SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

Research on Corporate Transparency

Element 8: Rationales for Regulation

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Motivating question

Why is corporate reporting regulated?

Intuitive Answer

Because it addresses information externalities, helps contracting and to realize economies of scale

Or because this happens to be the outcome of the political bargaining process

Information externalities

- Financial externalities: Information that helps to assess the value of firm A will be informative about the value of firm B whenever the firm values of A and B can be expected to be correlated
- Real externalities: Information about, for example,
  - production capacities,
  - cost structures or
  - (realized) demand for products

  of firm A can inform decisions of firm B and other market participants
- These externalities are normally not entering the disclosure decision of firm A but related disclosures might be welfare enhancing
- But: This is not always the case: Redistribution effects and even welfare decreasing externalities are also possible

Contracting

- Information can help mitigate adverse selection issues in contracting
- Example: A simple managerial compensation contract with a risk-neutral principal (investor) and a risk-averse agent (manager) with unobservable effort
  - if a reporting regime making managerial effort observable would be available this would allow achieving first best risk sharing (all risk being carried by the investor)
  - voluntary reporting not feasible as soon as effort signal is used in contracts (miss-aligned incentives and cheap talk)
  - Cheating does not pay off to manager but will happen in equilibrium
  - Regulatory commitment to truthful reporting increases welfare

Economies of scale

- Economies of scale arise when multiple firms use the same reporting system
- They are also understood as positive network externalities
- Coordination on common set of standards increases comparability and reduces information processing cost

But…

- … direct disclosure costs exist and might not be marginal
- Real information externalities can induce wealth transfer and politically costly distribution effects
- Some contractual arrangements (e.g., insurance contracts and risk sharing) critically depend on information asymmetry
- Mandatory information can crowd out private information production

So...

- A need for regulated transparency is likely but not obvious
- Trade-off between public and private contracting
- Details matter (alternative information sources, disclosure channels, information frictions, contractual arrangements)
- Observed heterogeneity in regulation (cross-country, public vs. private firms)
- Political economy of transparency regulation is an interesting field to study!