

Discussion of
“When Monitors Don’t Help:
The Costs of Collusion-Proof Contracts”
by Abigail Brown

Edward Simpson Prescott¹

Federal Reserve Bank of Richmond

January 6, 2012
IBEFAs, Chicago

¹The views expressed in this discussion do not necessarily reflect the views of the Federal Reserve Bank of Richmond or the Federal Reserve System.

Approach

Principal-multi-agent model

Two agents: Producer (the “agent”) and Monitor

- Each one has private information
- They can collude
- Collusion adds additional constraints to programming problem

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Principal does not receive return until after agent paid (**Imptnt**)

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(Other basics - risk neutrality, limited liability)

Information Production

Benchmark Model

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- **How to monitor the Monitor?**
 - Principal observes own signal of monitor lying
 - Principal can impose penalty on both

Results

Analysis: Restricts monitor contracts to flat fees

Findings:

Benefits of a monitor

- Increases effort of agent

Costs of a monitor

- Need to pay monitor
- Agent is paid more (works harder)
- Payments to prevent collusion

In general, can't rank the models analytically

- Quantitative question

Mapping the Model to Observation

Motivated by observations of credit rating agencies/external auditors.

Looks like model - firm (agent) hires (colludes) with accounting firm (monitor).

But What About the Principal?

Model has two departures from literature, which is often motivated by manager-supervisor-employee type hierarchies

1. Return is not known with certainty
2. Principal's resources can be used for side payments
 - Implicit in assumption that principal can only impose penalty if lying detected

Argues that these assumptions are what makes this a model of external information production.

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Agree that these (particularly 1.) are important, but there is another distinctive feature of the “principal” in external information production environments.

Production of Financial Information

Information as a commodity

- Not used up
- Easy to copy. Hard to prevent others from using.
- Like a public good

Examples: Financial statements, ratings

- Users - the firm, actual investors, potential investors
- Firm pays to produce to deal with free riding problem

Thinking about the principal as the “market” might be valuable. Not sure that the moral hazard problem that the principal in the model is dealing with is all that goes on. The produced information is valuable for allocating capital and other resources in the economy.

Production of Financial Information Clearly Important

Uses a lot of resources

- Outside auditors produce financial statements
 - Expensive - \$6 Billion in audit fees (Demski (2005))
- Credit ratings

Several Costly Failures in Info Production

- Enron scandal
- Credit rating agencies in the recent crisis

Mechanisms to Mitigate Collusion in Accounting Industry

- Ethics codes
- Reputation
- Partner rotation
 - Some countries rotate auditing firms
- Investment restrictions on accountants
- Development of a concentrated accounting industry with large firms that can pay out large legal judgements
- Flat fees

Model is silent about these other factors (that may be OK)

Conclusion

Model where information production is valuable.
Collusion is a real concern even with flat fees.

Directions to push this research

- Quantitative evaluation
- Try to bring in risk aversion
- Dynamics seem important
 - Lots of relationships are repeated