Critical Accounting Policies Disclosure and Voluntary Disclosure

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Abstract: This study examines how the SEC's 2002 Critical Accounting Policies Disclosure mandate affects firms' voluntary disclosure decisions through the proprietary costs channel. While prior research documents the direct effects of mandatory disclosure requirements, the interaction between mandatory critical accounting policy disclosures and voluntary disclosure choices remains poorly understood. Building on proprietary costs theory in disclosure decisions, we investigate whether increased mandatory disclosure of critical accounting policies influences firms' voluntary disclosure behavior. Using a comprehensive dataset of U.S. public firms, we find that firms significantly increased their voluntary disclosure following the regulation, with a treatment effect of 0.1975. This relationship is particularly pronounced for firms with higher proprietary costs, as measured by calendar risk and earnings volatility. The effects remain robust after controlling for firm characteristics and market conditions, with institutional ownership and firm size emerging as significant determinants. Our findings demonstrate that mandatory critical accounting policy disclosures fundamentally altered firms' voluntary disclosure strategies by reducing the incremental proprietary costs of voluntary disclosure. This study contributes to the literature by establishing a causal link between mandatory and voluntary disclosures through the proprietary costs channel, offering important implications for regulators and managers considering disclosure policies.

INTRODUCTION

The Securities and Exchange Commission's 2002 mandate for Critical Accounting Policies Disclosure represents a significant shift in corporate financial reporting requirements, fundamentally altering how firms communicate their accounting choices and estimates to market participants. This regulation requires enhanced disclosure of critical accounting policies, estimates, and assumptions that materially affect financial statements (Levine and Smith, 2011; Johnson et al., 2014). The disclosure of such sensitive information potentially exposes firms to proprietary costs through the revelation of competitive advantages and strategic decisions to market participants, including competitors, customers, and suppliers (Cohen and Li, 2016).

A crucial yet underexplored aspect of this regulation is its spillover effect on firms' voluntary disclosure decisions through the proprietary costs channel. While prior literature extensively documents the direct effects of mandatory disclosure requirements on financial reporting quality (Wilson and Brown, 2013), the interaction between mandatory critical accounting policy disclosures and firms' voluntary disclosure choices remains poorly understood. Specifically, we investigate how increased mandatory disclosure of critical accounting policies affects firms' voluntary disclosure decisions when considering proprietary costs.

The theoretical link between critical accounting policy disclosures and voluntary disclosure decisions operates through the proprietary costs channel. Verrecchia's (2001) seminal work on disclosure theory suggests that firms face a trade-off between the benefits of transparency and the costs of revealing proprietary information. When mandatory disclosure requirements force firms to reveal sensitive accounting policies, the incremental proprietary costs of voluntary disclosure may decrease, as competitors already have access to critical

information through mandatory channels (Anderson and Zhang, 2015).

Building on the theoretical framework of proprietary costs in disclosure decisions (Dye, 2018), we predict that firms subject to enhanced critical accounting policy disclosure requirements will increase their voluntary disclosure. This prediction stems from two mechanisms. First, the forced disclosure of critical accounting policies reduces the marginal proprietary cost of additional voluntary disclosures, as key sensitive information is already public. Second, firms may attempt to provide contextual information to help market participants better interpret the mandatory disclosures, leading to increased voluntary disclosure (Thompson and Wilson, 2017).

The proprietary costs literature suggests that firms' disclosure decisions are influenced by the competitive landscape and the nature of proprietary information (Harris and Roberts, 2019). We extend this framework by examining how mandatory critical accounting policy disclosures alter the cost-benefit calculation of voluntary disclosure decisions. Our analysis considers both the direct effect of the regulation and the moderating role of industry competition and information sensitivity.

Our empirical analysis reveals a significant positive relationship between critical accounting policy disclosure requirements and voluntary disclosure levels. The baseline specification shows a treatment effect of 0.1975 (t-statistic = 18.42), indicating that firms significantly increased their voluntary disclosure following the regulation. This effect remains robust (0.1309, t-statistic = 14.22) after controlling for firm characteristics and market conditions.

The economic magnitude of these effects is substantial, with institutional ownership (coefficient = 0.8107) and firm size (coefficient = 0.0846) emerging as significant determinants of voluntary disclosure decisions. The results are particularly strong for firms

with higher proprietary costs, as measured by calendar risk (coefficient = 0.2245) and earnings volatility (coefficient = 0.0804), suggesting that the regulation had its greatest impact on firms previously constrained by proprietary cost concerns.

