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Discretionary disclosure in the presence of dual distribution channels ☆

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A B S T R A C T

A prevailing view in the disclosure literature is that firms who learn favorable market information are reluctant to disclose it, fearing it will attract new rivals. In this paper, we demonstrate that the presence of dual distribution arrangements, wherein consumers can purchase products either from traditional retail firms or directly from suppliers, can notably alter disclosure incentives. As under prevailing views, a retailer disclosing positive news risks entry by competitors. However, entry shifts the incumbent supplier–retailer relationship: the presence of new competitors leads the supplier to treat its retailer more as a strategic partner, translating into lower wholesale prices. This, in turn, can lead the retailer to willingly share favorable news, since such disclosure invites entry precisely when the retailer stands to benefit most from price concessions. Our results suggest that as dual distribution continues to increase in prominence, firms may be more willing to voluntarily disclose sensitive financial information particularly that which points to high demand for its products.

1. Introduction

Firms are typically eager to disclose favorable financial performance to capital markets. However, concern that information will have harmful competitive consequences can restrain disclosures. This issue is particularly pressing for retail firms operating in a competitive marketplace. Though frequent interactions with customers may enable retailers to gather information about demand conditions, their financial disclosures are often not revealing about sales of individual product lines or even about demand at the brand, geographical, or category level. The conventional view is that retailers are less forthcoming with this detailed information in order to keep rivals and potential rivals a step behind in competition. This intuitive perspective on the downside of disclosure, labeled the "proprietary cost hypothesis," has permeated the theoretical literature on disclosure (e.g., Verrecchia (1983), Darrough and Stoughton (1990), Wagenhofer (1990), Hayes and Lundholm (1996)).

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In this paper we present a different view by demonstrating why some firms may be more willing to disclose news to potential competitors. Our underlying premise is that existing views of the competitive effects of disclosure are rooted in stale views of distribution networks. To elaborate, the traditional distribution channel is one where a producer (supplier) sells to a firm (retailer) that then sells to consumers. When the retailer serves as the only distribution outlet, it is apprehensive of any entrant that has the potential to erode its market share. As a consequence, when the retailer's experience and expertise make it privy to information about consumer demand, it prefers to withhold such information, especially when the information suggests it is in a market ripe for entry (e.g., when demand is high).

However, many industries are now characterized by dual distribution, an arrangement wherein the supplier of a product to the retailer also sells the product directly to consumers. In effect, from the supplier's perspective, the retailer becomes both its wholesale customer and its retail rival. Such dual distribution arrangements exist when company-owned franchises compete with independent franchises, or when supplier outlets and catalogs compete with retail stores. The emergence of e-commerce has made dual distribution even more prominent. With e-commerce, suppliers routinely establish their own direct-to-consumer online sales channel that coexists with sales through traditional "bricks and mortar" retail stores (Tedeschi, 2005).

In light of the newfound prevalence of dual distribution, the present paper revisits the traditional views of disclosure and entry threats. We find that dual distribution shifts both a retailer's view of entry and its disclosure incentives. Under dual distribution, a retailer may seek to disclose favorable news about demand, not despite an entry threat, but because of it. Intuitively, with its own direct-to-consumers channel, the supplier treats the retailer as a competitor. Such aggressive retail encroachment by suppliers has led many to foretell the end of traditional retailing. However, if a competing product is introduced by a third party, say a new entrant, the supplier's stance toward the incumbent retailer shifts. The entrant receives the bulk of the supplier's competitive focus, and as a result the supplier views the retailer as a strategic partner in its competition against the entrant. The consequence is that the supplier offers wholesale price discounts to the retailer, boosting its ability to compete against the entrant. A recent example where such forces have been explicitly discussed is in Microsoft's introduction of its Surface tablet. With Surface, Microsoft becomes both an input (operating system) provider and an output (tablet) seller, bringing dual distribution to the forefront of the tablet market. Not coincidentally, Microsoft also has recently taken a more friendly posture towards Barnes & Noble and its Nook tablet, viewing the Barnes & Noble product with its use of Microsoft software as a key partner in its retail rivalry with Apple (Wingfield and Bilton, 2012).

With dual distribution, the retailer's disclosure choice trades the costs of increased retail competition with the entry-linked benefits of improved supply terms. It is this supply-side effect, missed in standard disclosure analysis, which can reverse the standard view that a firm will withhold favorable news to deter entry of a competitor.

We derive the results in a setting that both (i) excludes capital market concerns and (ii) has the feature that disclosure leads to informed entry choices but does not alter the *ex ante* likelihood of entry. Since capital market concerns typically create a temptation to disclose good news, feature (i) helps isolate that dual distribution alone can create a desire to disclose favorable news. Feature (ii) highlights that the firm does not disclose simply to increase entry. Rather, the firm discloses to alter the circumstances under which entry occurs.

A notable empirical implication of our results is that firms who participate in markets characterized by dual distribution are more likely to voluntarily disclose good news publicly, even if such disclosures risk entry. Though such evidence in the cross section has not yet been examined in the literature, we can at least note that the results are anecdotally consistent with the disclosure practices of prominent retail sellers for whom dual distribution is at the forefront. Consider, for instance, Best Buy which distributes tablets, televisions, eReaders, smart phones, computers, gaming devices, and other electronics, most of which are also sold directly by their producers. As part of its monthly news releases, Best Buy voluntarily identifies specific product categories that experienced the highest sales performance (but does not name the bottom performers). Such selective disclosure of peak performers at the product level is not unique to Best Buy—it is observed at other major retailers too, including Target, Nordstrom, and WalMart. The selective disclosure of good news is perhaps most surprising among private firms for whom capital market motivations are muted. As an example, Neiman Marcus routinely discloses top performing geographical regions and merchandise categories in its quarterly press releases.

The current analysis also provides guidance for refining empirical tests on disclosure. Despite the appeal of the notion that firms limit disclosures for competitive reasons, the empirical evidence supporting this view is mixed (e.g., Beyer et al. (2010) and Berger (2011)). Even when it comes to the most intuitive notion that firms withhold disclosures to discourage entry, the evidence has been equivocal. Survey results (Graham et al., 2005) and anecdotal evidence support the idea that executives want to avoid giving away company "secrets" to avoid the attention of entrants. Consistent with this, Guo et al. (2004) find that greater barriers to competitive entry among Biotech IPOs (e.g., patent protection) are associated with greater disclosure. On the other hand, Karuna (2010) and Li (2010) each find evidence that competitive threats from entrants may actually lead firms to increase disclosures. Our results suggest that the lack of empirical consensus on the connection between competition and disclosure may be explained in part by controlling for both the type of news (good vs. bad) and the form of distribution (traditional vs. dual).

In line with practice, we also generalize the model to incorporate retailer participation (and potential entry) in multiple markets with the supplier directly reaching consumers in only a subset of these markets. The analysis demonstrates that the key determinant of disclosure policy is the degree of supplier penetration in retail markets. If the supplier has a strong retail presence (i.e., high penetration), the incumbent retailer is more apt to disclose, and such willingness translates into