

The social costs of financial misrepresentation: A framework and some empirical estimates

PCAOB Roundtable

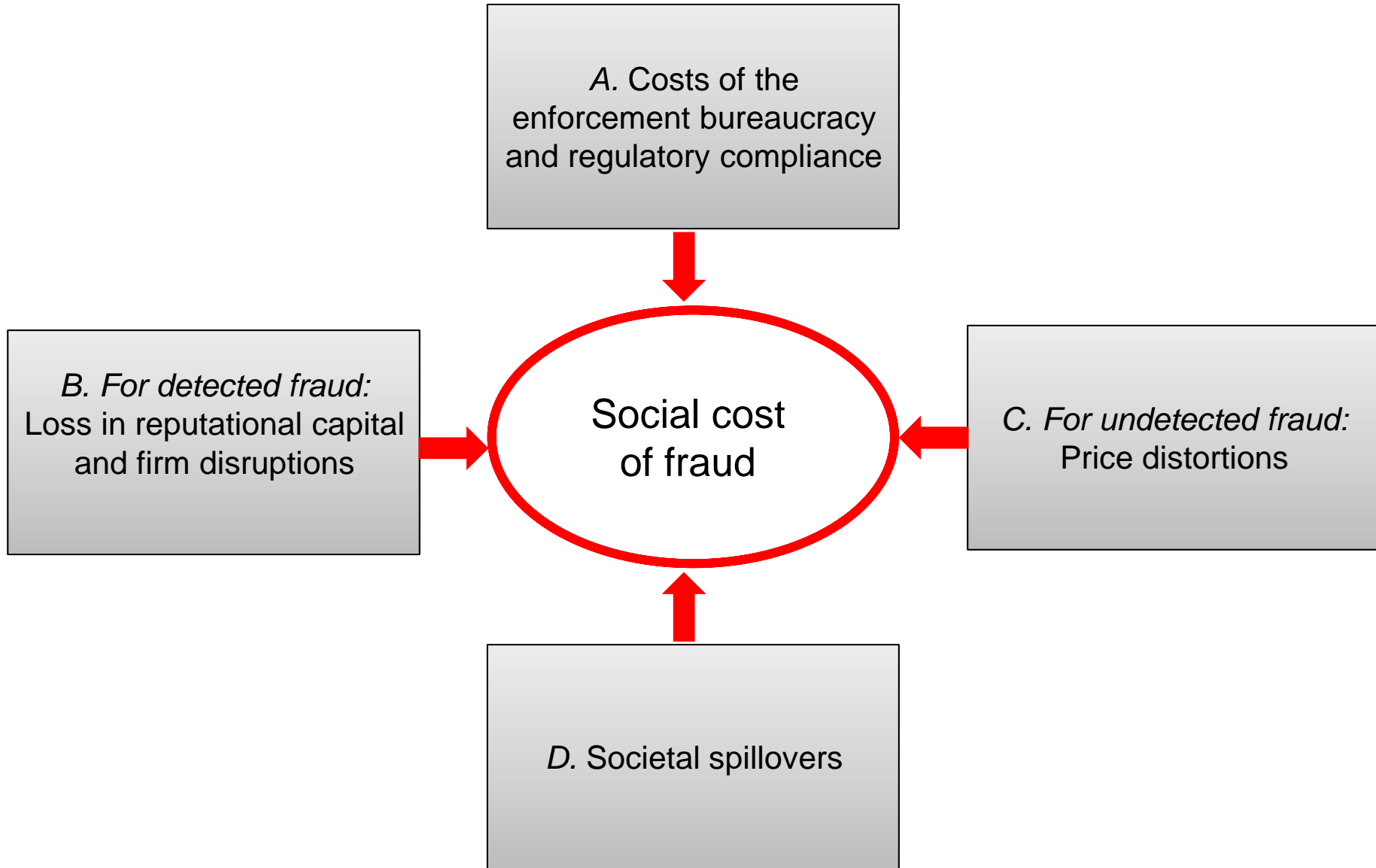
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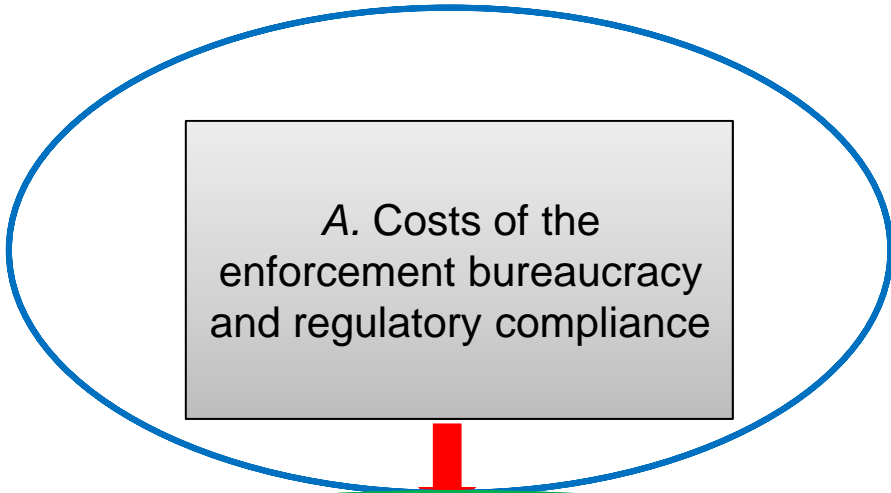