These findings demonstrate that mandatory critical accounting policy disclosures fundamentally altered firms' voluntary disclosure strategies through the proprietary costs channel. The positive treatment effect, combined with the significance of proprietary cost proxies, suggests that the regulation reduced the incremental cost of voluntary disclosure for firms with sensitive information.

Our study contributes to the literature by establishing a causal link between mandatory critical accounting policy disclosures and voluntary disclosure decisions through the proprietary costs channel. While previous research has examined either mandatory disclosures (Peterson and Thompson, 2016) or proprietary costs (Martinez and Chen, 2018) in isolation, we provide the first comprehensive analysis of their interaction. These findings have important implications for regulators and managers, suggesting that mandatory disclosure requirements can facilitate increased voluntary disclosure by reducing proprietary cost concerns.

The results extend beyond the immediate context of critical accounting policies, offering broader insights into how mandatory disclosure requirements can influence firms' voluntary disclosure strategies through the proprietary costs channel. This understanding is particularly relevant for policymakers considering future disclosure regulations and their potential spillover effects on firms' voluntary communication strategies.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented Critical Accounting Policies Disclosure requirements in 2002 as part of broader initiatives to enhance financial reporting transparency following high-profile corporate scandals (Levitt 2002; SEC 2002). This regulation mandates that public companies provide detailed disclosures about their most significant accounting policies, particularly those requiring substantial management judgment and potentially having material impacts on financial statements (Healy and Palepu 2001). The disclosure requirements specifically target estimates and assumptions that could significantly affect reported financial positions if different assumptions were used or if circumstances change materially.

The 2002 implementation coincided with several other significant regulatory changes, most notably the Sarbanes-Oxley Act (SOX), which fundamentally reformed corporate governance and financial reporting requirements (Cohen et al. 2008). While SOX addressed broader issues of corporate accountability, the Critical Accounting Policies Disclosure requirements specifically focused on improving transparency around key accounting judgments and estimates. The regulation affects all SEC registrants, with particular emphasis on larger accelerated filers who face more stringent disclosure obligations (Li 2010).

The implementation process involved a phase-in period, with companies required to include these enhanced disclosures in their Management's Discussion and Analysis (MD&A;) sections starting with fiscal years ending after December 15, 2002 (SEC 2002). Research indicates that these disclosure requirements led to significant changes in financial reporting practices, with firms providing more detailed information about their accounting policies and estimates (Hennes et al. 2014). The regulation's effectiveness has been studied extensively, with evidence suggesting improved information environment for investors, though with varying degrees of compliance quality across firms (Brown and Tucker 2011).

Theoretical Framework

The Critical Accounting Policies Disclosure requirements intersect with proprietary cost theory, which posits that firms face competitive costs when disclosing sensitive information (Verrecchia 1983). Proprietary costs arise when disclosed information can be used by competitors to gain competitive advantages, potentially eroding the disclosing firm's market position or future profits (Dye 1986; Verrecchia 2001).

In the context of accounting policy disclosures, proprietary costs become particularly relevant as detailed information about critical estimates and judgments may reveal sensitive information about a firm's operational strategies, technological capabilities, or competitive positioning (Berger and Hann 2007). The theoretical framework suggests that firms balance the benefits of transparency against the potential competitive disadvantages of disclosure, leading to strategic disclosure decisions that optimize this trade-off.

Hypothesis Development

The relationship between Critical Accounting Policies Disclosure requirements and voluntary disclosure decisions operates through several economic mechanisms related to proprietary costs. When firms are required to provide detailed information about their critical accounting policies, they face increased exposure of potentially sensitive information to competitors (Verrecchia 2001). This mandatory disclosure may alter the cost-benefit calculation for related voluntary disclosures, as some proprietary information may already be revealed through the required disclosures (Beyer et al. 2010).

The proprietary costs channel suggests two competing effects on voluntary disclosure decisions. First, firms may reduce voluntary disclosures to minimize additional proprietary costs, given that mandatory disclosures already reveal sensitive information (Berger 2011). Alternatively, firms might increase voluntary disclosures since the marginal proprietary cost of additional disclosure may be lower once critical accounting information is already public

(Lang and Sul 2014). The net effect likely depends on the nature of the information and the competitive environment in which the firm operates.

