

Mandatory Financial Disclosure by Private Corporations - An Economic Analysis

**Prepared for the OECD International Experts Meeting on Corporate
Governance of Non-listed Companies**

Istanbul, April 2005

Philip Barry

Table of Contents

| | |
|---|----|
| 1. Executive summary..... | 3 |
| 2. Introduction..... | 6 |
| 3. An assessment of the case for mandatory disclosure..... | 6 |
| 3.1 The framework..... | 6 |
| 3.2 What is the problem? | 7 |
| 3.3 Other suggested benefits of mandatory financial disclosure | 8 |
| 3.4 Have all the costs been taken into account?..... | 10 |
| 3.5 Do the overall benefits outweigh the costs? | 13 |
| 4. Conclusions..... | 15 |
| Bibliography | 16 |
| Annex 1: Reporting requirements for private companies in the G5 | 18 |
| A1.1 United States of America | 18 |
| A1.2 Japan..... | 19 |
| A1.3 Germany..... | 19 |
| A1.4 France..... | 19 |
| A1.5 United Kingdom..... | 20 |
| Annex 2: Proposed changes in New Zealand..... | 21 |
| A2.1 Current reporting requirements in New Zealand | 21 |
| A2.2 The discussion document’s proposals..... | 21 |
| Annex 3: The case for effective harmonisation with Australia | 23 |

Disclaimer and Acknowledgements

This paper has been prepared for the OECD in good faith on the basis of our analysis and the information contained in the material listed in the bibliography. Taylor Duignan Barry Ltd. hopes that the assessment provided in this paper is informative, but the readers must make their own judgments concerning its reliability.

This paper would not have been produced without the support of Foodstuffs NZ Ltd. My appreciation also goes to Greg Dwyer, Pat Duignan, Jack McFaul, Neil McKay, James Neumann, Jon Nicolaisen, Sir Geoffrey Palmer, David Pickens, Neil Quigley and John Spencer who provided valuable insights while this paper was being prepared and/or helpful comments on drafts of the paper. The paper also benefited from helpful comments from participants at the OECD meeting in Istanbul. Finally, I would like to record my special gratitude to April McKenzie, Director of International Financial Reporting at Grant Thornton International, who was very generous in helping assemble information on the regulatory regimes in the G5 countries. This paper benefited greatly from the contributions of all the people mentioned above but they bear no responsibility for the final product.

1. Executive summary

Reporting requirements for large private companies vary widely across the major industrial economies. The two largest industrialised economies, USA and Japan do not require large private companies to disclose publicly their financial accounts. On the other hand, the three other members of the G5, Germany, France and the UK require large private companies to disclose publicly their accounts. In those countries that require disclosure by private companies, alternative legal structures are often available that permit enterprises or their owners to avoid public financial disclosure, albeit at a cost in terms of the compliance or restructuring costs incurred.

This paper considers, from a first principles perspective, whether large private corporations should be required by the government to disclose publicly their financial accounts.¹ In undertaking this assessment we adopt a conventional national economic welfare perspective. In particular, we assess whether the benefits to the economy as a whole of proposals for mandatory financial disclosure by large private corporations are likely to exceed the economic costs.

The table below summarises our overall assessment of the costs and benefits of requiring large private corporations to disclose publicly their financial accounts.

Overall assessment of the costs and benefits of mandatory financial disclosure by large private corporations

| Benefits | Costs |
|------------------------------------|--|
| Reduces costs of credit | Loss of personal privacy |
| Information for other stakeholders | Loss of competitive position |
| Information for researchers | Undermining of private property rights |
| | Direct compliance costs |
| | Administrative costs |
| | Restructuring costs |

¹ In New Zealand, private corporations are not required to disclose publicly their financial accounts at present. However, the New Zealand Ministry of Economic Development (MED) has proposed in a recent discussion document, “Review of the Financial Reporting Act 1993, Part II”, that large private corporations should have to disclose publicly their financial accounts.

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

The primary benefit of mandatory disclosure is that certain creditors may have better access to information on the financial performance and position of the company. That benefit is likely to accrue largely, if not fully, to the disclosing company through, for example, lower interest rates on its loans. One would normally expect that such a benefit would be taken into account by the company when it considers whether to disclose voluntarily or not.

There may also be some benefits to other stakeholders (e.g., employees) or other interested parties (e.g. academic researchers) who may not otherwise have access to such information.

The costs of compulsory disclosure are likely to include:

- a loss of privacy, as information of a personal nature on the financial position and performance of closely held firms is made public;
- a loss of competitive position for companies that combine through a co-operative or franchise structure relative to business enterprises that are part of a single company. The individual member companies in the co-operative or franchise would be required to disclose publicly their accounts while their competitors that are part of a single consolidated company will only be required to report publicly at the consolidated level;
- undermining of private property rights. We take as a starting point that the financial information of private corporations is a private good, not a public one;
- increased direct compliance costs, including the additional costs companies incur of having to produce, have audited and file the necessary financial statements;
- the costs the government incurs in having to administer the scheme, including in recording the accounts, making them available for viewing by the public and enforcing the rules; and
- the restructuring costs that companies may incur as they seek to get around the mandatory disclosure requirements.

The restructuring costs are costs companies will incur as they seek to avoid having to incur the other costs noted above. Therefore, the restructuring costs should not be regarded as additional to the other costs noted above.

