EUROPEAN DISCLOSURE: THE COMPETITIVE DISCLOSURE HYPOTHESIS

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This article examines European financial reporting in relation to the emergent Eurobond Market. Contrary to popular belief, there apparently is a competitive value to voluntary corporate disclosure.

In the wake of increasing international business diversification, external capital financing is emerging as a dominant variable in the competitive calculus of the multinational enterprise. Confronted with limited sources of domestic capital, many financial managers have been innovative in tapping the savings of transnational investor groups. While international financing techniques have been documented in the literature, little attention has been accorded the attendant dimensions of corporate financial reporting and disclosure.

This paper describes the effects which recent financing developments in Europe have had upon the financial disclosure policy of a representative sample of leading European multinational corporations. The evidence presented herein suggests the existence of a direct relationship between improved financial disclosure and entry into the international capital markets. Contrary to popular belief, there apparently is a competitive value to voluntary corporate disclosure.

Extent of Disclosure – Contrasting Viewpoints

A subject which has long been controversial in financial circles is the question of how much financial information should be disclosed by a corporate borrower making a public issue. One viewpoint on the subject, and one typically voiced in the U.S., is that more disclosure is generally perferable to less. The consensus among some Americans is that increased disclosure helps to make the capital markets both operationally and allocationally efficient. Disclosure laws such as the U.S. Securities Acts were designed to help bring about this desired state of affairs.

An opposing argument, which has traditionally characterized the Continental European viewpoint, is that while some information about a borrowing firm has to be provided, it should be kept to an absolute minimum.

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Disclosure levels such as those attained in the U.S. are said to be not only "bothersome" but unnecessary. The remainder of this paper will show how this Continental attitude toward corporate secrecy is eroding.

Enter – The Eurodollar Bond Market

In recent years, many European companies have tapped what has become a truly international capital market for external financing. This market, which arose largely as a result of governmental controls over foreign access to a number of national capital markets,[1] has come to be known as the Eurodollar bond market.[2]

The Eurobond market is characterized by the fact that it is relatively unregulated. Since investors participate in security transactions which represent for them foreign assets, ultimate claims against enterprise-borrowers are generally made in countries outside the legal jurisdiction of the security holder. The great geographical coverage of the market, arising from the international syndication and distribution of Eurobonds, makes the concept "market of issue" quite vague. It also renders impractical attempted controls over the market. For example, who is to administer such controls and on what criteria have remained absolute imponderables.

Financial Disclosure and Entry to the Eurobond Market – A Hypothesis

In the absence of required disclosure norms,[3] it is of interest to discover whether financial reporting and disclosure were integral features of the Eurobond market's phenomenal growth. That is, has the development of the Eurobond market affected European disclosure practices? This question is especially significant in view of the secretiveness which has characterized Continental financial reporting in the past.

To answer this question, the effects of entry into the Eurobond market upon the disclosure practices of a sample of European borrowers were noted. The reason for this choice was that a firm would be expected to make its security issue relatively appealing by greater disclosure during entry in order to attract support from an audience who possessed alternative outlets for their savings. While investors within a given country typically have access to a variety of competing information sources about a particular firm, this is usually not the case in the international sphere. One might expect that increases in corporate disclosure benefit international investors. The author therefore hypothesized that Continental firms vying for access to the relatively unregulated and competitive Eurobond market would significantly increase their financial disclosure upon entry.

The Significance of Disclosure upon Entry

To test the foregoing hypothesis, a means of operationalizing the concept of increased disclosure was necessary. This was accomplished by constructing a disclosure index (see Table 1). The index contains a listing of accounting and related information about a firm and its environment deemed relevant to international investors.[4] Items selected for inclusion in the index were obtained in the following manner. Disclosure criteria were first derived from an investor decision framework. These criteria were then applied to existing disclosure indexes published in the accounting and finance literature. To give the index an international focus, the disclosure criteria were also applied to reported accounting numbers and other corporate data revealed in a sample of foreign annual reports. Minimum as well as more detailed specifications of accounting numbers and other relevant corporate data contained throughout the sampled annual reports were established for each item in the checklist.