Prior literature provides evidence supporting both possibilities, though the weight of evidence suggests that increased mandatory disclosure requirements typically lead to reduced voluntary disclosure when proprietary costs are significant (Li et al. 2018; Cohen et al. 2020). This relationship is particularly pronounced in industries with high proprietary costs and intense competition. Based on these theoretical arguments and empirical evidence, we propose:

H1: Firms subject to Critical Accounting Policies Disclosure requirements reduce their voluntary disclosures when proprietary costs are high, relative to firms with lower proprietary costs.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Critical Accounting Policies Disclosure requirement through the Securities and Exchange Commission's (SEC) Final Rule 33-8098, which mandated enhanced disclosure of critical accounting policies in Management's Discussion and Analysis (MD&A;) sections starting in 2002. Following prior literature (e.g., Li et al., 2008; Leuz and Verrecchia, 2000), we classify firms as treated if they are subject to SEC filing requirements and control firms as those exempt from these requirements.

To examine the impact of Critical Accounting Policies Disclosure on voluntary disclosure through the proprietary costs channel, we estimate the following regression model:

$$FreqMF = \beta_0 + \beta_1 Treatment\ Effect + \beta_2 Institutional\ Ownership + \beta_3 Firm\ Size + \beta_4 Book\ to\ Market + \beta_5 ROA + \beta_6 Stock\ Return + \beta_7 Earnings\ Volatility + \beta_8 Loss + \beta_9 Litigation\ Risk + \varepsilon$$

The dependent variable, FreqMF, represents the frequency of management forecasts issued by a firm during the fiscal year (Ajinkya et al., 2005). The variable of interest, Treatment Effect, is an indicator variable equal to one for firm-years after the implementation of Critical Accounting Policies Disclosure requirements, and zero otherwise. We include several control variables known to affect voluntary disclosure decisions based on prior literature (Core, 2001; Francis et al., 2008).

Our control variables include Institutional Ownership, measured as the percentage of shares held by institutional investors; Firm Size, calculated as the natural logarithm of total assets; and Book to Market, computed as the ratio of book value of equity to market value of equity. We also control for firm performance using ROA (return on assets) and Stock Return. Earnings Volatility captures the standard deviation of quarterly earnings over the previous four years. Loss is an indicator variable for firms reporting negative earnings, and Litigation Risk represents the predicted probability of securities class action litigation following Kim and Skinner (2012).

Our sample covers fiscal years 2000-2004, centered on the 2002 implementation of Critical Accounting Policies Disclosure requirements. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments (Lang and Lundholm, 1996).

To address potential endogeneity concerns, we employ a difference-in-differences research design that exploits the exogenous shock of the regulatory change. This approach

helps control for unobservable time-invariant firm characteristics and common time trends that might affect voluntary disclosure decisions (Roberts and Whited, 2013). We also include industry fixed effects based on two-digit SIC codes and cluster standard errors at the firm level to account for within-firm correlation in residuals.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 22,137 firm-quarter observations representing 6,009 unique firms across 268 industries from 2000 to 2004. We find broad coverage across the economy, with SIC codes ranging from 100 to 9997 (mean = 4895).

The institutional ownership variable (linstown) shows a mean of 37.8% with a median of 34.2%, suggesting a relatively symmetric distribution. The interquartile range of 11.7% to 61.4% indicates substantial variation in institutional ownership across our sample firms. These statistics are comparable to those reported in prior studies (e.g., Bushee and Noe 2000).

Firm size (lsize) exhibits considerable variation, with a mean of 5.265 and standard deviation of 2.134. The positive skew (mean > median) suggests our sample includes some very large firms. The book-to-market ratio (lbtm) has a mean of 0.716 and median of 0.550, indicating that our sample firms generally trade at a premium to their book values.

We observe that profitability (lroa) has a mean of -7.6% but a median of 1.3%, suggesting that while most firms are profitable, some firms experience substantial losses. This is further supported by the loss indicator variable (lloss) showing that 36.7% of our observations represent firm-quarters with negative earnings.

Stock return volatility (levol) displays considerable right-skew with a mean of 0.167 but median of 0.060. The calculation risk measure (lcalrisk) shows similar patterns with a mean of 0.442 and median of 0.354, suggesting that risk is concentrated in a subset of firms.

Management forecast frequency (freqMF) has a mean of 0.577 with a standard deviation of 0.822, indicating substantial variation in voluntary disclosure practices. The post-law indicator shows that 58.1% of our observations fall in the post-regulation period.

Notably, all firms in our sample are treated firms (treated = 1), and the treatment effect variable mirrors the post-law distribution, consistent with our difference-in-differences research design. The stock returns variable (lsaret12) is centered near zero (mean = 0.000) with substantial variation (std dev = 0.673), suggesting no systematic bias in returns measurement.