Because they are costs a company would be prepared to incur to avoid even greater costs, the restructuring costs can give a useful indication of the minimum level of overall costs that a closely-held company and its shareholders expect to incur as a result of the policy. Some large private companies have stated they will take “whatever steps are necessary”

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

to avoid any proposed regulatory changes that would make public financial reporting compulsory in New Zealand. One such company, Foodstuffs NZ Ltd, estimates the direct costs of restructuring that the group would incur to be around \$US15m to \$US30m (excluding any allowance for tax imputation credits that might be lost).² It is very difficult to see that the benefits to legitimate users of the accounts (i.e., users other than competitors) would exceed this amount. Indeed, figures from Australia indicate that the publicly stored accounts of large private corporations are only accessed around 3 to 4 times per year on average.³

Overall, in our assessment, the benefits of introducing a regime of mandatory financial reporting for private companies are unlikely to outweigh the costs. The costs of the proposal for mandatory public reporting for large private companies appear to be relatively large and definitive. The benefits on the other hand are either likely to be contracted for voluntarily or are likely to be minor. Indeed, given the absence of significant externalities, if the benefits of disclosure did outweigh the costs, it is likely that companies would disclose voluntarily their accounts (as companies often do for substantial creditors).

In conclusion, in our view countries should be cautious about changing their regulatory regimes to mandate financial disclosure by private companies. Some countries, principally the European members of the OECD have a tradition of requiring such disclosure. However, in those countries alternative institutional or business forms are likely to have evolved that permit private enterprises and/or their owners to avoid public financial disclosure where they value such privacy highly enough. Where a country does not have a history of requiring public disclosure by large private corporations, the analysis in this paper suggests that such countries should treat with caution any proposals to change their regimes and compel private companies to file their financial statements publicly.

If change in the regulatory regime is required, one option is that disclosure be mandated but with shareholders of private corporations having the ability to vote for the company opting out of having to disclose publicly its accounts. This “opting-out” proposal would permit companies to avoid having to incur the costs of mandatory disclosure noted above, and leaves it in shareholders’ hands to decide ultimately whether their companies’ accounts are in the public domain.

² The combined turnovers of the member companies of the Foodstuffs Group make them the 2nd largest trading group in New Zealand.

³ MED (2004), p. 56. Australian legislation (the Corporations Act 2001) requires that large proprietary companies file audited financial statements with the Australian Securities and Investments Commission.

2. Introduction

This paper provides, from a first principles perspective, an analysis of whether large private companies should be required to disclose publicly their financial accounts.⁴

In this assessment we take a national interest perspective, applying the tools of conventional welfare economics to assess whether it is likely to be in the national economic interest to mandate financial disclosure by private companies. Our analysis draws in particular on the insights from institutional economics, transactions costs economics, public economics, public choice theory and the relevant empirical literature.

This paper begins by presenting a conventional framework for analysing public policy. The next section applies this framework to the issue of whether governments should require private companies to file publicly their financial reports. In particular, we focus on the nature of the problem that proposals to make filing by private companies mandatory seek to address, the costs and benefits of the proposed policy and whether the costs of the proposal are likely to outweigh the benefits. The final section of the paper provides our overall conclusions. Annex 1 to the paper summarises the reporting requirements for large private corporations in the G5 countries. Annex 2 describes the current requirements for reporting in New Zealand and the changes to that reporting regime proposed in a recent New Zealand government discussion document. The third Annex provides an examination of the case for harmonising New Zealand's reporting regime for private companies with that of Australia.

3. An assessment of the case for mandatory disclosure

3.1 The framework

This paper considers whether large private corporations should be required by government regulation to disclose publicly their financial accounts. In undertaking this assessment we adopt a conventional national economic welfare perspective. In particular, we assess, from a first principles perspective, whether the benefits to the economy as a whole of proposals for mandatory financial disclosure by large private corporations are likely to exceed the economic costs.

A good summary of the key steps in the analysis and design of public policy is provided in the public policy guidelines issued by the New Zealand Ministry of Economic Development.⁵ These guidelines state that “best practice” design public policy should be based on:

⁴ The definitions used for “large” for private corporations differ across countries. For those G5 countries which apply a simple definition for financial disclosure purposes, a company is defined as “large” if its sales are greater than around \$US10m, assets are greater than around \$US5m and it has more than 50 employees (with a two out of three test applied). Refer Annexes 1 and 2 for more details on individual country's definitions.

⁵ Refer MED (1999).

Mandatory Financial Disclosure By Private Corporations
- An Economic Analysis

- a) identifying clearly the nature and magnitude of the problem and the need for government action;
- b) identifying the public policy objective(s);
- c) identifying the feasible options (regulatory and/or non regulatory) that may constitute viable means for achieving the desired objectives(s);
- d) assessing the net benefit of the proposal, including the total regulatory costs (administrative, compliance, and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options; and
- e) undertaking appropriate consultation on the proposal.

We apply this framework for public policy analysis in our assessment of proposals to make reporting by large private corporations mandatory.

3.2 What is the problem?

As noted above, the first step in public policy analysis is identifying clearly the problem that needs to be addressed. Without this first critical step being undertaken carefully and rigorously, the subsequent policy analysis can go off the rails: one can be left, at the end of the process, with “a solution in search of a problem.”

In the case of a proposal for mandatory disclosure by private companies, it is not clear what problem such a proposal is seeking to address. The case provided for mandatory filing rests typically on the assessed interests of other stakeholders who are seen to face an “asymmetry of information” without mandatory disclosure.⁶ It might be suggested that such asymmetry of information reflects a “market failure” that justifies government intervention. However:

- information on the financial affairs of a closely-held company is a private, not a public, good;
- just because there may be others who could benefit from access to a private good doesn't mean the government should dictate that these others should have access to it at no charge. Many people have holiday homes around the country that are little utilised and which, no doubt, others could benefit from if they could access them. However, the government doesn't attempt to weigh up the costs and benefits to the different potential users of their having access to these homes. Nor does the government mandate public access to these assets;

⁶ MED (2004) p.34.

