibility by management toward employees and shareholders for the latter's willingness to invest in corporations and for the quality and quantity of products and services provided to consumers should be examined. But even if one decides that employees have "a right to know," it is doubtful that government required disclosure of financial data can provide them with relevant information. As is discussed above, accounting statements provide rather crude measures of the economic condition and progress of an enterprise. For example, employees cannot learn from financial statements whether or not specific plants will offer continued employment at any given level. Neither can the ability of a company to pay a wage increase be determined from its earnings report, except where the company clearly has absorbed losses. Therefore, whether or not the costs to shareholders and the economy would offset benefits to employees from receiving financial data, employees appear to obtain few benefits from required disclosure.

Finally, with respect to the public's right to know, it is difficult to determine whether the expected externality of a more efficient economy would be a consequence of required disclosure. If public reporting of financial figures would tend to make managements more efficient and allocate resources to their most productive uses, it is unclear whether the cost to shareholders (corporations) of providing the information exceeds the benefits derived therefrom. In any event, if this type of information is useful to the general public, it is most likely limited to rather broad data such as net income, sales, changes in capital investments and inventories, etc.. It is difficult to imagine how detailed information on allowances for depreciation, accrued expenses, subcategories of revenue, etc., can be assimilated, much less used, for general analysis of the economy. While at specific times specific information may be desired by some people, it would seem that the cost of requiring all corporations to report data that are, at best, meaningful to a few, would result in costs that exceed any benefit.

A claimed public benefit from required financial disclosure, revelation of the "excessive" profits of some corporations (such as many oil producers), should be considered. Some advocates of required disclosure believe that oligopolistic pricing practices and government subsidies (direct and indirect as a consequence of tariffs, etc.) can be reduced or eliminated as a consequence of public knowledge ("sunlight is the best disinfectant") and outrage. They should consider that the traditional accounting practices currently enforced by the SEC provide poor measures of economic profits, particularly during and after periods of unstable general prices. They also should consider that the conceptional impossibility of "correct" allocations of joint costs over products and over time allows management considerable latitude in reporting the amount of profits on individual products. Consequently, it is doubtful that the reported information would provide the public with other than misleading conclusions about markets and the consequences of corporate practices.

POLITICAL CONSIDERATIONS

Though many shareholders and managers might not want government to interfere in their private contracts by requiring disclosure, they should consider the political aspects of disclosure laws. These laws may substitute for much more restrictive, and hence much more costly, statutory and administrative arrangements, such as commissions who must pass on the merits of securities before they may be purchased by the public.

Required disclosure may be a benefit were it to prevent scandals or the appearance of scandals that seem to necessitate governmentally-imposed remedies. Those who oppose required disclosure should consider that legislators and political leaders are expected to solve problems. However, because of the relatively short range of political horizons, the appearance of solving a problem generally is an acceptable and often a preferable substitute for its actual solution. Study of the causes of problems and the effectiveness of proposed solutions usually is too time consuming to be pursued. In addition, studies often result in the uncovering of additional, even more intractable problems and conclude with ambiguous suggestions. Therefore, given a crisis or scandal, government tends to take immediate action, any action.

The specific action taken depends on the ability of the lawmakers and their staffs to understand the situation and draft legislation and on the skill of special interest groups in getting their views represented in the bills. These special interest groups are in an advantageous position for having laws drafted in their favor since they generally have well-defined views whose implementation via legislation is well thought out. Therefore it is not surprising that laws passed to alleviate a crisis or correct abuses discovered as a result of a scandal often turn out to serve quite different purposes. Specifically, versions of the U.S. securities laws had been proposed for years before their passage in 1933 and 1934. Investment bankers wanted a law that would bring their smaller competitors "up to their standards," reformers appalled by some reporting practices wanted legislation to enforce acceptance of their ideas, other reformers wanted a government agency to pass on the merits of securities, corporations that disclosed more wanted similar practices required of their competitors, some accountants wanted a means to require clients to follow practices the accountants thought correct, etc.. Virtually no group had prepared studies to support their beliefs. The legislation passed was a function of the special interest groups' demands, newspaper reporting of a few scandalous happenings in the late 1920s, and the demand that the government "do something."

Therefore, if some disclosure of financial information and the required auditing of financial statements by independent accountants prevents or reduces the incidence of scandal, the benefit from avoiding circumstances in which punitive or special interest legislation can be passed may exceed the cost to private corporations. In this regard, it would seem that more emphasis should be placed on auditing to prevent or reduce misappropriation of resources and similar frauds, events which are considered "scandals" when they occur. Prevention of general, precipitous declines in share prices also would be advisable. Unfortunately, there is no reasoning or evidence that supports the contention that required financial disclosure would play this role.

SUMMARY AND CONCLUSIONS

A number of reasons that would justify government interference with the rights of individuals to write contracts -- specifically contracts that would or would not require publication of financial information by corporations to which people entrusted their resources -- were examined.

The first reason concerns the implied contract that corporate officers act in a fiduciary capacity towards shareholders (and to a lesser extent, towards creditors). Self-serving actions by management and false or misleading financial reports given to prospective investors would constitute frauds which would involve mediation and redress by government. Consequently, government might find it more efficient to require financial disclosure should this requirement prevent or reduce fraud and misrepresentation. An examination of the extent of fraudulent financial statements before disclosure was required by the Securities Acts revealed very little evidence of this practice. Rather, it appears that the fraud that existed occurred primarily before the early 1920's, aside from a few highly publicized cases. This is not to say that the late 1920's were free from fraudulent financial statements. But then neither are the post-SEC, required disclosure years, as a reading of recent newspaper stories shows. Indeed, there is some reason to believe that SEC regulation has tended to make investors too accepting of financial statement data even though these data cannot provide unambiguous measures of a company's economic position and activity. Further, by insisting on conservative practices (such as historical costs) and rigid rules the SEC has allowed managers to manipulate net income while appearing to follow generally accepted accounting practices.

