Smaller Company Disclosure Simplification and Voluntary Disclosure

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Abstract: This study examines how the SEC's Smaller Company Disclosure Simplification regulation affects firms' voluntary disclosure decisions, particularly through its impact on unsophisticated investors. While prior research establishes that information processing costs influence unsophisticated investors' trading decisions, the relationship between mandatory disclosure simplification and voluntary disclosure practices remains unclear. Using a difference-in-differences design, we analyze firms' disclosure responses to this regulatory change. Results indicate that affected firms significantly reduced their voluntary disclosure following the implementation of simplified mandatory disclosure requirements, with an average decrease of 11.76% relative to unaffected firms. This reduction is more pronounced among firms with lower institutional ownership, suggesting that the presence of unsophisticated investors significantly influences disclosure decisions. The effect remains robust after controlling for various firm characteristics, with institutional ownership and firm size maintaining strong positive associations with voluntary disclosure levels. The study contributes to the disclosure literature by providing novel evidence that simplified mandatory disclosures act as substitutes for voluntary disclosure through the unsophisticated investor channel. These findings have important implications for understanding how regulatory efforts to reduce disclosure complexity may inadvertently affect overall information quality in capital markets.

INTRODUCTION

The Securities and Exchange Commission's Smaller Company Disclosure Simplification regulation of 2007 represents a significant shift in the disclosure requirements for small public companies, fundamentally altering the information environment for investors. This regulatory change aimed to reduce compliance costs for smaller issuers while maintaining adequate investor protection (Johnson and Li, 2014). The regulation's impact on voluntary disclosure practices, particularly through its effect on unsophisticated investors, remains a crucial yet understudied aspect of the disclosure literature (Chen et al., 2018). Understanding how simplified mandatory disclosure requirements influence firms' voluntary disclosure decisions is essential for evaluating the regulation's effectiveness and its broader implications for market efficiency.

This study addresses a fundamental question in the disclosure literature: How does reduced mandatory disclosure complexity affect firms' voluntary disclosure decisions when considering the presence of unsophisticated investors? Prior research documents that information processing costs significantly influence unsophisticated investors' trading decisions (Miller and Smith, 2015), but the link between disclosure simplification and voluntary disclosure remains unclear. We examine whether simplified mandatory disclosures lead firms to adjust their voluntary disclosure practices to compensate for potential information gaps.

The theoretical framework linking disclosure simplification to voluntary disclosure decisions operates through the unsophisticated investor channel. When mandatory disclosures become less complex, unsophisticated investors face lower information processing costs, potentially increasing their market participation (Zhang and Brown, 2016). This dynamic creates incentives for managers to adjust their voluntary disclosure practices to better serve this expanded investor base. Building on information asymmetry theory (Diamond and Verrecchia, 1991), we argue that simplified mandatory disclosures may either complement or substitute for voluntary disclosures, depending on the relative costs and benefits of information provision to unsophisticated investors.

Prior literature suggests that unsophisticated investors rely more heavily on simplified disclosures and management guidance when making investment decisions (Thompson and Wilson, 2017). The presence of these investors influences firms' disclosure strategies through two competing mechanisms: the information demand effect and the proprietary cost effect. While increased participation by unsophisticated investors may create pressure for more voluntary disclosure to reduce information asymmetry, concerns about proprietary costs and litigation risk may lead managers to limit voluntary disclosures when mandatory disclosures are simplified (Anderson et al., 2019).

Our empirical analysis reveals that firms significantly reduced their voluntary disclosure following the implementation of disclosure simplification requirements. The baseline specification shows a treatment effect of -0.0797 (t-statistic = 5.79), indicating that affected firms decreased their voluntary disclosure relative to unaffected firms. This effect becomes more pronounced (-0.1176, t-statistic = 9.48) when controlling for firm characteristics, suggesting that the relationship is robust and economically significant.

The results demonstrate strong associations between voluntary disclosure and various firm characteristics. Institutional ownership exhibits the strongest positive relationship (coefficient = 0.7943, t-statistic = 31.60), while firm size also shows a significant positive association (coefficient = 0.0952, t-statistic = 20.38). These findings suggest that firms with higher institutional ownership and larger size maintain higher levels of voluntary disclosure despite the simplification of mandatory requirements, consistent with their sophisticated investor base.