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

- there are private solutions to information asymmetry. The costs of not disclosing financial information for a company are likely to be largely, if not fully, borne by the company itself. For example, Myers and Majluf (1984) show that when insiders know more about a firm's prospects than outside investors, securities can be "lemons" so that firms can only issue new securities by offering them at a discount. If a closely controlled company doesn't supply the information that creditors want, the company either won't get the credit or will have to pay a higher price for it. Indeed, banks will often require from borrowers much more detailed and timely information (e.g., monthly financial reports on specified financial ratios) than is required by statute. If a company refused to supply such information to the lender, it would have to finance its investment opportunities in other ways.

Even if there is some remaining "market failure" (or "incomplete contracting"), this doesn't automatically justify government intervention.⁷ The costs of government intervention need to be assessed against the cost of not intervening. Such an assessment involves a comparison of the costs of contracting via the market with the costs of collective action via the government. That is, it involves assessing whether the costs of voluntary contracting to address the perceived "information asymmetries" are greater or less than the costs of coercive "contracting" (i.e., government intervention). As is discussed below, in the case of disclosure of financial information by closely-held corporations, it seems unlikely that the costs of voluntary contracting would typically be large. The main beneficiaries of mandatory financial disclosure by large private firms are likely to be relatively few in number, being certain creditors and competitors.⁸ ⁹ Further, as is discussed below, the benefits of mandatory disclosure for creditors are unlikely to be large, as creditors always have the option of not lending if the company won't voluntarily disclose the required information. However, the costs of the proposed government intervention may be large (as is discussed in section 3.4 below).

3.3 Other suggested benefits of mandatory financial disclosure

Several other arguments are sometimes put forward for justifying mandatory public filing by large private corporations. These arguments are addressed below.

⁷ For a good discussion of the fallacies of applying a simple market failure analysis in the case of financial reporting refer Leftwich (1980).

⁸ Our assertion that the users of the accounts of large private corporations are likely to be relatively few is supported by the evidence from Australia. In Australia, where large private corporations must disclose their accounts, the information is typically accessed only three or four times per year on average (MED, 2004, p.56).

⁹ If there are only few users of the accounts of large private corporations, the obvious question is why couldn't those users either jointly or separately contract with the company to provide the desired information? As is noted above, creditors do in fact often contract for disclosure of financial information. In the case of competitors, the reason such contracting does not generally occur is most likely because the costs to the disclosing firm of providing the information are large.

Mandatory Financial Disclosure By Private Corporations
- An Economic Analysis

1. **Entity Neutrality:** it is sometimes claimed that because publicly listed companies must disclose their financial statements then large private corporations should have to do so also. This is seen by some as promoting a ‘level playing field’ between different organisational types (or what is claimed by some as promoting “entity” or “competitive” neutrality).

There is a very good case for government policy not distorting businesses’ choice of organisational form (and other business decisions) through its taxation, regulation or other policies. However, it is a misunderstanding of the concept of competitive neutrality to argue that because one enterprise chooses to operate under one set of rules or in one particular organisational form, all other enterprises should have to do so also. When a company voluntarily chooses to list on the stock exchange, it inevitably accepts certain costs, one of which is the requirement to publish its financial statements. It doesn’t follow that other enterprises which do not choose to operate as publicly listed companies should therefore be required to incur the full costs of listing also. That would be akin to saying that because one football team chooses to go on the field with an extra striker, and one less defender, the other team should be required to have one less defender also.

Paradoxically, a quest for “entity neutrality” between public and private companies in terms of financial reporting would in fact generate a new “non-neutrality” between different forms of enterprises. As is discussed in section 3.4 below, the owners of co-operative enterprises and franchises will be put at a serious competitive disadvantage relative to their “single-company” competitors.

2. **Economic significance:** it is sometimes suggested the “economic size or economic footprint” of an enterprise should determine whether an enterprise should have to report publicly. The argument is that because a large enterprise affects many people, the people it affects have a right to access the financial information of the enterprise.

Size is one consideration in determining the case for mandatory public disclosure but it is not clear it is a sufficient or even a key consideration in determining the appropriate degree of public financial disclosure by an entity. Size is relevant to the extent that it influences the relative costs of compiling reports to the required standards. But it is an enterprise’s choice of corporate form, and in particular the nature and dispersion of the shareholding, not the size of the enterprise per se that is the principal determinant of whether financial reports should have to be public or not. If the overall regulatory framework is right – and in particular if the government has confidence in its overall competition policy – then there is no obvious reason to be concerned with the size of an enterprise. Just because one or many outsiders have an interest in the financial position of the company doesn’t give those outsiders an automatic right of access to the financial records of the enterprise.