TABLE 1

Index of Disclosure

Items of Disclosure

Narrative

1. Discussion of economic variables correlated with sales/ performance of the enterprise
2. Discussion of major industry trends
3. Discussion of other major factors tending to affect future business
4. Discussion of competitive position of the firm
5. Forecast of company performance
6. Breakdown of sales-earnings performance
    a. Consolidated group – Parent – Subsidiaries
    b. Domestic – Foreign
    c. Major product line/activity
    d. Major customer
7. Discussion of reasons for changes in current operating performance
8. List of Directors/Managers
9. Emoluments of Directors/Managers
10. Discussion of basic policies/objectives of management
11. Discussion of marketing network for finished goods/services
12. Discussion of recent acquisition – formation/spin-off activities
13. Description of major products/operating activities
14. Physical production statistics
15. Orders booked
16. Backlogs
17. Supply of raw materials

TABLE 1 (cont.)

18. Capital expenditures
    a. Past
    b. Planned
19. Recent capital market activities
20. Description of principal plants
21. Discussion of research and development activities
22. Number of employees
23. Information on labor contracts/relations
24. Social responsibility activities (i.e., environmental, etc.)
25. Number of shareholders

Financial Statements

26. Income statement
    a. Single
    b. Comparative
    c. Relevant subclassifications
27. Distribution of income schedule
28. Dividends
29. Balance sheet
    a. Single
    b. Comparative
    c. Relevant subclassifications
        1) Subclassification
        2) Method of valuation
30. Auditor's report
31. Statement of accounting principles used in statement preparation
32. Multiple language translations
33. Multiple currency translations

Supplementary Information

34. Sources and uses of funds/cash flow statement
    a. Single
    b. Comparative
35. Statement of reconciliation of earned surplus
36. Summary of important financial statistics
    a. 10 years or more
    b. 6-9 years
    c. 3-5 years

While corporate disclosure could be made via a number of alternative media, a firm's published annual report was selected as a principal means of observing changes in disclosure. The disclosure index was applied to the entire report to arrive at a "disclosure score" for a given year. That is, each company's annual report was given a numerical score which was a function of the items contained in the index which also appeared in the firm's annual report. Positive changes in disclosure scores between two successive time periods were construed as an increase in disclosure.

The population of continental European borrowers examined consisted of private industrials which entered the Eurobond market prior to July 1971. The annual reports of 14 Continental entrants from 9 different countries were then examined over a five-year interval (3 years prior to and a year subsequent to entry) to note the presence or absence of any increases in corporate disclosure.[5] The five-year interval was designed to capture any leads or lags which might characterize a company's competitive disclosure policy to the event *entry*.

To assure that any measured increases in disclosure were indeed a reflection of the event entry and not some event or variable extraneous to the research question of interest, the effects of entry on the disclosure practices of a sample of Eurobond participants were tested relative to changes in the disclosure practices of a control group of nonparticipants. Eurobond entrants and their nonparticipating counterparts were matched in terms of their relative size, industry affiliation, and national origin.[6]

Statistical tests revealed that measured disclosure changes of the Eurobond participants were significantly greater than those of the control group of nonparticipants. The sample studied thus suggests that Continental firms entering the Eurobond market significantly increase their disclosure upon entry.

Items tending to recur most frequently among the positive disclosure changes observed in the sample of Eurobond participants were:

1. Forecasts of company performance for the coming year
2. Discussion of past sales performance by geographic area
3. Discussion of capital expenditures both past and planned
4. Discussion of current research and development activities
5. Discussion of the method of translation of accounts into foreign currency equivalents
6. Provision of earnings per share statistics
7. Inclusion of sources and uses of funds/cash flow statements
8. Provision of financial and operating trend statistics

Pattern of Competitive Disclosure Response

An indication of when, during the five-year period, the competitive pressures surrounding entry tended to manifest themselves can be gleaned from the graphs in Figures 1 and 2. The vertical axis in Figure 1 represents the average *change* in the number of financial items disclosed by the sample of Eurobond participants, denoted ΔP, i.e., $\Delta P_t = P_t - P_{t-1}$ where P_t = the disclosure score assigned to a Eurobond participant's annual report in period t, P_{t-1} = the disclosure score assigned to the same company's annual report during the previous accounting period, and ΔP_t = the observed change in a Eurobond participant's disclosure score during period t. The absence of any observed changes in corporate financial disclosure would be denoted by $\Delta P = 0$. The vertical axis in Figure 2 represents the average differences (D) in disclosure scores of the Eurobond participants, ΔP, over and above that of the control group of nonparticipants $\Delta \overline{P}$, i.e., $D = \Delta P - \Delta \overline{P}$. The horizontal axis in both figures represents the annual financial reporting periods prior to and subsequent to entry. Thus, $t = -1$ represents the accounting period just prior to the year of entry, $t = 0$ represents the reporting period coinciding with the year of entry, and $t = +1$ represents the accounting period following the year of entry.

