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Equilibrium (dis)honesty

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Abstract

This paper analyzes the production of fraudulent financial statements in a model featuring the main characteristics of the US corporate information market. Main players are managers, shareholders, auditors and the auditors' public supervisor. It is shown that, in the overall equilibrium, not only managers at the head of bad firms, but also some of those running good firms may resort to dishonest reporting. The probability of cheating appears to be positively related to the frequency of good firms. Pushing too far the supervisor's incentives to fight fraud might prompt more good firms' managers to provide dishonest reports.

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1. Introduction

According to broad consensus in social science, what can be called "ethical behavior" should play an important role in the proper functioning of capitalist economies; since their resource allocation system builds on voluntary exchange between individuals, positive social externalities such as trust, loyalty and truth-telling would oil the economic machinery (Arrow, 1974; McKean, 1975; Brickley et al., 2002). The most optimistic scholars even argued that in a market economy, individuals would spontaneously prefer honesty to dishonesty (Kohlberg, 1969, 1981; Frank,

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1987) and that, in the long run, competition would support the moral development of market economies (Shleifer, 2004).

Yet the wave of corporate scandals that marked the end of the Internet bubble recalled with strength that in the realm of trust and honesty, shareholder capitalism comes with its own limits. As pointed out by William Donaldson, the former chairman of the *US Securities and Exchange Commission*, "Starting with the unfolding of the *Enron* story in October 2001, it became apparent that the boom years had been accompanied by fraud, other misconduct and serious erosion in business principles" (Donaldson, 2003a). While conflicts of interest between managers and shareholders are an old story, the New Economy period proved to be very fertile ground for financial fraud, which can be seen as an extreme development of this conflict (Demski, 2003; Donaldson, 2003a,b; Healy and Palepu, 2003). In particular, criminal investigations proved that on the eve of the crisis, several large firm CEOs resorted to corrupt auditors to produce false, overly optimistic financial statements, which helped inflate share values. In what appeared to be outrageous conduct, some executives reaped million dollar gains by exercising pending stock-options just before the collapse of the company (Lev, 2003; Shleifer, 2004; Hall, 2005).

Such proliferation of dishonest behavior on behalf of both managers and auditors brought about large economic costs connected to the public's distrust with two pillars of capitalism: large publicly traded companies and the stock market. To cope with this problem, the US Administration reacted promptly, mainly through the *Sarbanes-Oxley Act* of 2002. The law aimed to increase the accountability of the executives, strengthen corporate surveillance, fight fraudulent accounting practices and enhance the effectiveness of the legal system in this field. Prior to the corporate crisis of 2001, it was widely agreed that self-regulation induced by peer pressure and competition in the market for auditors would suffice to prevent abuse. After the storm, the US Administration gave up the principle of auditors' self-regulation and created a new regulator. As required by Section 101 of the *Sarbanes-Oxley Act*, a *Public Company Accounting Oversight Board* (PCAOB) was set up in January 2003. The Board, an independent non-profit organization founded by compulsory contributions from all listed companies and security issuers, has important inspection and normative attributes over all auditing firms. The EU is considering a move in the same direction; in December 2004 the European finance ministers endorsed proposals aiming to end the self-regulation of auditing firms.[1]

This paper analyzes the recourse to dishonest reporting as the equilibrium of a corporate information market whose institutional setup takes into account the recent changes in the US corporate regulation. Main players are managers of publicly traded companies, shareholders, auditors and their public supervisor. Special emphasis is set on the relationship between the signal delivered by the financial statement and a firm's share value.

The model is made up of two distinct but interdependent blocks. The first one investigates the demand for dishonest reporting as the solution to a game between managers and shareholders. The corporate sector is made up of both solid and fragile firms. Homogenous shareholders know the distribution of firms but cannot directly infer the type of a given firm. They can improve their expectations after reading a financial report about the financial status of the firm, drafted (or certified) by an external auditor. The manager may demand either an *honest* report, informative but imprecise, or a *faked* report issued by a corrupt auditor. The latter will state that the firm is

[1] The PCAOB mission statement and various inspection reports are available on the official website of the organization, at http://www.pcaobus.org. See also Called to account (2004), Holmstrom and Kaplan (2005) and Vranceanu (2005).