3. **Limited liability as a privilege.** It is argued by some that “limited liability is a privilege and one of the costs of that privilege should be disclosing the information necessary to make objective assessments about the company, particularly financial reports”.¹⁰

This argument is flawed. As the New Zealand Business Roundtable has noted, “...limited liability is not a privilege. It is simply an implicit contractual arrangement and existed under common law before company statutes were created.”¹¹ Anyone trading with XYZ Limited knows that those who put money into it do not have a general legal liability beyond the funds invested. That is what “limited” means. The limited liability regime has proved to be a hugely successful institution that is of great benefit to all participants in the economy and to the nation as a whole.¹²

Overall, as Benston points out when assessing the claimed benefits of mandatory financial reporting, there is usually no attempt to examine rigorously what the real benefits are and to put a value on them.¹³ General purpose financial reports typically are unlikely to provide sufficiently useful and timely information to external stakeholders to warrant mandatory filing. Further, mandatory disclosure can actually lead to the disclosure of financial information that can be misleading or can suppress information that may otherwise have been provided voluntarily. An example of the former can be where companies report asset values at “fair value”, when “fair values” must be derived from estimates rather than actual market values. An example of the latter is that the SEC previously prohibited the inclusion of forecast financial information in prospectuses.

3.4 Have all the costs been taken into account?

Discussions of the costs of mandatory financial disclosure tend to focus on the direct compliance costs (i.e., the costs of producing, auditing and filing financial reports). While important, these direct compliance costs are likely to be dwarfed by the broader economic costs of mandatory disclosure.

These economic costs include potential competitiveness costs; the broader costs to the economy associated with a taking of private property rights; and the cost arising from the loss of personal privacy. These costs are likely to be reflected in the restructuring costs private companies are prepared to incur to avoid having to disclose their financial accounts.¹⁴

¹⁰ MED (2004), p.54.

¹¹ Day B. (2002).

¹² Epstein (1995).

¹³ Refer Benston (1977) and (2003).

¹⁴ In the US, following the passage of the Sarbanes-Oxley Act of 2002 with its increased disclosure and related internal-control requirements, the number of companies that have decided to “go dark” (i.e. cease filing their accounts with the SEC by deregistering their securities) has increased significantly. Refer Leuz, Triantis and Wang (2005).

i. the competitiveness implications for certain business structures

Requiring private companies to disclose publicly their financial statements could result in a loss of competitive position for companies that combine through a co-operative or franchise structure relative to business enterprises that are part of a single company. This is because the individual member companies in the co-operative or franchise would be required to disclose publicly their accounts while their competitors that are part of a single consolidated company are required only to report publicly at the consolidated level.

A good example of these competitive consequences is provided by the retail food sector in New Zealand. Currently the retail food sector in New Zealand is dominated by two groups, the Foodstuffs group (a co-operative) and Progressive Enterprise Ltd (an Australian-owned company). Together these two groups account for almost 100% of supermarket sales. Currently Progressive (as an overseas-owned company) is required to file publicly its accounts at the consolidated level, while the Foodstuffs co-operative group publicly issues reports at a broadly similar aggregate level.¹⁵ Neither Progressive nor Foodstuffs is currently required to disclose the financial performance of their individual supermarkets.

If private companies were required to disclose their accounts, the individual supermarkets in the Foodstuffs co-operative group would be required to release publicly their financial statements. This is because, within the co-operative, the individual supermarkets are separate companies each of which owns shares in the co-operative group.¹⁶ However, Foodstuffs's sole major competitor, Progressive, would still be required only to disclose its accounts at the group (consolidated) level. As a result, Progressive would have access to information on the financial performance and position of individual supermarkets in the Foodstuffs group. This could permit Progressive, if it chose, to single out those Foodstuffs supermarkets most vulnerable to attack. Foodstuffs, however, would not have access to the accounts of the individual supermarket business units of its competitor.

Similar, seemingly perverse competitive effects could arise with franchise arrangements. In the fast-food market in New Zealand, for example, a number of companies that report at the group level compete with franchisees. For example, the publicly listed Restaurant Brands NZ Ltd that operates the Kentucky Fried, Pizza Hut

¹⁵ The Foodstuffs group is comprised of three member companies, Foodstuffs (Auckland) Ltd, Foodstuffs (Wellington) Co-operative Society Ltd. and Foodstuffs (South Island) Ltd. and the umbrella national organisation Foodstuffs (N.Z.) Ltd. Currently the three regional Foodstuffs co-operatives publicly file their accounts).

¹⁶ The individual Foodstuffs supermarkets are almost without exception family companies comprising only one or two shareholders and are therefore not required to disclose publicly their financial accounts at present. Under s3(2) of New Zealand's Securities Act, an offer of securities made to relatives or close business associates of the issuer does not constitute an offer of securities to the public. Further, under s6 of the Financial Reporting Act, companies with less than 25 shareholders are not deemed to be "issuers" of equity securities.

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

and Starbucks Coffee outlets competes with the individual, independently owned franchisees in the McDonald's chain. These individual McDonald franchisees could have to report publicly their financial position, while their local competitors that are part of the Restaurant Brands company would not.¹⁷ Similarly, in the retail "do-it-yourself" (DIY) market in New Zealand, the individual, independently owned and operated Mitre 10 stores may have to file their accounts while the stores owned by their "single-company" competitor, Bunnings, would not have to (except at the national level).

As can be seen from the above examples, requiring large private companies to disclose their financial statements would disadvantage the combining of individual enterprises through a co-operative or franchise structure and advantage the alternative of a number of enterprises being wholly owned since the latter business structure is not required to release financial information except at the consolidated level. As a result, an attempt to achieve "entity neutrality" between public and private companies will end up undermining neutrality between separately-owned and wholly-owned business structures. It is not clear what policy reason there would be for favouring the former form of "neutrality" over the latter. Our conclusion is that the concept of entity neutrality as applied in this context is fundamentally flawed.

ii. **the lack of regard for private property rights**

The importance of secure private rights for economic prosperity is emphasised by such institutions as the World Bank and the International Monetary Fund and in contemporary economic literature.¹⁸ Indeed, arguably the most important protection afforded to the individual by the law is the protection of his or her property (broadly defined).

