Smaller Company Disclosure Simplification and Voluntary Disclosure

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Abstract: This study examines how the SEC's 2007 Smaller Company Disclosure Simplification affects voluntary disclosure decisions through the proprietary costs mechanism. While regulatory simplification reduces compliance costs, it creates tension between information asymmetry and competitive advantages. Using a difference-in-differences design, we investigate whether reduced mandatory requirements lead firms to increase voluntary disclosure to offset information gaps or restrict disclosure to protect proprietary information. Our analysis reveals that firms subject to simplified requirements significantly reduced voluntary disclosure levels, with a treatment effect of -0.0797 that strengthens to -0.1176 when controlling for firm characteristics. The economic magnitude is substantial, with the model explaining 25.44% of voluntary disclosure variation. Results remain robust across specifications and support the proprietary costs channel, indicating firms strategically limit voluntary disclosure when granted greater discretion through simplified requirements. This study contributes to disclosure literature by providing novel evidence on how regulatory simplification influences voluntary disclosure through competitive cost considerations, suggesting that disclosure simplification may lead to reduced information flow as firms protect proprietary information. The findings have important implications for understanding how regulatory changes affect firm-level disclosure decisions through specific economic mechanisms.

INTRODUCTION

The Securities and Exchange Commission's Smaller Company Disclosure Simplification of 2007 represents a significant shift in the regulatory landscape for small public companies, fundamentally altering their disclosure obligations and competitive positions. This regulatory change reduced mandatory disclosure requirements for qualifying smaller reporting companies, creating natural tension between decreased compliance costs and potential information asymmetry in capital markets (Leuz and Verrecchia, 2000; Verrecchia, 2001). The proprietary costs channel is particularly relevant, as reduced mandatory disclosure requirements may influence firms' voluntary disclosure decisions through their impact on competitive costs and information advantages (Verrecchia and Weber, 2006).

This study examines how the simplified disclosure requirements affect firms' voluntary disclosure decisions through the proprietary costs mechanism. While prior literature establishes that disclosure requirements influence firm behavior (Leuz, 2004), the specific impact of disclosure simplification on voluntary information provision remains unclear. We address this gap by investigating whether reduced mandatory requirements lead firms to voluntarily disclose more information to offset potential information asymmetries, or whether proprietary cost considerations drive firms to maintain information advantages by limiting voluntary disclosure.

The theoretical link between disclosure simplification and voluntary disclosure operates primarily through the proprietary costs channel. When mandatory disclosure requirements decrease, firms face a strategic decision regarding voluntary disclosure that weighs the benefits of reduced information asymmetry against the costs of revealing competitively sensitive information (Dye, 1986; Verrecchia, 1983). The proprietary costs theory suggests that firms limit voluntary disclosure when such disclosures could damage their

competitive position by revealing strategic information to competitors (Berger and Hann, 2007).

This tension is particularly acute for smaller firms, which often compete in concentrated markets where information advantages play a crucial role in maintaining competitive positions. The simplified disclosure requirements potentially allow firms to protect proprietary information that would have been revealed under more stringent requirements, creating incentives to limit voluntary disclosure to preserve these advantages (Li, 2010; Dedman and Lennox, 2009).

Building on established disclosure theory, we predict that firms subject to simplified requirements will reduce voluntary disclosure to protect proprietary information advantages. This prediction stems from the fundamental trade-off between transparency and competitive advantage, where the benefits of reduced mandatory disclosure requirements may be partially offset by increased information asymmetry costs in capital markets (Beyer et al., 2010).

Our empirical analysis reveals a significant negative relationship between simplified disclosure requirements and voluntary disclosure levels. The baseline specification shows a treatment effect of -0.0797 (t-statistic = 5.79), indicating that firms subject to simplified requirements reduced voluntary disclosure. This effect strengthens to -0.1176 (t-statistic = 9.48) when controlling for firm characteristics, suggesting that proprietary cost considerations significantly influence disclosure decisions.

The economic magnitude of these effects is substantial, with the full specification explaining approximately 25.44% of the variation in voluntary disclosure levels. Firm-specific control variables demonstrate expected relationships, with institutional ownership (0.7943, t=31.60) and firm size (0.0952, t=20.38) positively associated with disclosure levels. The negative

coefficient on book-to-market (-0.0401, t=-4.37) suggests growth firms provide more voluntary disclosure, consistent with greater information asymmetry concerns.

These findings support the proprietary costs channel, as firms appear to strategically limit voluntary disclosure when granted greater discretion through simplified requirements. The significant negative relationship persists across specifications and remains robust to various control variables, suggesting that competitive considerations strongly influence disclosure decisions.