A framework

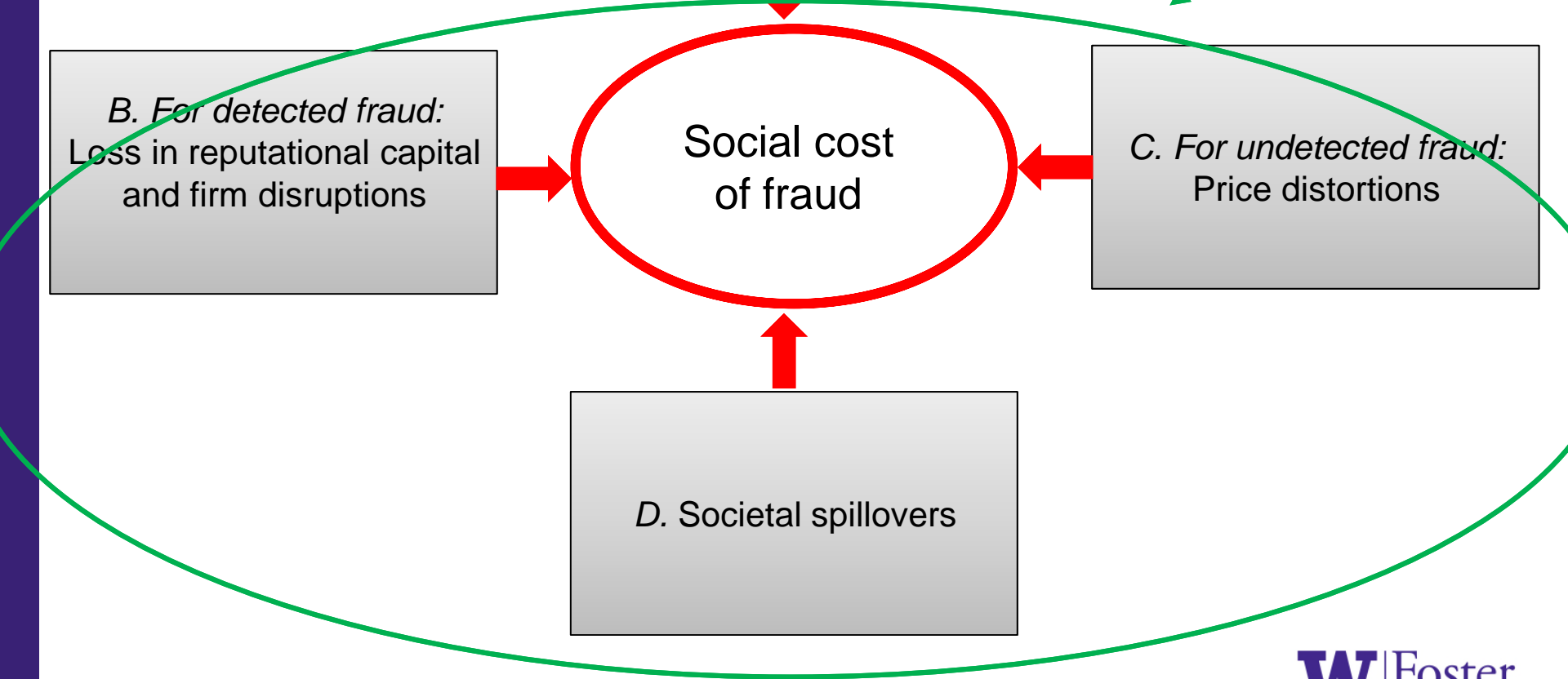
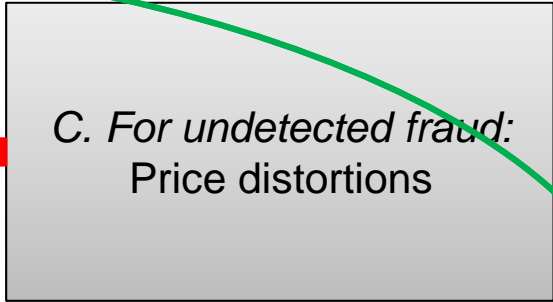
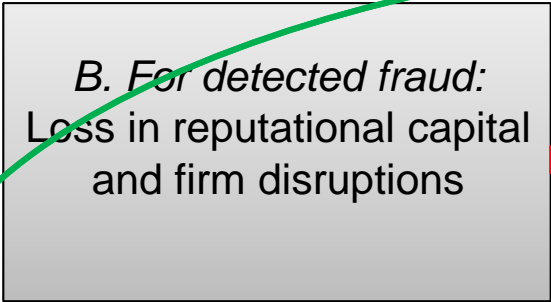