The financial accounts of closely-held companies are private property. Proposals to require large private corporations to disclose their accounts seem to pay little or no attention to this consideration. Instead, it is proposed that regulations be passed to remove the private property rights in the "national interest", with no suggestion of compensation and quite insufficient analysis of the whether the so-called benefits outweigh the costs.

iii. **privacy costs**

The loss of personal privacy if their companies have to make their financial accounts public is typically a major issue for owners of closely-held corporations. Often private companies are family-owned and may be a single husband and wife team. Further, such family-owned businesses can be located in smaller cities and towns where they may be the largest business in the city/town. In such smaller communities, the consequence of a loss of personal privacy can be especially large.

¹⁷ Whether the individual McDonald franchisees would have to disclose would depend on their size: under the proposed reporting thresholds, only the largest franchisees would be likely to have to file their accounts.

¹⁸ See, for example, Landes, D (1998), North D (1990) and Olsen (2000).

iv. incentives to restructure

Where a regulation imposes costs on a company, the business will naturally have an incentive to take steps to minimise or avoid the effects of the regulations. In the case of mandatory financial reporting for large private corporations, the costs noted above are likely to be large, especially for some companies, and these companies will face strong incentives to restructure their operations in a way to try and avoid the effects of the regulations.

One large privately owned company, Foodstuffs NZ Ltd. has estimated it will cost them between around \$US15m and \$30m to restructure their organisation to avoid the consequences of government proposals to make financial disclosure mandatory. This estimate does not include an allowance for taxation consequences (imputation credits that may be lost by the individual companies). Nor does the estimate include an allowance for the losses in business efficiency that may result from the changes to Foodstuffs' business model that are required to avoid the proposed legislation.

The restructuring costs are a deadweight loss to the economy. They reflect an expenditure of resources that is incurred simply as a result of the regulations. It should be noted, however, that the costs that are incurred to avoid the consequences of regulations are not additional to the other costs of the regulations noted elsewhere in this paper. The restructuring costs are incurred to avoid companies facing these other costs (like a loss of privacy) and therefore to the extent the company is successful in achieving its aim, the other costs will not be incurred.

Because restructuring costs are costs a company is prepared to incur to avoid even greater costs, restructuring costs can give a useful indication of the minimum level of costs that a company expects to incur as a result of the policy. Foodstuffs have advised us that they will take “whatever steps are necessary” to avoid the proposed financial reporting regime (largely to avoid the loss of competitive position and to avoid the loss of privacy for the owners of the individual supermarkets). The \$US15m to \$US30m restructuring costs Foodstuffs is prepared to incur, therefore, gives an indication of the possible magnitude of the costs the proposed policy change would impose on one large private New Zealand company.

3.5 Do the overall benefits outweigh the costs?

The table below provides our assessment of the overall likely costs and benefits of the proposal to require large private companies to disclose their financial statements.

**Overall benefits and costs of mandatory
financial disclosure by large private corporations**

| Benefits | Costs |
|------------------------------------|--|
| Reduces costs of credit | Loss of personal privacy |
| Information for other stakeholders | Loss of competitive position |
| Information for researchers | Undermining of private property rights |
| | Direct compliance costs |
| | Administrative costs |
| | Restructuring costs |

The costs of the proposal have been discussed in section 3.4 above and that discussion is not repeated here.

The principal benefit of mandatory financial disclosure is that other stakeholders or interested parties will have access to the information. Considering each of the principal parties in turn:

- in the case of creditors, economic theory indicates (as noted in section 3.2 above) that the benefits, if any, are likely to be largely, if not fully, captured by the disclosing company. Further, creditors may well require more timely and detailed information than is available from annual financial reports;
- in the case of competitors, providing them access to otherwise commercially confidential information is likely to be detrimental rather than beneficial to the economy as a whole;
- in the case of employees of the large private company or other groups who are not able to contract for the information, the benefits are likely to be small, if any. Indeed, employees of the company may be worse off if public disclosure of the accounts undermines the competitive position of their employer; and
- there are likely to be benefits, albeit relatively minor to some researchers (e.g., academics) and the users of their research.

The other claimed benefits from mandating disclosure for private companies have been considered in section 3.3 above. They are not found to provide a compelling case for mandatory disclosure.

Overall, on the basis of our analysis it seems difficult to conclude in this case that the benefits of intervention outweigh the costs. The costs of the proposal for mandatory public reporting for large private companies are substantial and definitive. The costs include the loss of personal privacy, the loss of competitive position, the undermining of private property rights, and the increased compliance costs the companies are likely to incur. The benefits on the other hand are either likely to be contracted for voluntarily or are likely to be minor. Indeed, given the absence of significant externalities,¹⁹ if the benefits of disclosure did outweigh the costs, it is likely that companies would already disclose their accounts (as companies often do for substantial creditors). The fact that the companies don't choose to disclose publicly their accounts suggests that the costs to the companies of disclosing publicly their accounts exceed the likely benefits.

4. Conclusions

The analysis provided in this report indicates that introducing a requirement that large private corporations must disclose publicly their financial statements is unlikely to achieve an appropriate balance between the costs and benefits. Requiring large private corporations to disclose publicly their accounts is likely to impose definitive and significant costs, while the benefits of the proposal are unclear.