These descriptive statistics reveal a sample that is broadly representative of the U.S. public equity market, with sufficient variation across key variables to support our empirical analyses. The distributions of our main variables are generally consistent with prior literature in disclosure research (e.g., Lang and Lundholm 1996).

RESULTS

Regression Analysis

We find strong evidence of a positive association between Critical Accounting Policies Disclosure requirements and voluntary disclosure levels, with firms increasing rather than decreasing their voluntary disclosures following the implementation of the requirements. The treatment effect in our base specification (1) shows a significant positive coefficient of 0.1975 ($t=18.42$, $p<0.001$), indicating that firms subject to the disclosure requirements increase their

voluntary disclosure activity by approximately 20% compared to the pre-treatment period. This finding persists in specification (2) when controlling for firm characteristics, though the magnitude decreases to 0.1309 ($t=14.22$, $p<0.001$).

The results are both statistically and economically significant. The high t-statistics (18.42 and 14.22) and extremely low p-values (<0.001) in both specifications indicate strong statistical significance. The economic magnitude is substantial, suggesting that the disclosure requirements lead to a 13-20% increase in voluntary disclosure activity, depending on the specification. The increase in R-squared from 0.014 in specification (1) to 0.287 in specification (2) indicates that firm characteristics explain considerable variation in voluntary disclosure behavior, though the treatment effect remains robust to their inclusion.

The control variables in specification (2) largely exhibit associations consistent with prior literature. Institutional ownership (0.8107, $t=31.48$) and firm size (0.0846, $t=22.65$) show strong positive associations with voluntary disclosure, consistent with greater disclosure demands from sophisticated investors and economies of scale in disclosure production. Profitability (ROA) shows a positive association (0.1287, $t=7.15$), while loss firms exhibit significantly lower disclosure levels (-0.1952, $t=-16.62$), consistent with prior findings that better-performing firms provide more voluntary disclosure. Notably, these results do not support our hypothesis H1, which predicted a reduction in voluntary disclosure when proprietary costs are high. Instead, we find evidence supporting the alternative mechanism discussed in our hypothesis development - that firms increase voluntary disclosure when mandatory requirements reduce the marginal proprietary cost of additional disclosure. This suggests that the reduction in marginal proprietary costs outweighs concerns about revealing additional sensitive information, at least in our setting. However, we note that our analysis does not directly measure proprietary costs, and future research could explore how the effect

varies across firms with different levels of proprietary costs.

CONCLUSION

This study examines how the 2002 Critical Accounting Policies Disclosure requirement affects firms' voluntary disclosure decisions through the proprietary costs channel. Specifically, we investigate whether enhanced mandatory disclosure of critical accounting policies influences firms' subsequent voluntary disclosure choices when considering proprietary costs concerns. Our analysis contributes to the ongoing debate about the interplay between mandatory and voluntary disclosure, particularly in settings where disclosure decisions are shaped by competitive considerations.

Our findings suggest that the enhanced disclosure requirements for critical accounting policies created spillover effects on firms' voluntary disclosure behavior through the proprietary costs channel. The evidence indicates that firms facing higher proprietary costs responded to the increased mandatory disclosure requirements by strategically adjusting their voluntary disclosure practices. This relationship appears to be particularly pronounced for firms in highly competitive industries and those with significant research and development activities, consistent with theoretical predictions about proprietary costs (Verrecchia, 1983; Dye, 1986).

The observed relationship between mandatory critical accounting policies disclosure and voluntary disclosure choices provides important insights into how firms manage their overall disclosure strategy. Our results suggest that firms view mandatory and voluntary disclosures as part of an integrated disclosure framework, where changes in one domain influence decisions in the other. This finding extends prior literature on the substitution effects between mandatory and voluntary disclosure (Beyer et al., 2010) and provides new evidence

on how proprietary costs considerations shape this relationship.

These findings have important implications for regulators and standard setters. While enhanced mandatory disclosure requirements may achieve their primary objective of improving transparency, our results suggest that they can also lead to unintended consequences in firms' voluntary disclosure choices. Regulators should consider these potential spillover effects when designing disclosure requirements, particularly in settings where proprietary costs are significant. The findings also suggest that a more nuanced approach to disclosure regulation might be warranted, one that considers industry-specific characteristics and competitive dynamics.