As can be seen in Figure 1, positive disclosure *changes* on the part of the Eurobond participants generally attained a peak during the year of entry, averaging 9.2 items of disclosure, then resumed a more normal pattern of change during the following year. Changes in average disclosure scores of the Eurobond participants over and above their nonparticipating counterparts demonstrated a similar pattern. It is significant that the sampled participants apparently considered successful entry of such import as to begin selective improvements in their financial communications with the investing public *prior* to entering the international capital market.

Implications

The findings presented above have rather important implications for the internationally-oriented financial executive. Foremost, and perhaps most direct, is the implication that financial disclosure appears to be an important consideration in granting firms access to the international reservoirs of consumer savings. While the subject warrants further investigation, the evidence presented here would appear to contradict the usual arguments advanced in support of management's traditional reluctance to disclose, e.g., the competitive disadvantage argument, and the cost of data accumulation argument. The observed behavior of aggressive and globally-oriented firms in search of scarce capital funds suggests that there is apparently a competitive value to voluntary disclosure improvements.[7]

FIGURE 1

Changes in Disclosure Scores of the Eurobond Participants

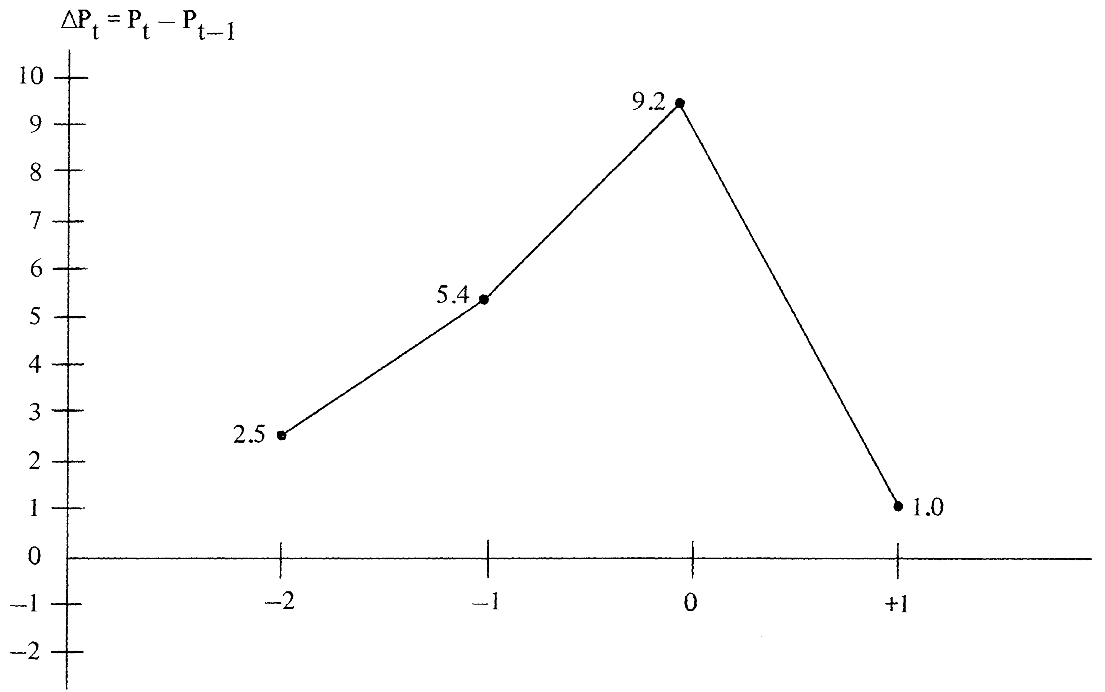
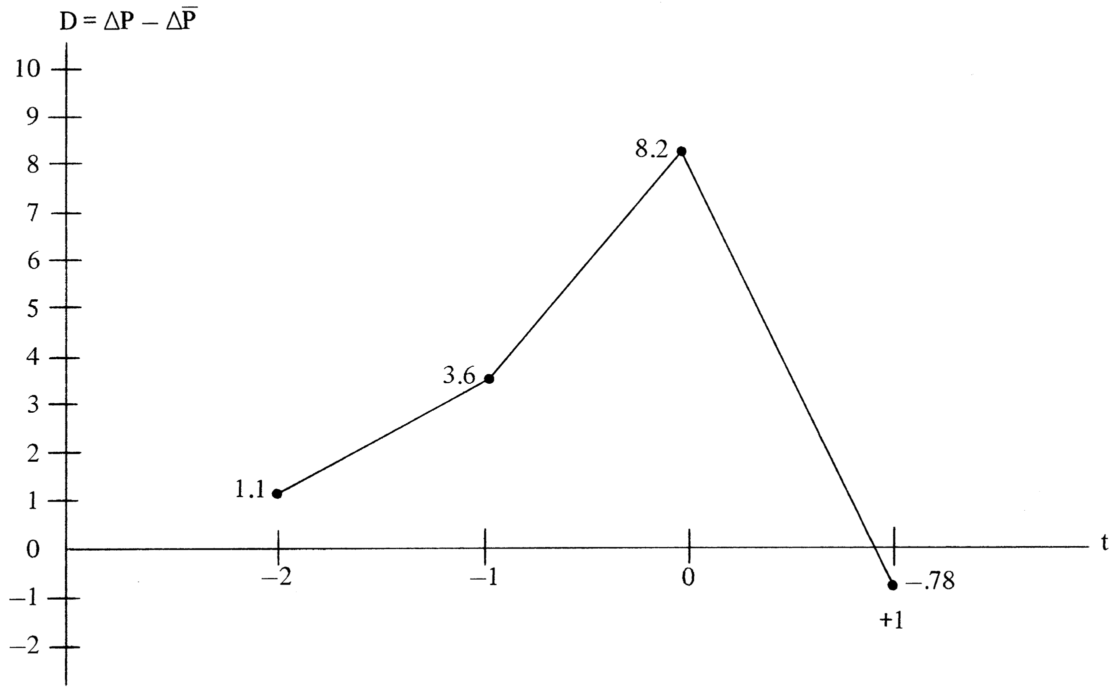