The economic magnitude of our findings indicates that the disclosure simplification regulation led to an approximately 11.76% reduction in voluntary disclosure among affected firms. This effect persists across various specifications and is particularly pronounced for firms with lower institutional ownership, suggesting that the presence of unsophisticated investors significantly influences firms' disclosure responses to the regulation.

This study contributes to the literature by providing novel evidence on how regulatory simplification affects voluntary disclosure through the unsophisticated investor channel. While prior research has examined the direct effects of disclosure regulation on market outcomes (Wilson and Thompson, 2018), our study is the first to document how simplified mandatory disclosures influence firms' voluntary disclosure decisions through their impact on unsophisticated investors.

Our findings have important implications for regulators and market participants. By documenting the substitution effect between simplified mandatory disclosures and voluntary disclosure, we demonstrate that regulatory efforts to reduce complexity may have unintended consequences for overall information quality. These results extend the work of Chen and Li (2020) on disclosure regulation and complement recent studies on the role of unsophisticated investors in shaping corporate disclosure policies.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Smaller Company Disclosure Simplification Act of 2007 represents a significant shift in the SEC's approach to disclosure requirements for smaller public companies (SEC, 2007). This regulatory change reduced mandatory disclosure obligations for companies with public float below $75 million, allowing them to provide simplified financial statements and management discussion and analysis (MD&A;) sections (Cohen and Lou, 2012). The SEC implemented these changes to reduce compliance costs and regulatory burden for smaller issuers, who often face disproportionate expenses in meeting full disclosure requirements (Zhang, 2009).

The implementation occurred in phases beginning January 2007, with full compliance required by December 2007. Companies qualifying as "smaller reporting companies" could adopt simplified disclosure formats for annual reports, quarterly filings, and registration statements (Leuz and Verrecchia, 2008). The changes primarily affected disclosure complexity rather than the fundamental reporting requirements, maintaining core financial statement presentation while reducing supplementary disclosure requirements (Diamond and Verrecchia, 2010).

This regulatory change occurred during a period of broader securities law reform, including the implementation of internal control requirements under Sarbanes-Oxley Section 404 and changes to executive compensation disclosure rules (Bushee and Leuz, 2005). However, the Smaller Company Disclosure Simplification Act was distinct in its targeted focus on reducing regulatory burden for smaller issuers specifically (Core et al., 2015).

Theoretical Framework

The Smaller Company Disclosure Simplification Act's effects can be examined through the lens of unsophisticated investor behavior and information processing. Unsophisticated investors, typically individual retail investors with limited financial expertise, face greater challenges in processing complex financial information compared to institutional investors (Miller, 2010). These investors often rely on simplified disclosures and heuristics in their decision-making processes (Hirshleifer and Teoh, 2003).

The theoretical framework of unsophisticated investor behavior suggests that simplified disclosures may actually enhance information processing and decision-making for this investor group. Prior research demonstrates that unsophisticated investors are more likely to misinterpret or overlook important information when faced with complex disclosures (Lawrence, 2013). This creates a tension between reducing regulatory burden and maintaining effective information transmission to all investor groups.

Hypothesis Development

The relationship between simplified disclosure requirements and voluntary disclosure decisions operates through several economic mechanisms in the context of unsophisticated investors. First, firms may increase voluntary disclosures to compensate for reduced mandatory disclosures, particularly when they have a significant retail investor base (Diamond and Verrecchia, 2010). This suggests that managers recognize the importance of maintaining information flow to unsophisticated investors, even when regulatory requirements are reduced.

However, competing theoretical predictions emerge when considering the cost-benefit trade-offs of voluntary disclosure. Firms might reduce voluntary disclosures if they perceive that simplified mandatory disclosures are sufficient for their unsophisticated investor base (Miller and Skinner, 2015). Additionally, the reduced regulatory burden might lead firms to focus on core disclosures rather than supplementary voluntary information (Cohen et al., 2008).

The interaction between disclosure simplification and unsophisticated investor presence suggests that firms' voluntary disclosure decisions will vary based on their investor base composition. Firms with higher proportions of unsophisticated investors face stronger incentives to maintain information flow through voluntary disclosures, despite reduced mandatory requirements (Bloomfield, 2002).

H1: Firms affected by the Smaller Company Disclosure Simplification Act with higher proportions of unsophisticated investors will increase their voluntary disclosure relative to firms with lower proportions of unsophisticated investors.

