Are Financial Statements Economically Efficient?

ECO 320 Assignment

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2024-03-13

Required Disclosure of Asymmetric Information in the Status Quo

Public companies are companies that have their stocks traded on an exchange like the New York Stock Exchange.The biggest benefit to being publicly traded is to raise funds from investors purchasing your stock. However, in order to be publicly traded, companies are required by law in Canada and the U.S. to regularly make information about their activities and financial status available to the public (Commission 2024). This process is known as continuous disclosure and is achieved through publishing quarterly and annual reports, like financial statements, executive compensation, and forward looking information circulars (Commission 2024). This requirement falls under the normative Hobbes Theorem where the law is structured to minimize harms caused by failures in private bargaining (Cooter and Ulen 2016, 92).

Continuous disclosure provides valuable information that investors and other stakeholders like unions, customers, and banks use to make decisions about the company in question. This information requires deliberate investment by the company to collect and organize, but companies often already have internal systems to acquire information for business decision making. This results in asymmetric information between companies and their stakeholders where companies have information readily available and stakeholders need to invest in deliberately searching for the same information. Required disclosure of this information in the status quo turns it from the property of the company into a public good, solving this asymmetry, but incurs both costs and benefits of its own.

Efficiency of Required Disclosure

Cost Savings

If it is assumed that it costs the same amount for a stakeholder to gather continuous disclosure information as the company itself already invested, then requiring disclosure saves for stakeholders the socially wasteful costs of searching for information that the company already has (Eisenberg 2003, 1611). To illustrate this, imagine that company A is negotiating a loan contract with a bank and they are not required by law to disclose any information. The bank want to know the financial information of company A so that they can be confident that their loan will be repaid with interest. If company A already has information the bank wants and believe that the information proves their financial health, increasing the chances of securing a loan, then they will share the information with the bank. This saves the bank costs of acquiring the information. On the other hand, if company A is not financially successful and believe that the information will decrease their chances of getting a loan, they will not willingly share the information, forcing the bank to spend money gathering information that company A already has, creating social inefficiency. In this case, compelling the company to publish this information by law saves the bank the cost of searching for information.

Time Savings

Outside of information gathering costs, the immediate availability of continuous disclosure information also allows faster allocation of goods to their highest-valued uses. Suppose that company B is competing for the same loan contract as company A and has higher value for the loan than company A. If the bank takes time to search for company A's financial information, the loan will remain un-allocated until the bank gathers enough information to decide which company to loan to. This is less efficient that if both companies' information were readily available because the bank can find the most efficient allocation of the loan immediately, saving the time it takes to transfer the loan to its highest value user.

Correcting Mistaken Assumptions

Previous examples have been instances where parties are negotiating a one-time contract, but companies are usually engaged with routine or continuous transactions with stakeholders. According to Kronman, “allocative efficiency is promoted by getting information of changed circumstances to the market as quickly as possible so that parties affected by the information can alter their behaviour to waste as little resources as possible” (Kronman 1978, 13). When companies are required to continuously disclose information, usually quarterly at minimum, it allows their stakeholders to quickly react to changed circumstances.

Suppose that companies are only required to disclose their financial and operational information once and not continuously. At the negotiation of an employment contract, the employees take into account the disclosed information and believe the company is financially healthy and is able to pay their salaries in the future. Some time passes and the company is no longer financially able to pay their employees, but they are not required to disclose this fact. The employee’s assumptions are now mistaken. In order for them to correct their mistaken assumption, they must gather their company’s financial information periodically which is a large cost to each employee, likely outweighing the benefits. In this scenario, it is most efficient for the company to continuously disclose their financial information, allowing employees to correct their mistaken assumptions and change behaviour by leaving the company.

Inefficiencies of Required Disclosure

Over Reliance

Over reliance on continuous disclosure information can harm stakeholders, as the requirement of disclosure can lead to inefficiency by decreasing the incentive to invest in the discovery of productive information (Eisenberg 2003, 1676). For instance, financial information can be legally manipulated to make the company seem more prosperous than it actually is. Even if the statements are audited, verified by an independent 3rd party, the manipulation can still occur to the detriment of all stakeholders (Bondarenko 2024). Stakeholders may over-rely on the validity of these statements and do nothing to verify or discover information to the contrary. This results in mistaken assumptions going uncorrected which increases the time and resources needed to move goods to their highest value users.

Conclusion

Appendix

Stakeholders

A stakeholder in a company is an individual or organization whose well being will be effected by the financial and operational health of the company. This means that they directly benefit from required disclosure where financial and operational information that they want to know are shared at no cost to them. For example, creditors who are owed money by the company want to know if the company has enough income to repay them. Other stakeholders include shareholders, suppliers, customers, employees, and unions among others.

References

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