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Properties of Optimal Accounting Rules in a Signaling Game*

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Abstract

We characterize the properties of optimal accounting rules in a signaling game. An impatient firm sells shares to competitive investors. The firm can signal its private information about the fundamental by retaining a fraction of the shares. In addition, the firm can commit to disclosing information according to a set of accounting rules chosen ex ante. Information disclosure reduces signaling cost so that perfect disclosure is optimal. When perfect disclosure is impossible, the optimal accounting rule features a lower bound and a summary statistic of the fundamental. The interpretation of the lower bound is consistent with accounting conservatism, and the statistic summarizes the information most relevant to the firm's valuation. The justification for accounting conservatism relies on the existence of information asymmetry and the infeasibility of perfect accounting disclosure. This is consistent with the conjecture of LaFond and Watts (2008) that information asymmetry calls for accounting conservatism.

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