On the costs and benefits of more transparency about equity-based incentives*

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Abstract

This study explores how greater transparency about equity-based incentives impacts efficiency, both in capital markets and within firms. Using a signal-jamming framework inspired by Fischer and Verrecchia (2000), we examine a scenario where managers, driven by unknown equity-based incentives, influence firm value through investment and productive actions while reporting earnings to the market.

Our findings reveal a more intricate picture than the traditional view. From a capital market perspective, increased transparency can enhance or reduce the value relevance of earnings and price efficiency - and these outcomes can even diverge. Similarly, from a firm perspective, transparency can improve or worsen investment efficiency and reporting bias. These nuanced effects contrast with the Fischer and Verrecchia model, where transparency consistently boosts market efficiency and amplifies reporting bias.

By considering managers' productive actions, our study provides fresh insights into the trade-offs of transparency initiatives, highlighting their far-reaching implications for market dynamics and firm behavior.

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