



# Discussion of “Is the risk of product market predation a cost of disclosure?”<sup>☆</sup>



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## ABSTRACT

Bernard (2016) proposes that financially constrained firms susceptible to “product market predation” are more likely to avoid complying with a mandatory requirement to publicly disclose financial statements. Bernard tests and finds that financially constrained private firms in Germany are less likely to disclose their financial statements despite being subject to a law requiring them to do so and interprets this evidence as consistent with predation risk affecting firms’ disclosure decisions. I discuss how Bernard’s findings advance our understanding of the incentives and disincentives for disclosure. I evaluate the theoretical rationale – i.e., product market predation – as the motive for non-disclosure as well as the strengths and weaknesses of his empirical analyses. My discussion highlights the implications of these findings for disclosure regulation, especially as it relates to small private firms. I end my discussion with suggestions for future research, including ideas to use the empirical setting identified by Bernard for answering other research questions.

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## 1. Introduction

Whether product market characteristics such as competition affect firms’ disclosure decisions is a topic of extensive research (see Core, 2001; Healy and Palepu, 2001; Verrecchia, 2001; Beyer et al., 2010 for reviews of the literature). One of the primary arguments for why firms might not voluntarily disclose all their private information is that disclosures reveal proprietary information to competitors, who might use a firm’s disclosures in a manner that disadvantages the disclosing firm in the product market. At a broad level, Bernard (2016) fits into the accounting literature on proprietary costs of disclosure. Its main contribution to this literature is that it predicts and empirically tests the proposition that information about a firm’s financing constraint is proprietary in nature because such information can be used by competitors to take advantage of, and prey on, the financially constrained firm. Bernard (2016) is a novel paper that makes a significant contribution to the disclosure literature.

Following prior research, Bernard (2016) defines product market predation as lowering prices or increasing expenditure on non-price competition (e.g., advertising) with the goal of forcing a rival to exit. To test whether predation risk affects firms’ disclosure decisions, Bernard identifies a setting in Germany where private firms are required by law to publicly disclose their financial statements. The German disclosure law was not enforced prior to 2006, leading to significant non-compliance, but in 2006, there was a sharp increase in enforcement that led to (almost) full compliance. As a result, Bernard

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is able to identify firms that exist in the economy pre-2006 yet choose to avoid disclosing their financial statements. Using this setting, Bernard finds that financially constrained firms are more likely to avoid disclosing their financial statements prior to the enforcement change in 2006. He interprets the association between financing constraints and non-disclosure as evidence consistent with predation. To support this inference, Bernard shows that the relation between financing constraints and non-disclosure is stronger among (i) smaller firms, (ii) less profitable firms, (iii) firms with a public rival and (iv) firms lacking long-term contracts. The intuition for these cross-sectional tests is that such firms are more susceptible to predation risk and thus are more likely to avoid disclosing their financial statements pre-2006. Finally, Bernard provides evidence that financially constrained firms that avoided disclosure pre-2006 lose market share post-2006. This evidence is consistent with the idea that predation occurs ex-post after firms are forced to disclose their financial statements, thereby allowing competitors to prey on them.

The big picture question of whether a firm's disclosures contain proprietary information that can lead to predation is interesting and important for several reasons. First, predation (unlike competition) is undesirable as it involves economically efficient firms exiting the market because they do not have the financial resources to sustain short-term losses from predatory pricing or advertising. Thus, predation can potentially reduce economic efficiency by lowering future competition, which is socially undesirable and in contrast to other forms of competition that promote economic efficiency (e.g., Shleifer and Vishny, 1997). As a result, it is important to understand how mandatory disclosure relates to predation risk.

Second, the evidence in Bernard suggests that forcing small, financially constrained firms to disclose their financial statements exposes such firms to predation risk by larger competitors. This inference suggests that a public disclosure mandate for small private firms can be quite costly for not only the individual firm but for the economy as a whole. Small private firms typically comprise a large percentage of firms in most countries (e.g., in the U.S., private firms account for over 95% of the number of firms, over 60% of the GDP, and a large proportion of employment; see Lisowsky and Minnis, 2015). Thus, any disclosure requirement that hinders the growth and development of small firms and helps larger firms drive smaller rivals out of business could be costly for the economy as a whole. Additional research is needed to understand the costs and benefits of forcing private firm disclosure and to further validate/measure the costs of a public disclosure requirement, such as predation risk, for small private firms.

Third, most prior disclosure research focuses on the benefits of disclosure. For example, prior research finds that disclosure helps lower the cost of capital, increases access to external finance, facilitates monitoring, and improves investment decisions. However, there is much less empirical evidence of the costs of disclosure. We need a better sense of the costs of disclosure to develop a more comprehensive understanding of why some firms are transparent and voluntarily disclose much information while other firms are relatively opaque and shy away from voluntary disclosures (despite the documented benefits). Bernard provides evidence consistent with one important cost of disclosure, but more research is needed to identify other disclosure costs as well as factors creating cross-sectional variation in disclosure costs.

Finally, the empirical setting in Bernard seems promising for examining additional questions related to voluntary disclosure. The primary features/benefits of his setting are: First, the disclosure decision leads to a large change in the amount of information publicly available about the firm. Specifically, the disclosure decision in Bernard involves disclosing the entire balance sheet and income statement while the decision to abstain from disclosing implies there is little public information about that firm. In contrast, typical voluntary disclosure studies focus on whether providing an additional management forecast or press release has economic effects in settings where there is plenty of public information even in the absence of the marginal disclosure. Second, the private firm setting allows researchers to abstract away from capital market incentives and focus on a narrower set of factors affecting firms' disclosure incentives. And third, the natural experiment that led to an increase in disclosure was determined at the European Union level and seems largely exogenous to economic conditions in Germany at that time. Given these features, Bernard's setting seems well suited for examining additional research questions related to disclosure.

Although Bernard (2016) is a welcome first step towards understanding whether predation risk affects disclosure decisions, it is important to highlight that the evidence in Bernard is indirect because of challenges in empirically measuring or identifying predation risk. Since predation risk is unobservable, Bernard is unable to directly test the relation between *predation risk* and disclosure, and instead uses the association between *financing constraints* (proxied using adjusted leverage) and disclosure to test his hypothesis.<sup>1</sup> While a negative association between financing constraints and disclosure is consistent with Bernard's hypothesis, this association might also be consistent with other interpretations if financing constraints is correlated other factors that affect firms' disclosure incentives. Bernard's empirical setting helps mitigate some of the obvious alternative interpretations of the financing constraints–disclosure association, but some alternative interpretations remain. Further, it is plausible that the relation between financing constraints and disclosure in Bernard's private firm setting has some new and atypical alternative interpretations that would not otherwise exist. For example, it is possible that highly levered firms avoid disclosing their financial statements pre-2006 not because they are concerned about predation risk; rather, it could be due to other incentives such as hiding their indebtedness from neighbors and relatives. Future

<sup>1</sup> The chain of logic embedded in Bernard's tests is: financially constrained firms are more subject to predation risk and consequently, financially constrained firms are more likely to avoid disclosure to mitigate predation risk. The maintained assumption is that predation occurs in equilibrium, which I evaluate in Section 3.

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