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Linking industry concentration to proprietary costs and disclosure: Challenges and opportunities

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ABSTRACT

Despite a substantial literature linking industry concentration, proprietary costs and disclosure, existing evidence is mixed. We discuss three challenges to the literature: lack of strong theoretical predictions, difficulty in measuring relevant aspects of industry concentration and difficulty in identifying disclosures that are likely to carry significant proprietary costs. We link each of the issues to the findings in [Ali et al. \(2014\)](#) and identify potential opportunities for future research.

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1. Introduction

The [Financial Accounting Standards Board \(FASB\) \(1991\)](#) notes that, while the costs of increased disclosure are often easier to identify, the benefits of disclosure tend to be more amorphous. (FASB, 1991) Yet, in the accounting and finance literatures, researchers have spent a great deal more effort, and have (arguably) had more success, in documenting the benefits of disclosure than its costs. Numerous papers purport to show, for example, links between disclosure, liquidity and cost of capital.¹

One criticism of the disclosure literature is that the magnitude of the implied benefits seems implausible given the lack of evidence on associated costs.² In most contexts, it is difficult to argue that the magnitude of the implied cost of capital effects would be more than offset by the direct costs of disclosure. A standard response is to invoke proprietary costs associated with disclosure, following the logic in [Verrecchia \(1983\)](#). An advantage of the proprietary cost explanation is that it has theoretical support and seems intuitively plausible. However, we know relatively little empirically about the likely prevalence and magnitude of proprietary costs in practice. While we have some notion that proprietary costs should be

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¹ For a review of the literature, see [Beyer et al. \(2010\)](#).

² For a discussion, see, for example, [Christensen \(2012\)](#).

related to, for example, industry structure, [Beyer et al. \(2010\)](#) survey the literature and conclude that, “there is no clear empirical evidence to date on how proprietary costs, as proxied by the level of competition in an industry, are related to voluntary disclosures.” (p. 306).

The notion that proprietary costs could be importantly related to disclosure levels has a long history in the literature. Most notably, [Verrecchia \(1983\)](#) demonstrates that, in the presence of proprietary costs, partial disclosure may be optimal, with the level of disclosure decreasing in the extent of proprietary costs. The existing literature has, in general, argued for a negative relation between industry concentration and disclosure and provided evidence consistent with that prediction. The typical argument is that concentrated industries are characterized by lower levels of competition which permit higher profits and, therefore, there are greater proprietary costs associated with disclosures that might jeopardize those profits. Consistent with that argument, [Harris \(1998\)](#) provides evidence that segment disclosure is less likely in concentrated industries, and [Bamber and Cheon \(1998\)](#) find that concentrated industries have a lower likelihood of issuing management earnings forecasts. Similarly, [Botosan and Harris \(2000\)](#) and [Botosan and Stanford \(2005\)](#) provide evidence suggesting a negative relation between industry concentration and disclosure based on segmental disaggregation. In general, these papers use COMPUSTAT-based measures of industry concentration in documenting the negative relation between industry concentration and disclosure.³

[Ali et al. \(2014\)](#) also provide empirical evidence of a negative relation between industry concentration and disclosure, consistent with much of the prior research. Their primary contribution is in using a more comprehensive measure of industry concentration based on U.S. Census data which includes both private and public firms. Their results are consistent across a range of disclosure measures including management forecast frequency and horizon as well as analyst disclosure rankings, forecast accuracy, dispersion and forecast revision volatility and even real economic decisions as reflected in the choice to raise capital through private placements rather than through public equity offerings. In addition, results are stronger for industries with lower financial leverage, consistent with the notion that higher financial leverage limits competitors' ability to exploit proprietary costs. Although the empirical findings in [Ali et al. \(2014\)](#) are consistent with much of the prior literature, their primary theoretical arguments with respect to competition differ. As discussed in more detail in the next section, [Ali et al. \(2014\)](#) predict greater competition in more concentrated industries based on product substitutability, but that proprietary costs are greater in more competitive industries.

We argue that there are three primary challenges to convincingly establishing the link between industry structure and disclosure: (1) developing theoretical predictions for the expected relation between industry structure and proprietary costs, (2) measuring industry structure in a way that is likely to reflect proprietary costs, and (3) capturing voluntary disclosures with a substantial proprietary component. We explore each of these challenges in general and the approaches applied to address them in the context of [Ali et al. \(2014\)](#). We conclude that, while [Ali et al. \(2014\)](#) make a substantial contribution to the literature, particularly in incorporating a more comprehensive measure of industry structure, challenges and opportunities remain in convincingly linking industry concentration to disclosure through proprietary costs.

2. Theoretical links between industry concentration and proprietary costs

Perhaps the principal challenge in this literature is in developing robust theoretical predictions for the link between industry concentration and proprietary costs. As [Ali et al. \(2014\)](#) note, there are at least three potential links between industry concentration and proprietary costs: through intensity of industry competition, innovation and information content. However, while there are theoretical reasons to expect that there might be a link between proprietary costs and industry structure, the direction of the predicted relation is more complicated.

In terms of intensity of industry competition, [Ali et al. \(2014\)](#)'s primary argument is that an observed negative relation between industry concentration and disclosure could reflect the fact that more concentrated industries are also more competitive based on the theoretical analysis in [Raith \(2003\)](#). On its face, that prediction seems surprising since a more traditional view of industry concentration is that higher levels of concentration tend to be associated with lower levels of competition.⁴ The basic argument in [Raith \(2003\)](#) is that, as competition through greater product substitutability increases, prices will fall, lowering profits and causing firms to exit the industry.

While that is an interesting argument, it is not as clear how it would tie to the link between industry concentration and disclosure. Even if more competitive industries have higher concentration, to the extent that industry concentration is associated with lower prices and profits, it is less clear that proprietary costs would be higher and, therefore, disclosure lower ([Raith \(2003\)](#) does not explicitly consider disclosure incentives). Further, papers that have explicitly modeled the relation between competition and disclosure provide differing predictions depending on the nature of the competition. For example, [Verrecchia \(1990\)](#) argues that greater competition from incumbents can lead to reduced disclosure, while

³ An exception to the general finding of a negative association between industry concentration and disclosure is [Verrecchia and Weber \(2006\)](#), who find that firms in concentrated industries are less likely to redact information from their filings relative to other firms. They argue that competition is likely to be lower in more concentrated industries, but note that theoretical predictions for the relation between competition and disclosure are mixed.

⁴ For example, the U.S. Department of Justice and Federal Trade Commission use industry concentration metrics, particularly Herfindahl–Hirschman Indices, as measures of competition under the assumption that greater industry concentration is associated with less competition (U.S. Department of Justice and Federal Trade Commission, 2010).

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