SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

# Research on Corporate Transparency

## Element 6: Cheap Talk

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# Motivating question

Can there be value in non-verifiable disclosure?

# Intuitive answer

Yes

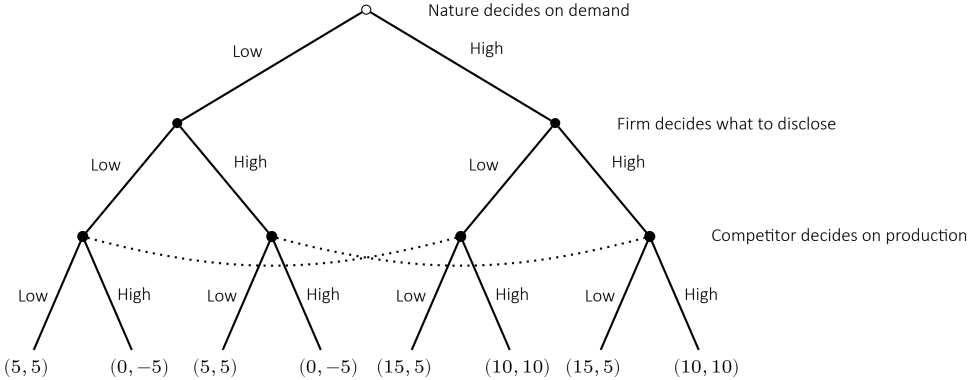
(if objectives are or can be aligned)

# Why can this be a big deal?

Consider the setting of Gigler (JAR, 1994)

- A firm facing Cournot competition has private information about aggregate demand
- It has the option to disclose its information but the disclosure cannot be verified
- Would it disclose this information?
- Assuming that it would, would the competitor act on the disclosure?

# A game tree

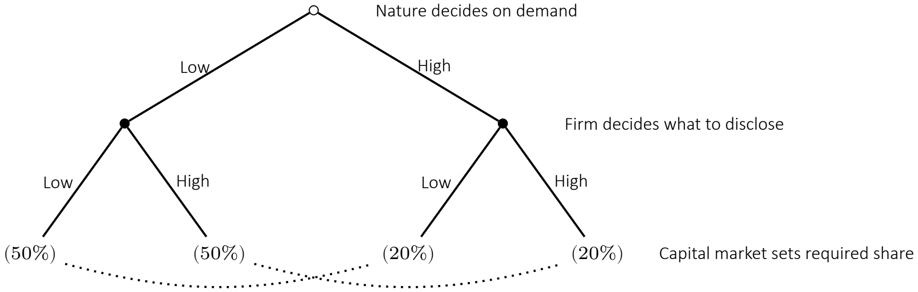

Nature decides on demand
Low
High
Firm decides what to disclose
Low
High
Low
High
Competitor decides on production
Low
High
Low
High
Low
High
Low
High
(5, 5)
(0, −5)
(5, 5)
(0, −5)
(15, 5)
(10, 10)
(15, 5)
(10, 10)

# OK. Now for something different

Now consider that there is a rational competitively pricing capital market and that the owner of the firm needs to sell a part of the firm to finance production

- Would the firm disclose its information to the capital market?
- Would the market act on this information?

# A somewhat simpler game tree



# And now: Together

Assuming that both, the competitor and the capital market trust the disclosure of the firm, the firm has an incentive to report truthfully.

| Strategy (demand/disclose) | L/L, H/H | L/L, H/L | L/H, H/H | L/H, H/L |
|---|---|---|---|---|
| Payoff for firm low demand | 5 | 5 | 0 | 0 |
| Payoff for firm high demand | 10 | 15 | 10 | 15 |
| Share to investor low demand | 50% | 50% | 20% | 20% |
| Share to investor high demand | 20% | 50% | 20% | 50% |
| Expected payoff to firm owner | 5.25 | 5.00 | 4.00 | 3.75 |

Tadaa: The incentives are aligned and we have an informative cheap talk equilibrium!