Optimal voluntary disclosure with reputational benefits of silence

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Abstract
In a continuous-time setting we investigate how the management of a firm controls a dynamic choice between two generic voluntary disclosure decision rules (strategies): one a full and transparent disclosure referred to as candid, the other, referred to as sparing, under which items only above a dynamic threshold value are disclosed. We show how management are rewarded with a reputational premium for being candid. The candid strategy is, however, costly because the alternative of sparing behaviour shields from a downgrade in disclosed low values. We show how parameters of the model such as news intensity, pay-for-performance and time-to-mandatory-disclosure determine the optimal choice of candid versus sparing strategies and optimal times for management to switch between the two. The private news updates received by management are modelled following a Poisson arrival process, occurring between the fixed (known) mandatory disclosure dates, such as fiscal years or quarters, with the news received by management generated by a background Black-Scholes model of economic activity and of its partial observation. The model presented develops a number of insights, based on a very simple ordinary differential equation (ODE) characterizing equilibrium in a piecewise-deterministic model, derivable from the background Black-Scholes model. When an at-most-single switching policy is assumed admissible, it is shown that a firm either employs a candid disclosure strategy throughout, or switches (alternates) between being candid and being sparing with the truth, in whatever order characterizes optimality, a feature confirmed in empirical findings. Joint work with Miles Gietzmann (Accounting Dept., U. Bocconi).