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Honesty in managerial reporting: How competition affects the benefits and costs of lying

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ABSTRACT

Although research on honesty in managerial reporting has provided important evidence for the idea that competition can restrict the relevance of honesty preferences, why exactly competition has this effect remains largely unexplored. This paper suggests that different aspects of competition independently affect honesty in managerial reporting: economic competition affects the economic benefits of lying, while rivalry diminishes the moral costs of lying. Based on recent findings from social psychology and experimental economics on a gender gap in competitiveness, the study further hypothesizes that the effects of competition on honesty differ across gender. A laboratory experiment was conducted, in which participants had to report cost information in a participative budgeting context under different competitive and non-competitive conditions. Results indicate that an individual's willingness to report honestly decreases significantly when rivalry is introduced, even if the economic benefits of lying remain constant. In contrast, economic competition only diminished the salience of honesty preferences of male participants in the experiment. In conclusion, corporate managers who wish to take advantage of the positive effects of competition, such as increased motivation and efficiency in capital allocation processes, should not only focus on its economic effects but also be aware of its potential negative impact.

1. Introduction

Can organizational incentives make honest people lie? This question is of particular relevance in participative budgeting processes. When subordinates are allowed to participate in target-budget setting or are asked to report actual or forecasted costs and revenues, they can often capitalize on their information advantage by misreporting (Fisher et al., 2002b; Jensen, 2003; Zhang, 2008). Traditionally, standard agency theory predicts that, as long as subordinates have an incentive to act opportunistically, they will misrepresent information for their private benefit (Young, 1985).

In contrast, recent experimental research on honesty in managerial reporting has produced two broad findings: first, participants' reporting behavior suggests they have a preference for honesty which prevents them from fully exploiting their information advantage by lying as much as possible (Brown et al., 2009). This is because, apparently, people suffer moral costs when they lie. Second, the willingness of individuals to sacrifice some monetary payoff for the sake of a desire to be honest does not persist unconditionally. Although research has consistently demonstrated that individuals report more

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honestly than predicted within a standard agency framework, various personal and situational factors can influence the trade-off between the costs and benefits of lying and thus limit the inclination to report honestly. For example, differences in payment schemes (Chow et al., 1988; Waller and Bishop, 1990), information asymmetry (Fisher et al., 2002a), reputation considerations (Webb, 2002), and the degree of participation in budget-setting (Fisher et al., 2000; Rankin et al., 2008) were all shown to diminish the actual degree of honesty in reporting.

One factor that has also been shown to influence the cost–benefit ratio of lying, is intra-organizational competition. Competition, as opposed to co-operation, is defined as a social situation of negative goal interdependence: the achievement of a goal by one or more members of a group necessarily implies that the other members do not achieve the same goal (Deutsch, 1949; Johnson and Johnson, 1989:4). Competitive social interactions are widespread in modern organizations. Because of their alleged capacity to increase organizational efficiency, internal market mechanisms, such as competition for scarce resources, are increasingly employed in organizations (Baiman et al., 2007; Halal et al., 1993; Malone, 2004) in the hope that they set incentives for certain desirable behaviors such as effort, motivation, or increased productivity.

As several recent experimental accounting studies have shown, competition can reduce individuals' willingness to resist economic incentives and report honestly. For example, the experimental study of Brüggen and Luft (2011) shows that across different competitive and non-competitive capital budgeting contexts, agents under modest competition were most likely to misrepresent their private information to superiors in order to increase the likelihood to win funding for their projects (Fisher et al., 2002b; Young et al., 1993).

Although such studies provide evidence that competition can reduce honesty in managerial reporting, the exact mechanisms through which competition unfolds these effects have largely remained unexplored. It has been acknowledged that competition involves "a combination of economic and psychological factors" (Fisher et al., 2002b:853), or that "economic and behavioral factors" (Frederickson, 1992) are necessary to explain effects of competition (also: Brüggen and Luft, 2011:402–3). However, these different factors and their relation have not been analyzed, yet, although a thorough understanding would be very important, e.g. for the purpose of identifying adequate contract designs.

Against this background, the goal of this study is to disentangle the economic and psychological effects of competition on reporting honesty. It extends prior research in the accounting literature by incorporating recent findings from the social psychology and experimental economics literatures. In particular, it will distinguish different modes of competition and analyze their effects on people's propensity to be honest despite economic incentives to lie. While one mode of competition involves an increase in economic pressure, the other mode induces rivalry amongst participants without, however, changing monetary incentives. In addition to analyzing the main effects of competition, recent findings from gender research will be used to investigate whether the magnitude or direction of these effects vary by gender. The study thus contributes to the literature on gender and ethical decision making in accounting (Keller et al., 2007).

To test the hypotheses, a laboratory experiment was designed and conducted. Participants in the role of subordinates had to submit budget proposals, which, when accepted, allowed them to invest in a project. Since proposals influenced actual budgets, participants had economic incentives to misrepresent the information they held privately. The three treatment groups differed in whether and what kind of competition prevailed. In the case of economic pressure, participants were competing for scarce resources; in the case of rivalry, participants' relative performance was ranked, as ranking induced rivalry amongst group members, without, however, changing their economic calculus. Data suggest that participants did not fully exploit the possibility of maximizing payoffs through misrepresenting their private information. As hypothesized, however, this inclination to report honestly decreased significantly when competition was introduced. Most interestingly, rivalry indeed increased misrepresentations even when the economic incentives to lie were held constant. In contrast, competitive economic pressure per se did not generally increase misrepresentations. While female participants' propensity to lie remained unaffected by economic pressure through competition, male participants misrepresented their private information to a higher degree in a competitive setting. The experiment's results thus provide evidence for the notion that social norms such as honesty become less salient when individuals find themselves in competitive situations.

2. Background and hypotheses

2.1. Participative budgeting and reporting honesty

In line with Gneezy's definition (2005), in the current study a misrepresentation of information is classified as lying if one person intentionally communicates incorrect information to increase his or her benefit at the expense of others. Lying can be a problem in participative budgeting contexts when information asymmetries exist between superiors and subordinates in the organizational hierarchy. For example, consider a situation in which division managers (the agents) can propose projects that require funding by the corporate headquarters (the principal). If only agents know the actual costs, they have an economic incentive to misrepresent their private information by demanding funding in excess of the amount actually needed for the project ("budgetary slack").

Accounting research has sought to predict agent behavior in light of such incentives. Scholars who base their arguments on standard agency theory have traditionally assumed that lying, in the form of intentionally inaccurate reporting, is merely a function of incentives: whether individuals tell the truth depends on whether there is a strong enough monetary incentive to do so (Baiman and Lewis, 1989). In contrast, other experimental studies suggest that the inherent preference of individuals