FIGURE 2

Disclosure Changes of the Eurobond Participants Over and Above Those of Their Nonparticipating Counterparts



One might speculate that this change in European disclosure attitudes was fostered by the earlier entry of progressive U.S. multinationals into the Eurobond market. Having been exposed to the higher disclosure norms of these corporations, foreign investors are now demanding better reporting practices from international borrowers. Explanations notwithstanding, it appears that disclosure is a very significant dimension of the Eurobond market. Voluntary disclosure precedents set by this market could offer valuable disclosure guides to those desirous of tapping the savings of transnational investor groups.

As multinational endeavors grow in both scope and capital intensity, particularly among the companies of the European Economic Community, competition for access to international reservoirs of money capital will no doubt intensify. While pressures for fuller disclosure from governments and professional groups continue, the evidence presented here supports the thesis that in the international sphere, at least, competition in the capital markets is emerging as the primary motivating force.[8]

Footnotes

1. Examples of precipitating factors in the Eurobond market's development were the U.S. Interest Equalization Tax and the U.S. voluntary (and subsequently mandatory) program for direct foreign investment.

2. For a more complete account of the nature and features of the Eurobond market, see Gunter Dufey, *The Eurobond Market: Function and Future* (Seattle, Washington: University of Washington Graduate School of Business Administration, 1969).

3. Legislative minima, such as the information requirements of the Securities and Exchange Commission in the U.S. or the various Companies Acts and Legislation in Europe, do not exist. Instead, there are a variety of borrowers, each having their own standards and attitudes toward disclosure. See Philip Howard, "Eurobond Disclosure," *Euromoney*, November, 1971, pp. 9-10.

4. The philosophy underlying the measurement of disclosure draws on the work of Professor Alan R. Cerf. See his *Corporate Reporting and Investment Decisions* (Berkeley, California: The University of California, 1961), pp.25-27.

5. Countries included in the sample were: Belgium, Denmark, France, Germany, Italy, The Netherlands, Norway, Sweden, and Switzerland.

6. See Frederick D. S. Choi, "Financial Disclosure and Entry to the European Capital Market," *The Journal of Accounting Research*, Autumn, 1973.

7. The benefits of improved corporate financial disclosure to a borrowing enterprise are explored in the author's article entitled, "Financial Disclosure in Relation to a Firm's Capital Costs," *Accounting and Business Research*, Autumn, 1973, pp. 272-282.

8. Jeffrey Arpan, "International Differences in Disclosure Practices," *Business Horizons*, October, 1971, p. 70.