The second reason analyzed is "fairness" in dealings among people. One operational definition of this concept is that one should be able to purchase or sell a company's securities with the knowledge that the economic effect of information about the company is impounded in the market price of its shares. In this event, the market is a "fair game." A related definition is that the ordinary shareholders should expect that share prices are not manipulated. The evidence on the random character of share price changes in the years before and after passage of the Securities Acts and in the United Kingdom (where much less disclosure is required than in the U.S.) is consistent with the belief that the market is a "fair game" with and without required disclosure. The operations of the manipulative practices of "pools" also appear to have no relationship to the extent of financial disclosure.

Improved efficiency of resource allocation is the third reason postulated. Despite the belief of those who enacted and administer the Securities Acts, there is little (if any) evidence to support the contention that financial statements provide useful information to investors. Statistical studies reveal little relationship between share price changes and the publication of financial statements. This lack of relationship may be due to (1) misspecification of the statistical model or mismeasurement of the variables, (2) to the poor measures of the economic condition and progress of companies reported in financial statements, or (3) to investors having knowledge from other sources of the data published before the statements were released. The first explanation is always possible, but has not been shown to be a serious problem by critics. With respect to the second explanation, the SEC has done little to improve accounting measurements and reports. The third explanation was tested and supported by a number of studies, particularly one which found that the 1934 requirement that sales be published had no discernible effect on the share prices or measured riskiness of companies who published the amount of their sales for the first time. Thus it appears that the third explanation, which does not support required disclosure, is the most likely one.

More efficient administration by government and employees' and the public's right to know is the fourth reason considered. Though no studies on this subject have been made, casual observation indicates that government would obtain required data more efficiently with stratified random sampling than by requiring continuous reporting by all corporations. Though it is debatable whether corporations have the same obligation towards employees as toward shareholders, it nevertheless is doubtful whether published financial statements would provide employees with useful information. In general, the data required to determine future employment possibilities, the maximum amount that could be won in wage bargaining, etc., is more specific and requires better estimates than are provided by the data presented in the statements. Finally, the public may have a general right to know how corporations are faring, but the information that can be provided by financial statements is, at best, crude and possibly misleading.

Political considerations is the last reason given for requiring financial disclosure. Legislatures and government administrators generally are motivated to take some action when a scandal is sufficiently serious to concern the general public. Therefore, those who oppose government interference in private affairs should consider that some sort of required disclosure is preferable to alternative laws (such as "merit" legislation), if disclosure prevents or mitigates the degree of scandals, or at least, gives the impression that no other general governmental action is desirable.

Thus, few of the often proposed reasons for government required disclosure are supported by the analysis. The only benefits that are supported are audits that prevent or reduce fraud and scandals and possibly the right of the public to some information about the operations of corporations. However there is no evidence that required disclosure as compared with voluntary disclosure provides the public with information that is more useful for the efficient allocation of resources in the economy.

Against these benefits one must consider the costs of required disclosure. Corporations, and hence shareholders, must incur the expense of producing, printing and distributing a large amount of data that provide few, if any, benefits to investors but may benefit competitors. The burdens also are relatively heavier on small than on large corporations.(10)

A CONCLUDING COMMENT

Assuming that the costs of required disclosure exceed the benefits to the public as a whole, would repeal of the disclosure statutes mean the absence of meaningful financial statements? The evidence indicates otherwise. Before passage of the Securities Exchange Act of 1934, all companies listed on the New York Stock Exchange (NYSE) published balance sheets and income statements. Ninety-four percent were audited by CPAs. Sixty-two percent disclosed sales, fifty-four percent cost of goods sold, and ninety-three percent depreciation. (At this time 70 percent of securities transactions took place on the NYSE). Though the extent of financial disclosure was increasing over time, the quantity of data made public proba-bly would not have been as great as is now required by the SEC. The cost of producing and distributing the data also would be lower. But there is no evidence or reason to believe the benefits derived from the smaller amount of data disclosed would be less than are garnered under our present laws and regulations.

*I gratefully acknowledge the helpful criticism of my colleagues, especially Jerold Zimmerman.

(1). See George J. Benston, "The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements," in Economic Policy and the Regulation of Corporate Securities, Henry G. Manne, Editor, American Enterprise Institute for Public Policy Research, Washington, D.C., 1969, pp. 515-32 for references and a more complete discussion.

(2). Ray Garrett, Jr., "New Directions in Professional Responsibility," The Business Lawyer, Vol. 29 (March 1974) p. 9.

(3). The literature on which this very brief summary is based is reviewed in George J. Benston, "Corporate Financial Disclosure in the U.K. and the U.S.: A Comparison and Analysis," unpublished manuscript, Chapter 4.2.5. References to some 33 articles are given there.

(4). See George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," American Economic Review, Vol. LXIII (March 1973), pp. 132-55.

(5). See Benston, ibid., among others.

(6). See Benston, "Corporate Financial Disclosure in the U.K ... .," section 4.2.6 for a review of this literature and for references thereto.

(7). Information may be obtained that is used for other than decision to buy, sell or hold the shares of the reporting corporation: unfortunately no studies have been published that test this hypothesis.

(8). See ibid., section 4.2.3 for a review of this literature and for references thereto.

(9). See Benston, "Required Disclosure and the Stock Market ... " for details.

(10). See Benston, "Corporate Financial Disclosure in the U.S. and the U.K ... ," op. cit., Chapter 3 for a more extended analysis.