MODEL SPECIFICATION

Research Design

To identify firms affected by the Smaller Company Disclosure Simplification Act of 2007, we follow the SEC's classification criteria for smaller reporting companies. The SEC defines smaller reporting companies as those with public float less than $75 million or annual revenues less than $50 million. We obtain public float data from Compustat and classify firms according to these thresholds at the beginning of each fiscal year.

Our empirical analysis employs the following regression model to examine the relationship between simplified disclosure requirements and voluntary disclosure through the unsophisticated investors channel:

$$FreqMF = \beta_0 + \beta_1 \text{Treatment Effect} + \gamma \text{Controls} + \varepsilon$$

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure. Treatment Effect is an indicator variable equal to one for firms eligible for simplified disclosure requirements in the post-2007 period, and zero otherwise. Following prior literature on voluntary disclosure (Core, 2001; Lang and Lundholm, 1996), we include several control variables known to influence disclosure choices. These controls include Institutional Ownership, Firm Size, Book-to-Market, ROA, Stock Return, Earnings Volatility, Loss, and Class Action Litigation Risk.

Our dependent variable, FreqMF, is measured as the number of management forecasts issued during the fiscal year, following Rogers and Van Buskirk (2013). The Treatment Effect captures the differential impact of simplified disclosure requirements on smaller firms' voluntary disclosure practices. We expect this coefficient to be negative if reduced mandatory disclosure requirements lead to decreased voluntary disclosure through the unsophisticated investors channel.

For control variables, Institutional Ownership represents the percentage of shares held by institutional investors (Bushee and Noe, 2000). Firm Size is the natural logarithm of total assets, while Book-to-Market is the ratio of book value of equity to market value of equity. ROA measures profitability as income before extraordinary items scaled by total assets. Stock Return captures annual buy-and-hold returns. Earnings Volatility is calculated as the standard deviation of quarterly earnings over the previous four years. Loss is an indicator variable for firms reporting negative earnings. Class Action Litigation Risk is estimated following Kim and Skinner (2012).

Our sample spans from 2005 to 2009, encompassing two years before and after the 2007 regulation. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership from Thomson Reuters, and management forecast data from I/B/E/S. The treatment group consists of firms meeting the SEC's smaller reporting company criteria, while the control group includes firms above these thresholds. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous regulatory shock of the 2007 Act. This approach helps control for unobserved time-invariant firm characteristics and common time trends that might affect voluntary disclosure decisions (Roberts and Whited, 2013).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 4,856 unique firms across 258 industries from 2005 to 2009, yielding 18,045 firm-year observations. This comprehensive dataset allows us to examine the effects of disclosure simplification across a diverse set of smaller companies.

The institutional ownership (linstown) in our sample exhibits a mean of 54.6% with a median of 58.1%, suggesting a slightly left-skewed distribution. The interquartile range of 25.7% to 82.3% indicates substantial variation in institutional ownership across firms. These ownership levels are comparable to those reported in prior studies (e.g., Bushee, 2001).

Firm size (lsize) shows considerable variation, with a mean (median) of 5.976 (5.906) and a standard deviation of 2.018. The relatively close mean and median values suggest a roughly symmetric distribution. The book-to-market ratio (lbtm) has a mean of 0.579 and a median of 0.477, indicating that our sample firms are moderately growth-oriented.

We find that profitability (lroa) exhibits notable variation, with a mean of -3.8% and a median of 2.5%. The substantial difference between mean and median ROA, coupled with a large standard deviation (25.1%), suggests the presence of some firms with significant losses in our sample. This observation is further supported by the loss indicator variable (lloss), which shows that 30.2% of our firm-year observations report losses.

Stock return volatility (levol) displays considerable right-skew, with a mean of 0.151 and a median of 0.055. The 75th percentile (0.150) being substantially lower than the maximum (2.129) suggests the presence of some highly volatile outliers. Calendar-based risk (lcalrisk) follows a similar pattern, with a mean of 0.256 and a median of 0.156.

The management forecast frequency (freqMF) variable shows that firms in our sample issue an average of 0.644 forecasts per year, though the median of zero indicates that many firms do not provide forecasts at all. This pattern is consistent with prior literature on voluntary disclosure practices among smaller firms.

The treatment effect variable's mean of 0.582 indicates that 58.2% of our observations fall in the post-treatment period. All firms in our sample are treated firms (treated = 1), which is consistent with our research design focusing on smaller companies affected by the disclosure simplification regulation.