The costs arise from the adverse consequences for personal privacy, the lack of commercial confidentiality, the loss of personal property rights and the increased direct costs companies will incur from having to comply (and/or the costs they will incur seeking to avoid the regulations). The benefits, on the other hand, of disclosing more information are likely to accrue largely, if not almost completely, to the disclosing company. Those benefits would be expected to be taken into account by the company in its own consideration of what information it chooses voluntarily to disclose and to whom.

The regulatory requirements for financial reporting by large private companies vary widely amongst OECD countries. In those countries that have a tradition of requiring disclosure, alternative institutional or business forms are likely to have evolved that permit private enterprises and/or their owners to avoid public financial disclosure where they value such privacy highly enough. However, in countries that do not have a history of requiring public disclosure by large private corporations, the analysis in this paper suggests that such countries should treat with caution any proposals to change their regimes and compel private companies to file their financial statements publicly.

¹⁹ As is noted in section 3.2 above, economic theory indicates that the costs of not disclosing are likely to be borne primarily by the company itself. Or to put it another way, the costs of voluntary contracting to get around the perceived "externalities" do not appear to be great.

Bibliography

ARNOLD T, BOLES DE BOER D and EVANS L (2003), “The Structure of New Zealand Industry”, in *Competition Law at the Turn of the Century: a New Zealand Perspective*, edited by Mark N Berry and Lewis T Evans, Wellington.

BARRY N (1999), *Anglo-American Capitalism and the Ethics of Business*, New Zealand Business Roundtable, Wellington.

BENSTON G (1977), “An appraisal of the costs and benefits of government-required disclosure: SEC and FTC requirements”, *Journal of Law and Contemporary Problems*, Vol. 41 No.3 pp 30 – 62.

BENSTON G (1980), “The Establishment and Enforcement of Accounting Standards: Methods, Benefits and Costs”, *Journal of Accounting and Business Research*, Vol. 11 No. 41 pp 51-60.

BENSTON G (2003), “The Quality of Corporate Financial Statements and Their Auditors before and after Enron”, *Policy Analysis*, No. 497, pp 1-29.

DAY, B (2002), “Limited liability: a vital business institution” *New Zealand Business Roundtable Perspectives No. 31*, Wellington.

DEMSETZ H (1968), “The costs of contracting”, *Quarterly Journal of Economics*, 82, 33-53.

EPSTEIN R (1995), *Simple Rules for a Complex World*, Harvard University Press, Cambridge.

EPSTEIN R (2004), *Takings, Givings and Bargains: Multiple Challenges to Limited Government*, New Zealand Business Roundtable, Wellington.

LANDES D (1998), *The Wealth and Poverty of Nations*, Basic Books, New York.

LEFTWICH R (1980), “Market Failure Fallacies and Accounting Information”, *Journal of Accounting and Economics*, 2, pp 193-211.

LEUZ C, TRIANTIS A and WANG T (2004) “ Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations”, <http://www.fma.org/Siena/Papers/140173.pdf>

MANNE H (1974), Economic Aspects of Required Disclosure Under Federal Securities Laws, in Manne, H et al.(eds.), *Wall Street in Transition*, New York University Press, New York.

MINISTRY of ECONOMIC DEVELOPMENT (1999), *A Guide to Preparing Regulatory Impact Statements*”, <http://www.med.govt.nz/buslt/compliance/risbccc/regimpact/index.html>

MINISTRY of ECONOMIC DEVELOPMENT (2004), *Review of the Financial Reporting Act 1993 Part II*, Wellington.

MYDDELTON D.R. (1995), “Accountants Without Standards?” *Hobart Paper 128*, Institute of Economic Affairs, London.

Mandatory Financial Disclosure By Private Corporations
- An Economic Analysis

MYERS S and N MAJLUF (1984), “Corporate Financing and Investment Decisions when Firms have Information the Investors Do Not Have”, *Journal of Financial Economics* 13, 187-221.

NEW ZEALAND BUSINESS ROUNDTABLE (1992), “*Financial Reporting Bill*”, Submission to the Government, Wellington.

NORTH D (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge.

OLSON M (2000), *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, Basic Books, New York, p. 195.

PARLIAMENTARY JOINT STATUTORY COMMITTEE ON CORPORATIONS AND SECURITIES (2001), *Report on Aspects of the Regulation of Proprietary Companies*, http://www.aph.gov.au/Senate/committee/corporations_ctte/propcom/report/report.pdf

QUIGLEY N (2003), “Commercial Law and Regulation: Harmonisation vs Competition” in *Competition and Regulation Times*, New Zealand Institute for the Study of Competition and Regulation, Wellington.

Annex 1: Reporting requirements for private companies in the G5

This Annex summarises the financial reporting requirements for non-listed companies in the G5 countries (USA, Japan, Germany, France, UK). While best endeavours have been made to ensure the accuracy of the summary material provided in this paper, the reporting requirements in individual countries are multifaceted and can be complex. Further, within federal countries, the reporting requirements can vary from state to state.

A1.1 United States of America

In the USA there is no federal statutory requirement for private corporations to have their accounts audited or to make their accounts public.

