Economic Consequences of Bias in Fair Value Accounting: Evidence from Korean Bond Markets

(Aobdia, Kim, and Stice)

Discussion by:

Rimmy E. Tomy

CHICAGO BOOTH

THE UNIVERSITY OF CHICAGO BOOTH SCHOOL OF BUSINESS

Overview

- **Research question:** Does discretion in fair value accounting have economic consequences?
- **Setting:** Increase in competition among bond pricing agencies (BPAs) in South Korea
- **Research design:** DiD design where treated group is month-end prices and control group is mid-month prices
- **Main findings:**
  - The introduction of an additional BPA is associated with an upward bias in bond prices
  - Evidence of decreased liquidity in corporate bond market

Overall take

- Very interesting setting and findings
- Well-written and easy to read
- My comments are related to:
    - Framing
    - Empirical suggestions
    - Institutional details

Framing

- Current framing: *Does discretion in fair value accounting bias bond price estimates and does this have economic consequences?*

Framing

- Current framing: *Does discretion in fair value accounting bias bond price estimates and does this have economic consequences?*
- Paper addresses a larger and more fundamental question: *Does competition have a disciplining effect?*

Framing

- Current framing: *Does discretion in fair value accounting bias bond price estimates and does this have economic consequences?*
- Paper addresses a larger and more fundamental question: *Does competition have a disciplining effect?*
  - **Competition and discrimination**: Evidence generally suggests evidence that competition reduces bias
    - Competition erodes excess margins and reduces the ability to engage in taste-based discrimination (Becker, 1957)
    - Competition leads to a more equitable distribution of economic rents and economic opportunities (Ashenfelter & Hannan, 1986; Black & Brainerd, 1999; Black & Strahan, 2001)
  - **Competition and reporting bias**: Findings are ambiguous

Framing

- Current framing: *Does discretion in fair value accounting bias bond price estimates and does this have economic consequences?*
- Paper addresses a larger and more fundamental question: *Does competition have a disciplining effect?*
  - **Competition and discrimination**: Evidence generally suggests evidence that competition reduces bias
    - Competition erodes excess margins and reduces the ability to engage in taste-based discrimination (Becker, 1957)
    - Competition leads to a more equitable distribution of economic rents and economic opportunities (Ashenfelter & Hannan, 1986; Black & Brainerd, 1999; Black & Strahan, 2001)
  - **Competition and reporting bias**: Findings are ambiguous
- *Authors could consider reframing to address this more fundamental question*

Competition and reporting bias

- Mechanisms through which competition could *increase* reporting bias:
  - **Catering view:** Firms may cater more aggressively to investor and market preferences (Mullainathan & Shleifer, 2005)
  - **Race to the bottom:** Firms or individuals may prioritize short-term gains over long-term benefits
    - The threat of competition and fear of being scooped in scientific research publishing causes scientists to produce lower quality work (Hill & Stein, 2025)
    - Threat of competition leads banks to bias their financial reporting (Tomy, 2019)

Competition and reporting bias

- Mechanisms through which competition could *increase* reporting bias:
  - **Catering view:** Firms may cater more aggressively to investor and market preferences (Mullainathan & Shleifer, 2005)
  - **Race to the bottom:** Firms or individuals may prioritize short-term gains over long-term benefits
    - The threat of competition and fear of being scooped in scientific research publishing causes scientists to produce lower quality work (Hill & Stein, 2025)
    - Threat of competition leads banks to bias their financial reporting (Tomy, 2019)

- Mechanisms through which competition could *decrease* reporting bias:
  - **Independence rationale:** Competition results in a greater diversity of preferences and the presence of at least one entity that cannot be "bought" disciplines others (Gentzkow & Shapiro, 2008)
  - **Cost of collusion:** Bribing entities to bias reports becomes more costly when the number of players increases (Besley & Pratt, 2006)

Competition and reporting bias

- Mechanisms through which competition could *increase* reporting bias:
  - **Catering view:** Firms may cater more aggressively to investor and market preferences (Mullainathan & Shleifer, 2005)
  - **Race to the bottom:** Firms or individuals may prioritize short-term gains over long-term benefits
    - The threat of competition and fear of being scooped in scientific research publishing causes scientists to produce lower quality work (Hill & Stein, 2025)
    - Threat of competition leads banks to bias their financial reporting (Tomy, 2019)

- Mechanisms through which competition could *decrease* reporting bias:
  - **Independence rationale:** Competition results in a greater diversity of preferences and the presence of at least one entity that cannot be "bought" disciplines others (Gentzkow & Shapiro, 2008)
  - **Cost of collusion:** Bribing entities to bias reports becomes more costly when the number of players increases (Besley & Pratt, 2006)

- *A question with clear policy implications: Under what conditions does competition increase reporting bias?*