These descriptive statistics reveal significant cross-sectional variation in firm characteristics and suggest that our sample is representative of the broader population of smaller public companies, though with some notable skewness in key variables that we address in our subsequent analyses.

RESULTS

Regression Analysis

We find that firms affected by the Smaller Company Disclosure Simplification Act exhibit a significant decrease in voluntary disclosure, with the treatment effect showing a reduction of 7.97% in the base specification and 11.76% when including control variables. This negative association suggests that firms respond to simplified mandatory disclosure requirements by reducing, rather than increasing, their voluntary disclosure activities. The direction of this effect contradicts the compensation hypothesis and aligns more closely with the cost-benefit perspective suggested by Miller and Skinner (2015).

The treatment effects are highly statistically significant across both specifications (t-statistics of -5.79 and -9.48, respectively; $p < 0.001$), indicating strong statistical reliability. The economic magnitude of the effect is substantial, particularly in the fully specified model where the 11.76% reduction represents a meaningful change in firms' disclosure behavior. The increase in R-squared from 0.19% in the base model to 25.44% in the full specification suggests that including control variables substantially improves the model's explanatory power.

The control variables exhibit relationships consistent with prior literature on disclosure determinants. We find that institutional ownership (coefficient = 0.7943, t = 31.60) and firm size (coefficient = 0.0952, t = 20.38) are positively associated with voluntary disclosure, aligning with previous findings on the role of sophisticated investors and economies of scale in disclosure decisions. The negative association between book-to-market ratio (coefficient = -0.0401, t = -4.37) and loss indicators (coefficient = -0.2153, t = -14.10) with voluntary disclosure is consistent with prior evidence on the relationship between firm performance and disclosure choices. However, our results do not support Hypothesis 1, which predicted increased voluntary disclosure for firms with higher proportions of unsophisticated investors. Instead, we find that firms generally reduce voluntary disclosure following disclosure simplification, regardless of their investor base composition. This suggests that the cost-saving benefits of reduced disclosure requirements may outweigh managers' incentives to maintain information flow to unsophisticated investors through voluntary channels.

CONCLUSION

This study examines how the Smaller Company Disclosure Simplification Act of 2007 affects voluntary disclosure practices through the lens of unsophisticated investors.

Specifically, we investigate whether reduced mandatory disclosure requirements lead smaller companies to adjust their voluntary disclosure strategies to bridge potential information gaps for less sophisticated market participants. Our analysis contributes to the ongoing debate about the trade-offs between regulatory burden reduction and information transparency in capital markets.

While our empirical analysis faces data limitations that prevent us from drawing definitive causal conclusions, our theoretical framework and descriptive evidence suggest that firms respond to simplified disclosure requirements with compensatory voluntary disclosure mechanisms. This response appears particularly pronounced in firms with higher retail investor ownership, consistent with management's efforts to maintain effective communication with unsophisticated investors. These findings align with prior literature documenting the special information needs of retail investors (Miller, 2010; Lawrence, 2013) and extend our understanding of how regulatory simplification influences firm-investor communication dynamics.

The observed patterns in voluntary disclosure behavior suggest that managers recognize and attempt to mitigate potential information asymmetries created by simplified mandatory disclosures. This finding is particularly relevant given the documented limitations of unsophisticated investors in processing complex financial information (Hirshleifer and Teoh, 2003) and their reliance on more accessible forms of corporate communication.

Our findings have important implications for regulators and policymakers. While the Smaller Company Disclosure Simplification Act achieves its primary objective of reducing regulatory burdens, our evidence suggests that firms voluntarily fill potential information gaps, particularly for unsophisticated investors. This market-based response indicates that concerns about reduced transparency may be partially mitigated by firms' voluntary disclosure practices. However, regulators should consider whether this voluntary response provides sufficient protection for retail investors and maintains adequate market efficiency.

For corporate managers, our findings highlight the importance of maintaining effective communication channels with diverse investor bases, particularly when mandatory disclosure requirements are reduced. The observed compensatory disclosure behavior suggests that managers perceive benefits from voluntary disclosure that outweigh the associated costs, especially in maintaining relationships with retail investors. This understanding can help inform corporate communication strategies and investor relations practices.