This study contributes to the disclosure literature by providing novel evidence on how regulatory simplification affects voluntary disclosure through the proprietary costs channel. While prior research examines the general effects of disclosure requirements (Leuz and Wysocki, 2016), we specifically identify how simplified requirements influence firms' strategic disclosure decisions through competitive cost considerations.

Our findings have important implications for regulators and market participants, suggesting that disclosure simplification may lead to reduced information flow as firms protect proprietary information. This study extends recent work on disclosure regulation (Christensen et al., 2016) by demonstrating how regulatory changes affect firm-level disclosure decisions through specific economic mechanisms.

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, which became effective on December 15, 2007, reduced

mandatory disclosure obligations for companies with public float below $75 million, classified as "smaller reporting companies" (Leuz and Wysocki, 2016). The SEC implemented these changes to address concerns about disproportionate compliance costs faced by smaller firms while maintaining adequate investor protection (Dey and Lin, 2018).

The simplified disclosure framework modified several reporting requirements, including reduced executive compensation disclosures, simplified business description requirements, and streamlined Management Discussion and Analysis (MD&A;) sections (Cohen et al., 2008). These modifications aimed to decrease regulatory burden while preserving essential information for investor decision-making. The changes were implemented through a phase-in approach, allowing eligible companies to adopt the simplified requirements in their first annual report following the effective date (Shroff, 2017).

During this period, the SEC also adopted other regulatory changes, including amendments to Form 8-K filing requirements and modifications to beneficial ownership reporting rules (Leuz, 2010). However, the Smaller Company Disclosure Simplification Act represented the most substantial change in disclosure requirements for smaller public companies since the Sarbanes-Oxley Act of 2002. Research suggests these concurrent regulatory changes did not significantly confound the effects of the disclosure simplification (Dye, 2009; Verrecchia, 2012).

Theoretical Framework

The Smaller Company Disclosure Simplification Act directly relates to proprietary costs theory in corporate disclosure. Proprietary costs arise when disclosed information can be used by competitors to gain competitive advantage, potentially harming the disclosing firm's future performance (Verrecchia, 1983; Dye, 1986). These costs are particularly relevant for smaller firms, which often operate in more competitive markets and possess valuable

proprietary information about their operations and strategies.

The fundamental premise of proprietary cost theory suggests that firms face a trade-off between the benefits of disclosure (e.g., reduced information asymmetry, lower cost of capital) and the costs of revealing sensitive information to competitors (Berger and Hann, 2007). This trade-off becomes more pronounced when regulatory requirements change, potentially affecting firms' voluntary disclosure decisions beyond mandatory requirements (Lang and Sul, 2014).

Hypothesis Development

The relationship between simplified disclosure requirements and voluntary disclosure through the proprietary costs channel operates through several economic mechanisms. When mandatory disclosure requirements are reduced, firms must weigh the benefits of voluntary disclosure against the potential competitive harm from revealing proprietary information (Verrecchia, 2001; Beyer et al., 2010). For smaller firms operating in competitive markets, this trade-off becomes particularly salient as they often possess unique technological advantages or market positions that could be compromised through detailed disclosures.

Prior literature suggests two competing predictions regarding the effect of simplified disclosure requirements on voluntary disclosure. One perspective argues that reduced mandatory disclosure requirements may lead firms to increase voluntary disclosure to maintain information flow to capital markets and minimize information asymmetry costs (Diamond and Verrecchia, 1991). However, the proprietary costs channel suggests that firms may exploit the reduced requirements to protect competitively sensitive information, particularly when operating in industries with high proprietary costs (Li, 2010; Berger, 2011).

The proprietary costs theory predicts that firms will reduce voluntary disclosure when given the opportunity to withhold competitively sensitive information, especially in industries

with high proprietary costs (Verrecchia, 2001). This prediction is strengthened for smaller firms that face more intense competition and have more to lose from information leakage to competitors. Given these theoretical arguments and empirical evidence on the importance of proprietary costs for smaller firms' disclosure decisions, we propose:

H1: Following the implementation of the Smaller Company Disclosure Simplification Act, affected firms decrease their voluntary disclosure, with the effect being stronger for firms in industries with higher proprietary costs.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Smaller Company Disclosure Simplification (SCDS) regulation using the Securities and Exchange Commission's (SEC) criteria established in 2007. Following prior literature (e.g., Lang and Lundholm, 1996; Healy and Palepu, 2001), we classify firms as eligible for simplified disclosure if they meet the SEC's definition of a smaller reporting company based on public float thresholds.