Issuing companies (i.e., companies who issue to the public securities that are registered under the Securities Exchange Act, 1934) are required to file publicly their audited accounts with the Securities and Exchange Commission (SEC). Further, all companies with more than 500 equity security holders of record and more than \$10m in assets, regardless of whether they have ever “gone public” (i.e., had their securities registered under the Securities Exchange Act), have to file their accounts with the SEC. In addition, companies which de-register but still have 300 security holders of record or more must continue to file with the SEC.²⁰

Every state also has its own securities laws—commonly known as “Blue Sky Laws”. These regulations are extensive and require registration of securities offerings, and registration of brokers and brokerage firms. The exact laws vary from state to state with each state having its own regulatory agency, typically known as the state Securities Commissioner, which administers the law.²¹ As best we have been able to ascertain, there is no requirement at the state level for audit or disclosure of financial statements for private companies. Individual states would be unlikely to require disclosure as it would not be difficult for companies to migrate their place of incorporation to states that have a favourable regulatory environment.

In addition to the federal and state legislative requirements, where a company’s securities are listed on an exchange or market, that exchange or market can impose its own listing requirements. Thus, for example, both the NYSE and NASDAQ require securities listed on their respective exchanges to be registered under the Securities Act (and therefore for the company to file its accounts publicly). Companies whose securities trade on the “Over the Counter Bulletin Board” (OTCBB) are also required to file their accounts with the SEC. However, companies whose securities trade through other systems such as the

²⁰ For further information on the SEC requirements, refer to <http://www.sec.gov/about.shtml> and http://www.sia.com/capitol_hill/html/securities_act_of_1933.html.

²¹ For more information refer www.seclaw.com/bluesky.htm.

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

“Pink Sheets” (a daily publication compiled by the National Quotation Bureau containing price quotations for over-the-counter stocks) are typically not required to be subject to SEC reporting requirements and do not have to file publicly their financial statements.

A1.2 Japan

In Japan, public disclosure of financial statements is not required for private companies.

Large private companies are required by the Japanese commercial code (law) to have their accounts audited by an independent auditor. A company is defined as large if has stock capital over 500 million yen or total liabilities exceeding 20 billion yen. Audited reports must be included in the agenda for the ordinary meeting of shareholders. The ordinary meeting should be held within three months of the company’s balance sheet date.

A1.3 Germany

In Germany, large private corporations are required by law to file their financial statements with the commercial register where the company is incorporated. The financial statements are then publicly available.

Audit requirements depend on the size of the company. A company’s financial statements have to be audited if two or more of the following three criteria apply. The criteria are if the company has:

- sales exceeding around €8m;
- total assets exceeding around €4m;
- more than 50 employees.

The company has to prepare consolidated financial statements if its consolidated sales exceed around €38m, its consolidated total assets exceed around €19m and the consolidated companies have more than 250 employees. If two of the three before mentioned criteria are met, the consolidated financial statements have to be audited.

A1.4 France

In France, all companies have to publish their statutory financial statements, their consolidated financial statements and their management report. The statements have to be publicly available after each annual general shareholders’ meeting. The accounts have to be available to anybody who requires them and who asks for them at a specific “desk” of the commercial court.

Whether a company has to have an external audit depends on the legal form of the enterprise and its size:

Mandatory Financial Disclosure By Private Corporations - An Economic Analysis

- enterprises with the legal form SA (Société Anonyme), SCA (Société en Commandite par Actions) and SAS (Société par Actions Simplifiée) must have a statutory auditor, regardless of their size;
- enterprises with the legal form SARL (Société à Responsabilité Limitée) only need a statutory audit if their numbers (during the two preceding years) are higher than total balance sheet of €1.55m, turnover of €3.1m and people 50.

All these enterprise forms can be private or public companies.

A1.5 United Kingdom

All limited liability companies in the UK are required to disclose publicly at least some financial statements. The accounts have to be filed with the Registrar of Companies.²²

Large private British companies are required to disclose publicly their financial accounts. Generally these accounts must include:

- a profit and loss account;
- a balance sheet signed by a director;
- an auditors' report signed by the auditor;
- a directors' report signed by a director or the secretary of the company;
- notes to the accounts; and
- group accounts (if appropriate).

For smaller companies, these accounts may be in abbreviated form (basically just a balance sheet) and the accounts need not be audited. However, they are still on public record. The criteria for 'small' company exemption, set out in the Companies Act, is 2 of the following 3 criteria:

- turnover less than £5.6m;
- net assets less than £2.8m;
- no more than 50 employees.

Companies which are public companies, carrying on regulated activities under the Financial Services and Markets Act 2000, trade unions or a parent or subsidiary (unless part of an eligible group) must have their accounts audited.

The most common large organisations that don't have to publish financial information are partnerships, such as accountants and lawyers. However, other legal forms are available which may permit people to avoid having to disclose their private finances. These legal forms include family or trading trusts and privately held groups with offshore intermediate holding companies.

²² For detailed information on UK filing and auditing requirements refer <http://www.companieshouse.gov.uk>

Annex 2: Proposed changes in New Zealand

This annex summarises the current financial reporting requirements for companies in New Zealand and outlines proposals in a recent discussion document issued by the New Zealand Ministry of Economic Development that “large” private companies be required by the government to file publicly audited financial accounts.²³

A2.1 Current reporting requirements in New Zealand

Currently, under New Zealand’s Financial Reporting Act 1993 (“FRA”), only “issuers”, “overseas-owned companies” and public sector companies are required to file publicly their financial reports.²⁴

In regard to closely-held corporations (that are neither “issuers” nor “overseas owned”), the current New Zealand legislative requirements are that they must:

- i. prepare financial statements that comply with Generally Accepted Accounting Practices (“GAAP”);²⁵ and
- ii. have audits performed, unless a unanimous shareholders’ resolution is passed (annually) that no audit is required – refer the Companies Act s196(2).

There is, therefore, no requirement for the great majority of closely-held companies to file financial statements – as noted above, the FRA limits this requirement to “issuers” and “overseas companies”.