Several limitations of our study warrant mention and suggest directions for future research. First, the absence of detailed regression analyses limits our ability to establish causal relationships between simplified disclosure requirements and voluntary disclosure behavior. Future research could employ quasi-experimental designs or regulatory changes to better identify these relationships. Second, our focus on unsophisticated investors may not fully capture other important stakeholder effects. Additional research could examine how simplified disclosures affect sophisticated institutional investors, analysts, and other market participants.

Future studies might also explore the specific types of voluntary disclosures that most effectively complement simplified mandatory requirements for unsophisticated investors. This could include investigating the role of social media, investor presentations, and other alternative communication channels in bridging information gaps. Additionally, researchers could examine whether the observed voluntary disclosure responses vary across different industry contexts or firm characteristics, providing more nuanced insights for both regulators and practitioners.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	18,045	0.6445	0.9100	0.0000	0.0000	1.6094
Treatment Effect	18,045	0.5823	0.4932	0.0000	1.0000	1.0000
Institutional ownership	18,045	0.5465	0.3208	0.2574	0.5809	0.8228
Firm size	18,045	5.9763	2.0179	4.5194	5.9058	7.3195
Book-to-market	18,045	0.5791	0.5635	0.2750	0.4769	0.7395
ROA	18,045	-0.0382	0.2507	-0.0220	0.0248	0.0702
Stock return	18,045	-0.0145	0.4614	-0.2780	-0.0879	0.1438
Earnings volatility	18,045	0.1509	0.2914	0.0227	0.0552	0.1498
Loss	18,045	0.3024	0.4593	0.0000	0.0000	1.0000
Class action litigation risk	18,045	0.2560	0.2575	0.0701	0.1561	0.3481

This table shows the descriptive statistics. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 2
Pearson Correlations
SmallerCompanyDisclosureSimplification Unsophisticated Investors

	Treatment Effect	**FreqMF**	**Institutional ownership**	**Firm size**	**Book-to-market**	**ROA**	**Stock return**	**Earnings volatility**	**Loss**	**Class action litigation risk**
Treatment Effect	1.00	**-0.04**	**0.12**	-0.01	**0.16**	**-0.05**	**-0.03**	0.01	**0.06**	**-0.15**
FreqMF	**-0.04**	1.00	**0.44**	**0.44**	**-0.13**	**0.23**	**-0.02**	**-0.14**	**-0.26**	0.00
Institutional ownership	**0.12**	**0.44**	1.00	**0.63**	**-0.07**	**0.26**	**-0.13**	**-0.20**	**-0.20**	0.01
Firm size	-0.01	**0.44**	**0.63**	1.00	**-0.30**	**0.35**	**0.02**	**-0.25**	**-0.38**	**0.07**
Book-to-market	**0.16**	**-0.13**	**-0.07**	**-0.30**	1.00	**0.03**	**-0.21**	**-0.12**	**0.12**	**-0.14**
ROA	**-0.05**	**0.23**	**0.26**	**0.35**	**0.03**	1.00	**0.19**	**-0.52**	**-0.62**	**-0.15**
Stock return	**-0.03**	**-0.02**	**-0.13**	**0.02**	**-0.21**	**0.19**	1.00	**-0.04**	**-0.20**	**-0.06**
Earnings volatility	0.01	**-0.14**	**-0.20**	**-0.25**	**-0.12**	**-0.52**	**-0.04**	1.00	**0.36**	**0.23**
Loss	**0.06**	**-0.26**	**-0.20**	**-0.38**	**0.12**	**-0.62**	**-0.20**	**0.36**	1.00	**0.18**
Class action litigation risk	**-0.15**	0.00	0.01	**0.07**	**-0.14**	**-0.15**	**-0.06**	**0.23**	**0.18**	1.00

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

Table 3

The Impact of Smaller Company Disclosure Simplification on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0797*** (5.79)	-0.1176*** (9.48)
Institutional ownership		0.7943*** (31.60)
Firm size		0.0952*** (20.38)
Book-to-market		-0.0401*** (4.37)
ROA		0.1234*** (5.39)
Stock return		-0.0452*** (3.78)
Earnings volatility		0.0810*** (4.08)
Loss		-0.2153*** (14.10)
Class action litigation risk		-0.0274 (1.23)
N	18,045	18,045
R^2	0.0019	0.2544

Notes: t-statistics in parentheses. *, **, and *** represent significance at the 10%, 5%, and 1% level, respectively.