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Investor protection under unregulated financial reporting ☆

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Abstract

We examine whether availability of higher quality financial information lessens investor losses during a period seen as a stock market crash. We focus on October 1929, which partly motivated sweeping financial reporting regulations in the 1930s. Using a sample of 540 common stocks traded on the New York Stock Exchange during October 1929, we find that the quality of firms' financial reporting increases with managers' incentives to supply higher quality financial information demanded by investors. Moreover, firms with higher quality financial reporting before October 1929 experienced smaller stock price declines during the market crash.

JEL classification: D8; G1; K2; M4; N2

Keywords: Investor protection; Voluntary disclosure; Financial reporting quality; Financial reporting regulation; Stock market crashes

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1. Introduction

One view that often emerges after a financial crisis is that investor losses would have been lower had managers chosen to supply higher quality financial reporting. Such a view surfaced in 19th-century Great Britain after periods with high business failure rates (Littleton, 1933, pp. 272–287), and in the United States after stock market downturns in October 1929 and 2000–2001 (Pecora, 1939; U.S. House, 2002). In each of these cases, this view partly motivated sweeping changes in financial reporting regulation. This regularity naturally raises the question: To what extent do managers, absent a regulatory mandate, actually supply higher quality financial reporting that mitigates investor losses during a financial crisis?

We provide U.S. evidence on this issue by testing whether shareholders of firms with higher quality financial reporting during the late 1920s suffered smaller losses in the stock market crash of October 1929.[1] Specifically, we examine two hypotheses. The first concerns the extent to which, in the absence of a regulatory mandate, managers voluntarily supply higher quality financial reporting consistent with investors' economic interests. Our second hypothesis is whether financial reporting policies selected in an unregulated reporting environment are associated with beneficial investor protection as reflected in less negative common stock returns in October 1929.

The available evidence on the association between financial reporting quality and stock returns during a market crash is sparse and based on international data. Johnson et al. (2000) find no relation between country-specific measures of accounting quality and stock market performance in the 1997–1998 East Asian crisis. Using two firm-specific proxies for accounting quality (external audit by a Big 6 auditor and U.S. ADR listing), Mitton (2002) documents a positive relation between reporting quality and firms' stock returns during the East Asian crisis. Glaeser et al. (2001) compare stock market performance in Poland and the Czech Republic after the fall of communism in 1989. Poland adopted stringent reporting regulation (along with other legal requirements for protecting shareholders) and experienced strong capital market development over 1994–1998. In contrast, over the same period, the Czech financial market was much less regulated and experienced a substantial decline in aggregate market capitalization and number of listed firms.

Our focus on U.S. firms in the 1920s offers insights beyond prior studies for three reasons. First, the 1920s' reporting environment presents considerable cross-sectional variation in financial reporting, even on very basic choices such as disclosure of revenues and operating expenses (Benston, 1969). Hence, we can develop direct firm-specific measures of voluntarily chosen reporting quality and

[1] Hong and Stein (2003, p. 487) define a stock market crash as an event characterized by an unusually large negative price movement affecting multiple securities in the absence of new information. Identifying empirically whether an event represents a crash under this or any similar definition is difficult, if not impossible (Flood and Hodrick, 1990). As a result, our tests focus on an event (October 1929) widely perceived as a market crash, but we do not test formally whether such event is a crash as defined by Hong and Stein (2003). Thus, hereafter we use the term "crash" solely to refer to events such as October 1929 that are widely *perceived* by investors and policymakers to be stock market crashes.