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Discussion of "When does the peer information environment matter?"☆

Dawn A. Matsumoto*, Sarah Shaikh

University of Washington, Michael G. Foster School of Business Administration, Paccar Hall, Box 353226, Seattle, WA 98195, USA

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ABSTRACT

Shroff et al. (2017) examine whether a richer peer information environment reduces the cost of capital for firms with limited firm-specific information and whether this effect decreases as firm-specific information becomes more prevalent. Although much of the evidence supporting their hypotheses is based on a small highly idiosyncratic sample of firms issuing initial public debt, the authors provide corroborating evidence using samples of IPO and SEO firms. However, two research design choices make it difficult to discern the nature of the peer information that substitutes for firm information. Hence, the implications of the findings for disclosure regulation are limited.

1. Introduction

Does the information environment of a firm's industry affect a firm's cost of capital? And, if so, does this effect depend on the amount of firm-specific information available to capital providers? By addressing these questions, Shroff et al. (2017) further our understanding of disclosure externalities – the effect other firms' disclosures have on a firm – particularly, the effect of these externalities on a firm's cost of capital. Importantly, the study also demonstrates when these externalities are especially relevant, namely, when firm-specific information is limited. Understanding disclosure externalities is essential in any debate over disclosure regulation; thus, the evidence in Shroff et al. (2017) could be viewed as providing some evidence on the conditions under which disclosure externalities are more or less beneficial. However, as we discuss below, specific research design choices make it difficult to discern the *type* of peer information that is most beneficial to capital providers, which limits the implications of the study for disclosure regulation.

The authors address their research questions using a small sample of private firms issuing public debt for the first time and a larger sample of initial public offering (IPO) firms (private firms issuing public equity for the first time). The authors predict and find a negative association between a proxy for the richness of the information environment in the firm's industry, referred to as the "peer information environment", and proxies for a firm's cost of capital: namely, bond yields in the debt sample and bid-ask spreads in the IPO sample. This evidence supports the conjecture that peer disclosures reduce the information risk of newly public firms for which firm-specific information is scarce. In interpreting the results of their analyses, it is important to recognize that the peer information environment proxy is an industry-specific variable and is

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* Corresponding author.
E-mail addresses: damatsu@uw.edu (D.A. Matsumoto), sshaikh@uw.edu (S. Shaikh).

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not based on specific disclosures made by particular firms in the industry that are considered "peers". We will discuss the implications of this proxy further in Section Three below.

The authors then predict that this negative association is weaker when the amount of firm-specific information is greater, based on the idea that firm information substitutes for peer information. They establish this attenuation in a number of ways. First, they find that the association between their cost of capital proxies and the peer information environment proxy decreases in the years following the debt/equity issuance for their sample firms. Over time, these newly public firms would be subject to the mandatory disclosure requirements of the SEC, would potentially provide additional voluntary disclosures, and would have their securities trading on an open exchange, all of which are sources of firm-specific information for investors. Thus, the attenuation of the effect of peer information on a firm's cost of capital over time is consistent with the idea that increases in firm-specific information reduce the importance of the peer information environment. Moreover, because the authors follow a set of firms across time, their analysis addresses concerns about *static firm factors* that are associated with a firm's cost of capital and which could be correlated with the peer information environment proxy (a correlated omitted variable problem).

Second, they find a less negative association for firms in their sample that initially provide more firm-specific information and firms with higher trading volume in their first public quarter. Notably, the measure of firm-specific information used in this analysis is based on the level of disaggregation in the firm's financial statements, a coarse measure of firm-specific information that we will discuss further below.

Third, they find that the association is less negative for a matched sample of firms who issue new capital (either debt or equity) but who have been public for a period of time (i.e., are not newly public firms). The assumption here is that capital providers have access to more information about firms that have been registered with the SEC for a longer period of time. Because the matched sample of firms are from the same industry and also issue debt/equity in the same fiscal year, this analysis at least partially addresses concerns that some unidentified *industry-year specific factor* is associated with the cost of capital in the industry and also correlated with the peer information environment proxy.

Fourth, they identify a subsample of firms from their debt sample that also raise capital in the private debt market in the same fiscal period. Since private lenders are presumed to have access to private, firm-specific information, these lenders are less likely to rely on information from other firms in the industry in pricing debt. Consistent with their prediction, the authors find no association between loan spreads on private debt contracts and the peer information environment proxy. This analysis addresses concerns that some unidentified *firm-year specific factor* is associated with a firm's cost of capital and also correlated with the peer information environment proxy.

The authors also conduct what might be considered a falsification test of the attenuation of the relation between bond yields and the peer information environment proxy over time. Specifically, because all the bond issuances in their sample were initially issued to Qualified Institutional Buyers (QIBs) under SEC Rule 144A, but firm-specific information does not increase between the time these bonds are issued to the QIBs and the time they begin trading in the public markets, there should be no attenuation in the association between bond yields and the peer information environment proxy between the initial issuance and when the bonds are traded publicly. In contrast, if the attenuation occurs naturally over time irrespective of the amount of firm-specific information available, they would observe a similar attenuation during this time period. While they do not find that the association *attenuates* between the time of issuance to the QIBs and the first and second years of public trading, they do find that the association becomes *more negative* between these two periods. Since firm-specific information did not *decrease* between these two time periods, this evidence is not quite consistent with the narrative of the study.[1]

Finally, the authors utilize SEC requirements to reduce disclosure prior to seasoned equity offerings (SEOs), known as "quiet periods", to examine whether *decreases* in firm-specific information result in increases in the importance of the peer information environment. They find that the association between bid-ask spreads and the peer information proxy are significantly negative during quiet periods but not during adjacent periods. Moreover, this difference in association between quiet periods and adjacent periods disappears following reforms to the quiet period rules.

Overall, the evidence, while occasionally marginal in terms of statistical significance, all support the notion that: (1) a richer peer information environment reduces a firm's cost of capital and (2) as firm-specific information increases, the influence of the peer information environment on a firm's cost of capital attenuates. The numerous analyses, each of which at least partially address some potential concern with the main specification, make it difficult to think of an alternative explanation that might explain the totality of their results. Nevertheless, all the analyses are based on relatively small samples of self-selected firms that are raising capital (most for the first time), which limits the generalizability of the results. In addition, the measure of peer information is rather coarse and the nature of firm-specific information across the different analyses varies. Both factors make it difficult to discern the type of peer information that can substitute for firm information, limiting the implications of the findings for disclosure regulation. We discuss these points further in Sections Three, Four,

[1] The authors address this inconsistency on page 29 of the paper. One argument is that QIBs have access to alternative, private information that makes the peer information environment irrelevant in their pricing. The difficulty with that argument, however, is that if the QIBs intend to sell the bonds on the open market, they should price the bonds in anticipation of the pricing on the open market – i.e., they should factor the variation in the peer information environment that will subsequently determine the bond yield. A more compelling argument offered by the authors is that QIBs only float a proportion of their bonds and thus, the effect of peer information environment on the initial bond yields will be smaller than the effect on yields when the bonds trade publically.

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