The tradeoff

Increase these costs...



To try to decrease these costs...



A. Costs of the enforcement bureaucracy and regulatory compliance...

- Regulator enforcement budgets
- Firm-level compliance and audit costs
- Indirect costs of regulatory burden
 - Kalmenovitz (RFS 2023)
 - “Regulatory intensity leads to higher cost of goods sold, more overhead spending, lower capital investment, fewer hires, and more lobbying expenditures.”
 - Chang, Kalmenovitz, and Lopez-Lira (w.p. 2023)
 - The *prospect* of new regulations leads to increased overhead costs, lower profits, and reduced investment

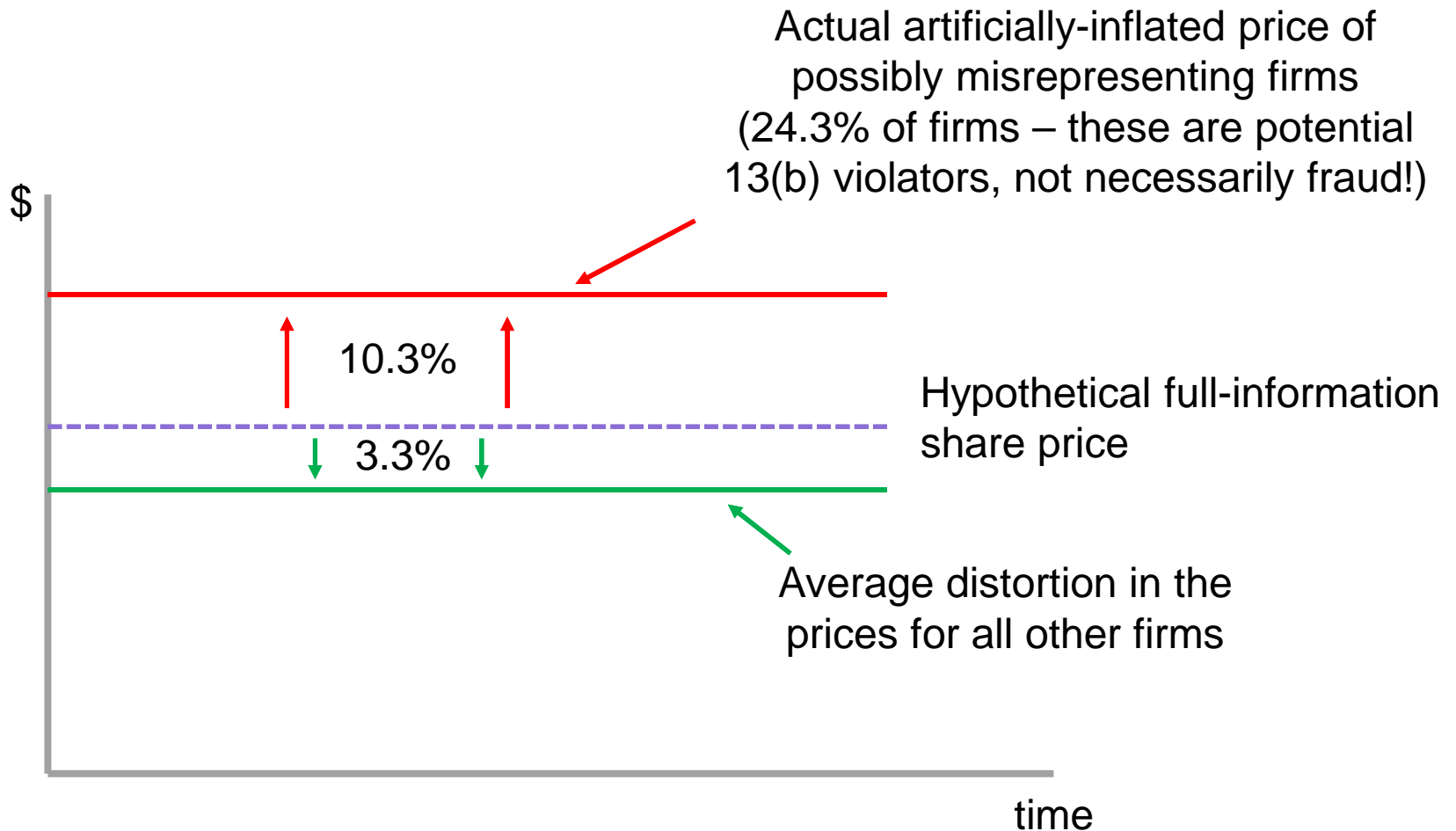
B. Costs of detected fraud

- Incremental costs of investigations and the legal process, including lawsuits
 - Note that financial penalties are transfers, not social costs
- Loss in reputational capital
 - This is the decrease in value of the firm's assets that help to bond the firm's contractual performance
 - Karpoff, Lee, and Martin (JFQA 2008): Base case estimate equals 25.3% of the firm's market capitalization
- Firm-level disruptions, including managerial turnover
 - Karpoff, Lee, and Martin (JFE 2008): 93% of named respondents in SEC enforcement actions lose their jobs

C. Costs of *undetected* fraud

- Market prices are distorted
 - Suboptimal investment
 - Using price signals, some firms invest too much, others too little
 - Managers use resources to maintain and cover up the fraud
 - Suboptimal portfolio formation and investor risk
 - Investors bear more or less risk than they desire