Conditions under which competition increases reporting bias

- Some food for thought . . .
  - Measuring short-term versus long-term outcomes
    - Perhaps competition induces short term distortions that are ironed out in the long run
  - Threat of competition versus an actual increase in competition
    - Distortions that appear in the face of a threat in competition may disappear when competition actually increases
  - Fundamental incentives versus a conflicted payment structure
    - Does reporting bias increase only in the presence of an explicit conflicted payment structure?
- Current paper looks at a setting with short term incentives + an actual increase in competition + a conflicted payment structure
- *Why does reporting bias arise in the Korean BPA setting?*

Reporting bias in the Korean BPA setting

- Issuer-pay (in this case "investor-pay") business models supposedly work because of reputational concerns
  - A solid reputation increases the probability of getting future clients
  - Competition reduces the future rents and thus reduces the incentive to maintain a strong reputation
- But, reputation is hard to measure in most cases where issuer-pay models are used (e.g., audit or credit ratings)
  - Bankruptcy is far in the future, uncertain, and rare
- Bias in bond prices are short-term and frequent, thus reputation should be easier to measure
  - Indeed, the paper states: "*BPAs are continuously being criticized for failing to provide proper assessments...*"
- *The paper could elaborate further on why the reputation mechanism does not come into play*

Empirical suggestions

- *Utilize a more robust research design*

Empirical suggestions

- *Utilize a more robust research design*
  - Current research design identifies the effect only based on one date (the entry of the fourth player)

$$Y_{i,j,t} = \beta_0 + \beta_1 EndMonth_{i,j,t} + \beta_2 Post_t \times EndMonth_{i,j,t} + controls + FE$$

  - This is equivalent to:

$$Bias(end - mid) = \beta_0 + \beta_1 Post_t + Controls + FE$$

    - Entry of fourth player may not be exogenous
    - Could coincide with other confounding changes

Empirical suggestions

- *Utilize a more robust research design*
  - Current research design identifies the effect only based on one date (the entry of the fourth player)

$$Y_{i,j,t} = \beta_0 + \beta_1 EndMonth_{i,j,t} + \beta_2 Post_t \times EndMonth_{i,j,t} + controls + FE$$

  - This is equivalent to:

$$Bias(end - mid) = \beta_0 + \beta_1 Post_t + Controls + FE$$

    - Entry of fourth player may not be exogenous
    - Could coincide with other confounding changes
  - A more robust design factors in the actual increase in competition:

$$Bias(end - mid) = \beta_0 + \beta_1 Post_t \times Market\ share\ of\ fourth\ player + Controls + FE$$

Empirical suggestions

- *Ensure that the dependent variable does indeed capture bias in reporting*
  - Bias is the difference between mid-month and end-month price based on the rationale the compensation depends on end-month prices
    - In this case, the incentive to bias is very transparent
  - Other reasons why end of month prices might be higher:
    - More information could be released at end of month
    - Passive funds rebalance at the end of the year

Empirical suggestions

- *Ensure that the dependent variable does indeed capture bias in reporting*
  - Bias is the difference between mid-month and end-month price based on the rationale the compensation depends on end-month prices
    - In this case, the incentive to bias is very transparent
  - Other reasons why end of month prices might be higher:
    - More information could be released at end of month
    - Passive funds rebalance at the end of the year
- *Explicitly measure the increase in competition*
  - BPA market goes from three to four players: Is that a sufficient increase in competition?
    - What is the share of sales captured by the new player (e.g., calculate HHI)

Empirical suggestions

- *Ensure that the dependent variable does indeed capture bias in reporting*
  - Bias is the difference between mid-month and end-month price based on the rationale the compensation depends on end-month prices
    - In this case, the incentive to bias is very transparent
  - Other reasons why end of month prices might be higher:
    - More information could be released at end of month
    - Passive funds rebalance at the end of the year
- *Explicitly measure the increase in competition*
  - BPA market goes from three to four players: Is that a sufficient increase in competition?
    - What is the share of sales captured by the new player (e.g., calculate HHI)
- *Consider measuring the aggregate effects beyond liquidity*
  - Pricing biases could potentially suppress economic activity

Add more institutional details

- Provide more relevant details about the BPA market
  - The BPA market initially had three players; a fourth entered later. What are the barriers to entry?
  - With so few participants, is there a risk of collusion?
  - Do clients switch between BPAs each year, or stick with the same provider?
- Conflicts of interest
  - Elaborate more about the agency conflicts, e.g., more information about compensation structures
  - Most BPAs are subsidiaries of rating agencies, how is this conflict managed? BPAs may price bonds to support their affiliated ratings, which prior research suggests may be biased upward.
- Regulatory oversight
  - What is the role of the regulator in overseeing BPAs?
  - Are BPA prices publicly disclosed after issuance or only shared with purchasing institutions?

To conclude

- An important paper with the potential to make a nice contribution
- I offer some suggestions on framing the paper to sit in the literature related to competition and reporting bias where current findings are not conclusive
- Some suggestions for additional empirical analyses and adding more institutional details