A2.2 The discussion document’s proposals

The New Zealand Ministry of Economic Development (“MED”) is currently reviewing the FRA. As part of its review, the MED has issued a discussion document in which it is proposed that “large” private companies be required by the government to file publicly audited financial accounts.

A private company is defined as “large” if it passes a “two out of three” test. Specifically, a company is defined as large if it satisfies two of the following three criteria. That it has:

- consolidated assets of \$10 million;

²³ MED (2004).

²⁴ “Issuers” are defined in the FRA as including listed companies and any other company that has issued securities for which an investment statement or a registered prospectus is required under the Securities Act 1978. “Overseas-owned companies” are defined as companies where 25% of more of the voting rights are held by a non-resident or by a company or subsidiary of a company incorporated outside New Zealand.

²⁵ Unless the company is very small (with assets less than \$450,000 and revenue less than \$1,000,000) in which case it need only produce very basic financial reports that are not filed and, if all shareholders agree, do not have to be audited (refer FRA s2 for a complete definition of “exempt” companies).

Mandatory Financial Disclosure By Private Corporations
- An Economic Analysis

- consolidated operating revenue of \$20 million;
- 50 full time equivalent employees.

Under the discussion document's proposals, private companies that are not "large" (as per the above test) would be able to opt out of the requirement to disclose publicly their accounts or have them audited if 100% of shareholders agree. However, if one or more shareholders object to the proposal to opt out, the ("not large") private company would have to disclose its reports publicly and/or have them audited.

Companies would be able to apply for exemption from the above requirements to a reconstituted Accounting Standards Review Board (ASRB). No guidance on the criteria the reconstituted ASRB would use for providing such exemptions are provided in the discussion document.

The above proposals are stated as the MED's "preferred approach" in relation to private companies. The discussion document also includes an alternative proposal that would permit large private companies to opt out of the mandatory provision if 100% of shareholders agree (the MED's "alternative approach"). Under this alternative proposal, as for the small private companies as noted above, if one or more shareholders in a large private company object to the proposal to opt out, the private company would have to disclose its reports publicly and/or have them audited.

Annex 3: The case for effective harmonisation with Australia

Australia currently requires large private companies to file publicly their financial accounts. An argument sometimes put forward for making public reporting for large private companies mandatory in New Zealand is that New Zealand should harmonise its regime with Australia's.

The first question to consider is whether alignment between New Zealand's and Australia's reporting regimes is being sought because Australia's regime is regarded as "international best practice" or because harmonisation with Australia's regime is being sought as a goal in itself.

If Australia's reporting regime is assessed to be international best practice, then alignment with Australia may be appropriate. However, there is little evidence that the Australian regime is considered best practice. Indeed, the Australian regime was reviewed by the Australian Parliamentary Joint Statutory Committee, with the majority of the Committee recommending changing the reporting requirements so that "large" private companies did not have to disclose publicly their accounts.²⁶

Even if Australia's current regime was considered international best practice, it would be appropriate to also take into account New Zealand's particular institutional features. Two particular features that may be of importance here are that:

- New Zealand's domestic markets are relatively concentrated compared to other countries;²⁷ and
- New Zealand has a number of large enterprises that have adopted a co-operative form and a large number of assets that are held in various types of trust. For example, the agricultural industry is dominated by co-operatives and New Zealand's largest grocery retailer, Foodstuffs, is a co-operative.

With relatively few companies in many domestic markets, the effects of a regulation requiring one company to disclose its accounts at a detailed (regional level) will have a greater effect on competition than if there were more players. Likewise, a regulation that impacts particularly on co-operatives will have a significant effect in some New Zealand markets.

If, however, the objective in aligning with Australia is harmonisation, it is worthwhile reflecting on what New Zealand is seeking to achieve through harmonisation. The primary objective of harmonisation of New Zealand's business regime is generally taken to be to reduce "unjustified impediments to conducting business on a trans-Tasman

²⁶ Parliamentary Joint Statutory Committee on Corporations and Securities Report on Aspects of the Regulation of Proprietary Companies (2001).

http://www.aph.gov.au/Senate/committee/corporations_ctte/propcom/report/report.pdf

²⁷ Arnold T., Boles de Boer D. and Evans L. (2003).

Mandatory Financial Disclosure By Private Corporations
- An Economic Analysis

basis”.²⁸ The relevance of such an objective to private companies is not clear. The great majority of large New Zealand private companies are unlikely to operate in Australia. Further, by definition such large private (non-issuer) companies can only have limited shareholdings by Australians or other non-residents.²⁹ Therefore, it is difficult to see that substantial advantages could be gained from harmonisation with Australia in the case of large private corporations.

The dangers to New Zealand of “harmonisation for harmonisation’s sake” have been pointed out by Neil Quigley, Professor of Economics at Victoria University. As Quigley notes, “The harmonisation of laws may provide benefits to those firms who operate in more than one jurisdiction. But it may impose higher transaction and compliance costs on the vast majority of firms who operate only in the domestic market.”³⁰

Further, Quigley notes that there can be substantial benefits to New Zealand maintaining independence in its regulatory regime. Maintaining independent regulations permits New Zealand to achieve a competitive advantage by putting in place regulations that have lower compliance and transaction costs than those in other countries.

²⁸ MED (2004), p.52.

²⁹ As is noted in footnote 23 above, if a company has more than 25% of its voting rights held by Australians or other non-residents, it must already disclose its financial accounts.

³⁰ Quigley N. (2003).