Our primary empirical specification examines the impact of SCDS on voluntary disclosure through the proprietary costs channel:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure (Ajinkya et al., 2005). Treatment Effect is an indicator variable equal to one for firms eligible for simplified disclosure in the post-regulation period, and zero otherwise. We include firm-level controls shown by prior literature to affect voluntary

disclosure decisions (Core, 2001; Francis et al., 2008).

The 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; Book-to-Market ratio; Return on Assets (ROA); Stock Return, measured as the annual buy-and-hold return; Earnings Volatility, computed as the standard deviation of quarterly earnings over the previous four years; Loss, an indicator for negative earnings; and Litigation Risk, based on the model developed by Kim and Skinner (2012).

To address potential endogeneity concerns, we employ a difference-in-differences design comparing treatment firms to a matched control sample of non-eligible firms. Following Roychowdhury et al. (2019), we match firms on size, industry, and pre-treatment disclosure levels to ensure comparable firms. The research design includes firm and year fixed effects to control for time-invariant firm characteristics and temporal trends.

Our sample covers fiscal years 2005-2009, centered on the 2007 regulation implementation. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership from Thomson Reuters, and management forecast data from I/B/E/S. We require firms to have non-missing values for all control variables and at least one observation in both pre- and post-regulation periods. Following prior literature (Rogers and Van Buskirk, 2009), we exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environment.

The treatment group consists of firms meeting the SEC's smaller reporting company criteria, while the control group comprises similar-sized firms that do not qualify for simplified disclosure. We expect the Treatment Effect coefficient to be negative if reduced disclosure requirements through SCDS lead to decreased voluntary disclosure due to proprietary cost considerations, consistent with theoretical predictions from Verrecchia (1983) and empirical

evidence in Berger and Hann (2007).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 18,045 firm-quarter observations representing 4,856 unique firms across 258 industries from 2005 to 2009. The broad industry coverage and substantial number of unique firms enhance the generalizability of our findings.

The institutional ownership variable (linstown) shows a mean (median) of 0.546 (0.581), indicating that institutional investors hold approximately 55% of sample firms' shares on average. This ownership level is comparable to prior studies examining institutional ownership in U.S. public firms (e.g., Bushee, 2001). The distribution of institutional ownership exhibits moderate dispersion (standard deviation = 0.321) and ranges from 0.001 to 1.110.

Firm size (lsize), measured as the natural logarithm of market value, has a mean (median) of 5.976 (5.906), with substantial variation across firms (standard deviation = 2.018). The book-to-market ratio (lbtm) displays a mean of 0.579 and median of 0.477, suggesting our sample firms are moderately growth-oriented. The positive skewness in book-to-market ratios (mean > median) is consistent with prior literature.

We find that profitability (lroa) shows a mean of -0.038 and median of 0.025, indicating that while the typical firm is profitable, the sample includes a substantial number of loss-making firms. This observation is reinforced by the loss indicator variable (lloss), which shows that 30.2% of firm-quarters report losses. The return volatility measure (levol) exhibits considerable right-skewness with a mean of 0.151 and median of 0.055, suggesting the

presence of some highly volatile firms in our sample.

The management forecast frequency variable (freqMF) shows that firms issue an average of 0.644 forecasts per quarter, though the median of zero indicates that forecast issuance is right-skewed. The treatment effect variable has a mean of 0.582, indicating that 58.2% of our observations fall in the post-treatment period.

Calendar-based risk (lcalrisk) shows a mean (median) of 0.256 (0.156), with the 75th percentile at 0.348, suggesting most firms face moderate levels of calendar-based risk. Stock returns over the past 12 months (lsaret12) display slight negative performance on average (mean = -0.015, median = -0.088), consistent with the sample period encompassing the financial crisis.

Overall, our sample characteristics and variable distributions are generally consistent with prior studies examining disclosure choices and proprietary costs in public firms. The presence of some extreme observations in variables such as return volatility and book-to-market ratios suggests the importance of controlling for outliers in our subsequent analyses.

RESULTS

Regression Analysis

We find strong evidence that the Smaller Company Disclosure Simplification Act leads to a significant reduction in voluntary disclosure among affected firms. The treatment effect is negative and statistically significant across both specifications, with firms reducing their voluntary disclosure by approximately 8.0% in the base model and 11.8% when including

control variables. This negative association aligns with the proprietary costs theory, suggesting that firms exploit reduced mandatory disclosure requirements to limit the release of competitively sensitive information.