Price distorting effects of misrepresentation

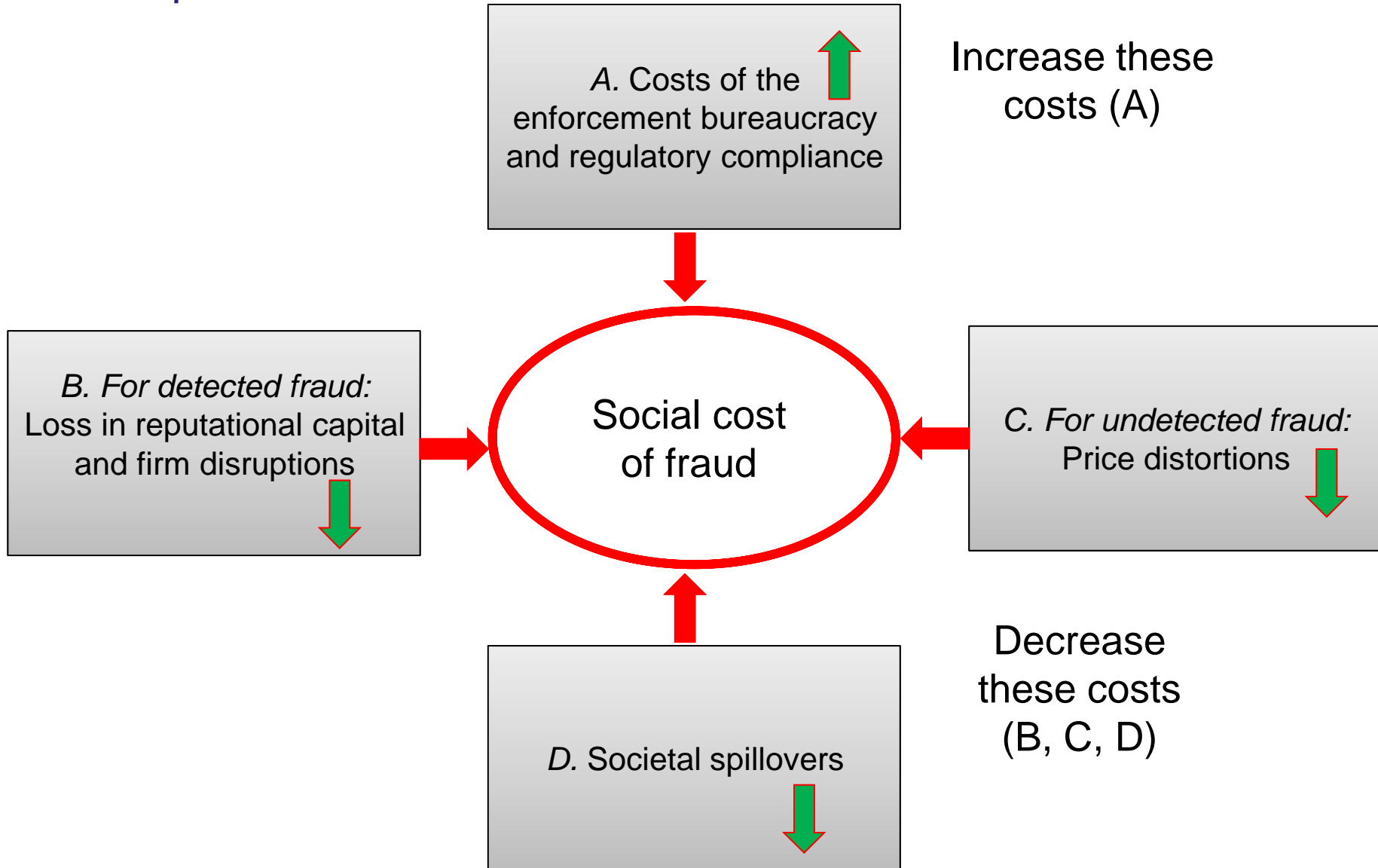


(From Alawadhi, Karpoff, Koski, and Martin, w.p. 2024)

D. Societal spillovers

- Decrease in trust and social capital
 - Knack and Keefer (QJE 1997), Guiso, Sapienza, and Zingales (AER 2004, JEP 2006, QJE 2009), Bloom et al. (QJE 2012)
 - Higher trust and social capital are associated with more use of credit, financial market development, industrialization, trade, and economic growth
- Lower stock market participation
 - Giannetti and Wang (JF 2016); Dupont (w.p. 2024)
- Increased investment in firm-level reputational capital investment
 - Endogenous adjustment to decrease in social capital

Recap – the tradeoff



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