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The 'Incomplete Revelation Hypothesis' and Financial Reporting

Cornell University Working Paper

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Robert J. Bloomfield (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=48324)
Cornell University - Samuel Curtis Johnson Graduate School of Management

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Abstract


Those who believe markets are inefficient rarely provide a coherent and refutable alternative to the Efficiency Markets Hypothesis (EMH). This paper presents the Incomplete Revelation Hypothesis (IRH) as such an alternative, and describes its implications for financial reporting research, practice and regulation. Inspired by "noisy rational expectations models," the IRH assumes that the costs of extracting useful statistics from public data keep markets from fully revealing the meaning of those statistics. The IRH can account for many of the phenomena that are central to financial reporting but inconsistent with the EMH. It predicts that investors devote substantial resources to identifying mispriced stocks on the basis of public data, that managers seek to boost stock prices by hiding bad news in footnotes, and that regulators may wish to defeat such efforts, because information that is hard to extract from financial statements will not be reflected in stock prices. The IRH also provides a number of novel and testable predictions that distinguish it from the EMH.

Keywords: Market Efficiency, Financial Reporting, Earnings Management, Anomalies, Behavioral Finance, Post-Earnings-Announcement Drift

JEL Classification: G12, M4

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