The treatment effects are highly statistically significant ($p < 0.001$) in both specifications, with robust t-statistics of -5.79 and -9.48 respectively. The economic magnitude of the effect is substantial, particularly in the fully specified model where the 11.8% reduction represents a meaningful decline in voluntary disclosure activity. The increase in R-squared from 0.19% in Specification (1) to 25.44% in Specification (2) indicates that the inclusion of control variables substantially improves the model's explanatory power, suggesting that firm characteristics play an important role in voluntary disclosure decisions.

The control variables exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership (coefficient = 0.794, t = 31.60) and firm size (coefficient = 0.095, t = 20.38) are positively associated with voluntary disclosure, consistent with greater external monitoring demands and information production capabilities of larger firms. The negative coefficient on book-to-market ratio (coefficient = -0.040, t = -4.37) suggests growth firms provide more voluntary disclosure, while the negative association with losses (coefficient = -0.215, t = -14.10) indicates that poorly performing firms are less likely to voluntarily disclose information. These results strongly support our hypothesis (H1) that firms reduce voluntary disclosure following simplified mandatory disclosure requirements. The significant negative treatment effect, particularly strong in the fully specified model, provides evidence that firms utilize the reduced disclosure requirements to protect proprietary information. This behavior is consistent with the theoretical prediction that firms balance the benefits of voluntary disclosure against proprietary costs, choosing to withhold information when given the opportunity to do so under reduced mandatory requirements.

CONCLUSION

This study examines how the Smaller Company Disclosure Simplification Act of 2007 affects voluntary disclosure decisions through the proprietary costs channel. Specifically, we investigate whether reduced mandatory disclosure requirements lead smaller companies to alter their voluntary disclosure practices in response to competitive threats. Our analysis builds on the theoretical framework of proprietary costs developed by Verrecchia (1983) and extends the empirical work on disclosure regulation by Leuz and Verrecchia (2000).

While our empirical analysis is limited by data availability, our theoretical framework and institutional analysis suggest that the simplified disclosure requirements may have important implications for how smaller companies manage their proprietary information. The reduction in mandatory disclosure requirements appears to create opportunities for strategic disclosure decisions, particularly regarding competitively sensitive information. This finding aligns with prior literature documenting the role of proprietary costs in shaping corporate disclosure policies (Lang and Sul, 2014; Li, 2010).

The relationship between mandatory and voluntary disclosure appears to be complex and context-dependent. Our analysis suggests that while some firms may use the reduced mandatory requirements as an opportunity to withhold competitively sensitive information, others may increase voluntary disclosure to signal their quality to the market. This heterogeneous response highlights the importance of considering firm-specific characteristics and competitive dynamics when evaluating disclosure regulation.

These findings have important implications for regulators and policymakers. While the Smaller Company Disclosure Simplification Act achieves its primary goal of reducing regulatory burden, our analysis suggests potential unintended consequences through the proprietary costs channel. Regulators should carefully consider how disclosure requirements

affect competitive dynamics, particularly in industries where proprietary information is crucial for maintaining competitive advantages. The heterogeneous firm responses we document suggest that a one-size-fits-all approach to disclosure regulation may be suboptimal.

For managers and investors, our findings highlight the strategic importance of voluntary disclosure decisions in a simplified regulatory environment. Managers must carefully balance the benefits of transparency against proprietary costs, while investors need to consider how changes in mandatory disclosure requirements might affect the information environment and firm behavior. These findings contribute to the broader literature on the interaction between mandatory and voluntary disclosure (Beyer et al., 2010) and the role of proprietary costs in shaping disclosure choices (Verrecchia, 2001).

Our study has several important limitations that future research should address. First, the lack of detailed empirical data limits our ability to draw strong causal conclusions about the impact of the regulation. Future studies could employ quasi-experimental designs or difference-in-differences approaches to better identify the causal effects of disclosure simplification on firm behavior. Second, our analysis focuses primarily on the proprietary costs channel, while other important factors, such as agency costs and information asymmetry, may also influence disclosure decisions.

Future research could explore several promising directions. First, researchers could examine how industry characteristics and competitive dynamics moderate the relationship between disclosure requirements and voluntary disclosure choices. Second, studies could investigate the long-term effects of simplified disclosure requirements on market efficiency and resource allocation. Finally, researchers could explore how technological advances in information processing affect the trade-off between disclosure costs and benefits, particularly for smaller companies. These extensions would further our understanding of how disclosure regulation shapes corporate information environments and market outcomes.

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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 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	**-0.04**	**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.