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ECONOMIC VIEW

Executive Greed? The Other Guy Started It

By EDUARDO PORTER

WHAT drives executives to cook the books seems painfully obvious: it's greed, isn't it? That cupidity - well oiled by stock options - would appear to be the principal cause for the spread of creative accounting during the 1990's, provoking executives from Computer Associates to Enron to inflate sales, mask debts or embellish profits, enhancing their own incomes along the way.

Despite the moral tidiness of greed as a motive, there is another powerful incentive helping to spread mischief in the executive suite. Competition, a primal force of capitalism, can steer even the nongreedy executive down an unethical path.

Andrei Shleifer, an economics professor at Harvard, argues that if unethical behavior drives down corporate costs, rivals will be compelled to do the same just to stay in business. In other words, companies will find the cost of ethical behavior too high.

"I really don't believe the saints-and-crooks theory," Mr. Shleifer said of the tendency to demonize business executives who engage in creative accounting. "Evidence tells us very clearly, even the most saintly C.E.O.'s were involved" in such accounting because of market pressure.

The principle works equally to explain accounting fraud, bribery or the use of child labor, Mr. Shleifer says. For instance, if a company gains a cost advantage by hiring children, and can thus offer lower prices to consumers, its rivals have a powerful incentive to hire children, too.

If a company can lower costs by paying bribes to government officials in exchange for a permit or to avoid a tax, other companies may be tempted to do the same to stay in the business. "The keener the competition, the higher is the pressure to reduce costs, and the more pervasive is corruption," Mr. Shleifer said.

In the case of creative accounting, books are massaged to raise the price of corporate shares. Though the practice undoubtedly lines some executives' pockets, it also reduces the cost of capital at their companies - giving them an edge by letting them raise more money in capital markets, attract better workers with stock options and even buy other companies with their own shares.

Greed, of course, is a very powerful motive. It is no coincidence that the boom in earnings manipulation during the 1990's coincided with a surge in equity-based executive compensation packages, as business gurus recommended that corporate boards award managers big lumps of stocks and options to align their incentives with those of other stockholders.

Indeed, a paper by two economists, Daniel Bergstresser of the Harvard Business School and Thomas Philippon of New York University, found that executives tended to exercise more stock options in periods when they tinkered often with their accounting - drawing a large share of profits from lower depreciation, changes in assets and liabilities, and other items beyond current cash flows.

But there are indications that accounting sleight of hand is sometimes used to pursue corporate objectives. In a recent paper, Mr. Bergstresser, Mihir Desai of the Harvard Business School and Joshua Rauh of the Massachusetts Institute of Technology found that a specific manipulation - propping up profits by changing the expected rate of return of a company pension fund - is more prevalent when companies acquire other businesses than it is when executives exercise lots of options.

Competition as an incentive helps explain the surge in pro forma accounting and similar shenanigans in the 1990's. In the merger frenzy of the dot-com era, the survival of many companies depended on keeping their share price high. Expensive shares could be used as currency to help a company buy its rivals - or to ensure that it did not end up as a rival's lunch.

One of the defining deals of the dot-com period was America Online's use of its richly valued shares in January 2001 to acquire Time Warner, which had four times AOL's revenue.

Today, the deal is much maligned. Shares of the combined company have plummeted by about two-thirds since then, and the online unit has been a drag on earnings. The Securities and Exchange Commission is investigating AOL's accounting.

Nonetheless, AOL's old shareholders have reason to be delighted. They own Time Warner.

From a regulatory standpoint, it may not make much of a difference if executives are motivated by greed or survival. From a legal standpoint, though, Mr. Shleifer's argument may provide some executives with an interesting avenue to explore: "Your honor, the market made me do it."

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