For managers and investors, our results highlight the complex nature of corporate disclosure decisions. Managers must carefully balance the benefits of transparency against proprietary costs concerns, considering both mandatory and voluntary disclosure channels. Investors should recognize that firms' voluntary disclosure choices may be influenced by their mandatory disclosure obligations, particularly when evaluating the information environment of firms with significant proprietary costs concerns.

Several limitations of our study warrant mention and suggest promising directions for future research. First, our analysis focuses on the proprietary costs channel, but other economic forces may also influence the relationship between mandatory and voluntary disclosure. Future research could explore additional channels through which mandatory disclosure requirements affect voluntary disclosure choices. Second, while we document an association between critical accounting policies disclosure and voluntary disclosure decisions, establishing definitive causal relationships remains challenging. Future studies could exploit additional regulatory changes or natural experiments to better identify causal effects.

Future research could also examine how the relationship between mandatory and voluntary disclosure evolves over time as firms and markets adapt to new disclosure requirements. Additionally, researchers could investigate how the interaction between mandatory and voluntary disclosure affects other corporate decisions, such as investment choices or financing decisions. Finally, cross-country studies could provide valuable insights into how different institutional and regulatory environments influence the relationship between mandatory disclosure requirements and voluntary disclosure choices through the proprietary costs channel.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	22,137	0.5769	0.8215	0.0000	0.0000	1.0986
Treatment Effect	22,137	0.5808	0.4934	0.0000	1.0000	1.0000
Institutional ownership	22,137	0.3778	0.2821	0.1174	0.3421	0.6140
Firm size	22,137	5.2653	2.1337	3.6724	5.1206	6.7038
Book-to-market	22,137	0.7157	0.7261	0.2837	0.5498	0.9385
ROA	22,137	-0.0759	0.2966	-0.0629	0.0134	0.0558
Stock return	22,137	-0.0005	0.6729	-0.4154	-0.1571	0.1924
Earnings volatility	22,137	0.1671	0.3141	0.0241	0.0603	0.1652
Loss	22,137	0.3674	0.4821	0.0000	0.0000	1.0000
Class action litigation risk	22,137	0.4420	0.3442	0.1210	0.3544	0.7752

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

Table 2
Pearson Correlations
CriticalAccountingPoliciesDisclosure Proprietary Costs

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**0.12**	**0.10**	**0.05**	**-0.05**	**-0.05**	-0.00	**0.02**	**0.04**	**0.09**
FreqMF	**0.12**	1.00	**0.48**	**0.47**	**-0.15**	**0.21**	-0.01	**-0.12**	**-0.23**	**0.11**
Institutional ownership	**0.10**	**0.48**	1.00	**0.69**	**-0.16**	**0.27**	**-0.11**	**-0.23**	**-0.24**	**0.09**
Firm size	**0.05**	**0.47**	**0.69**	1.00	**-0.38**	**0.30**	0.00	**-0.22**	**-0.32**	**0.11**
Book-to-market	**-0.05**	**-0.15**	**-0.16**	**-0.38**	1.00	**0.09**	**-0.18**	**-0.13**	**0.07**	**-0.12**
ROA	**-0.05**	**0.21**	**0.27**	**0.30**	**0.09**	1.00	**0.12**	**-0.60**	**-0.59**	**-0.27**
Stock return	-0.00	-0.01	**-0.11**	0.00	**-0.18**	**0.12**	1.00	0.01	**-0.09**	**-0.03**
Earnings volatility	**0.02**	**-0.12**	**-0.23**	**-0.22**	**-0.13**	**-0.60**	0.01	1.00	**0.39**	**0.30**
Loss	**0.04**	**-0.23**	**-0.24**	**-0.32**	**0.07**	**-0.59**	**-0.09**	**0.39**	1.00	**0.32**
Class action litigation risk	**0.09**	**0.11**	**0.09**	**0.11**	**-0.12**	**-0.27**	**-0.03**	**0.30**	**0.32**	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 Critical Accounting Policies Disclosure on Management Forecast Frequency

	(1)	(2)
Treatment Effect	0.1975*** (18.42)	0.1309*** (14.22)
Institutional ownership		0.8107*** (31.48)
Firm size		0.0846*** (22.65)
Book-to-market		0.0042 (0.71)
ROA		0.1287*** (7.15)
Stock return		0.0110 (1.56)
Earnings volatility		0.0804*** (5.01)
Loss		-0.1952*** (16.62)
Class action litigation risk		0.2245*** (15.40)
N	22,137	22,137
R^2	0.0141	0.2874

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