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Norm-based crisis and Deceitful firms

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Abstract: The aim of this paper is to provide an explanation of recent corporate malpractices in terms of individuals' norm-based behaviour. In particular, it suggests that corporate misbehaviour could be understood in terms of a system-wide explanation grounded in the way in which the market itself operates and the endogenous norms which regulate its operation.

Key words: Accounting misbehaviour, Deception, Economic crisis, Invisible-hand explanation, Norm.

JEL classifications: B3, M1, M4.

Introduction

When Jeffrey Skilling, who held high-level posts in Enron until August 2001, was a master's degree student at Harvard, one of his professors asked him what he would do if he knew the company he works for were selling products harmful to its customers' health. Skilling seems to have answered that 'I'd keep making and selling the product. My job as a businessman is to be a profit center and to maximize return to the shareholders' (see Fusaro and Miller, 2002, p. 28). This is nothing more than a MBA student's opinion, but, to a certain extent, it is making the *right* point: companies are not philanthropic societies and raising profits is one of an entrepreneur's main targets. However, at the same time, when we look at the question, Skilling's answer is rather disturbing. Whether the hypothetical company his professor referred to finally went bankrupt or otherwise, the undesirable consequences which would have been produced in the meantime raise the familiar question of trust in the operation of the market; i.e., how far shall *laissez-faire* be expected to generate desired results?

In the concluding remarks of *What Went Wrong at Enron?*, Fusaro and Miller state that, according to the invisible hand's logic, collective good will be achieved by individuals choosing according to their self-interest, on the assumption that 'they will not choose to break the rules of

the market'; that is, they will not choose to break the rules which define 'how a financial firm is supposed to operate ... what behavior is proper and what is improper' (*ibid.*, pp. 148 and 147). In this paper, our gaze will be turned towards norms too. However, the aim will not be to reassert the already known conclusion that the list of accounting scandals which have come to light recently are the result of either breaking or stretching the rules, whether legal rules or unwritten moral ones. In what, at first glance, may seem paradoxical, this paper has the opposite goal: it attempts to provide a possible explanation of these accounting and business malpractices in terms of individuals' norm-based behaviour.

In the face of the scandals noted above and the number of restatements made by corporations in their accounts in recent years, there are, in broad terms, two possible interpretations. The first is given by what could be called the *rotten apples* theory. According to it, the problem stems from the fact that there have been a few firms and executives—the *rotten apples*—who have taken advantage of shareholders' trust and have damaged the reputation of their peers. However, no general problem exists in relation to the operation of what might be called the *economic system* which revolves around companies' accounts—which includes, besides companies themselves, the accounting, auditing and consulting firms, investment banks, securities analysts, and shareholders. The only problem regarding this system is that it has been shown to have certain flaws which have been used by particular agents to take advantage of investors. According to this interpretation, the solution to the problem lies in correcting these flaws and giving exemplary punishments to those cheating firms and executives. Public trust in financial markets would be, thus, restored (see SEC, 2003A, p. 1).

The second possible interpretation does not imply contradicting the previous one: the economic system to which reference has been made has certain defects which should be redressed.[1] However, the number of scandals, their dimensions and the amount of money involved are so huge that there might be an opportunity to interpret what has happened in the corporate realm on the basis of how the firms and individuals concerned have interacted with

each other within the marketplace. In other words, the second interpretation, which will be developed below, suggests that the series of corporate misbehaviours and the crisis of confidence which they have engendered could be understood in terms of a system-wide explanation grounded in the way in which the market itself operates. From this viewpoint, the straightforward relation of causality which in principle could be established between a particular loophole in accounting law and a certain deceitful form of behaviour becomes more complex. For it seems advisable to embed its explanation in how the market operates.

In order to develop this second interpretation, the workings of the market will be analysed in terms of a critical reconstruction of Hayek's implicit economics (Vaughn, 1999). Three points are worthy of note in this regard. First, Hayek is a complex and often contradictory author. Accordingly, this theoretical reconstruction does not aim at being *the* interpretation of his thought. Indeed, it is a critical interpretation of his ideas. Second, the theoretical framework developed, needless to say, is not the only possible conception of the operation of the market (see, e.g., Leathers and Raines, 2004). However, an interpretation of recent corporate events grounded on it could provide a different viewpoint from which to look at such events and, therefore, could help to cast some new light upon the understanding of those events. Third, there is no lack of irony in the possibility of using Hayek's conception about the operation of the market process to interpret corporate misbehaviour. This implies that his writings would enable us to understand what could be considered the opposite of what they were written for. That is, the Hayekian theoretical framework can help to explain why the market process might sometimes bring about undesirable results which would raise doubts about how much trust should be placed on the blind forces of the market process.

For a suitable discussion of this second interpretation, the paper has been divided into four main sections. In Sections 2 and 3, the Hayekian problems of co-ordination and material progress are briefly discussed. In the following sections, recent accounting scandals and the crisis of confidence which they have provoked are interpreted in terms of a spontaneous norm selection

process. The concluding section focuses on the main consequences which can be drawn from the understanding of corporate malpractices as a result of a norm-based behaviour in tune with the logic of the market.

The main features of the co-ordination problem

The cornerstone of what Vaughn (1999) has called Hayek's 'implicit economics' is the notion of 'spontaneous social order'. Particularly, the spontaneous social order brought about by 'the anonymous and seemingly irrational forces' (Hayek, [1948] 1980, p. 24) on which the free market operation is based. These forces take shape in the interrelation among the actions freely undertaken by a great number of individuals who, in the attempt to reach their aims, try to adapt their behaviour successfully to the flux of changing circumstances of the market (see, e.g., Hayek, [1973] 1983, pp. 36-8; 1978, pp. 71-97). The relevance of these spontaneous market forces in the Hayekian theoretical system has its roots in the fact that, given the collective outcomes which other known decision-making systems would produce, the level of adaptation to circumstances which market forces bring about is second to none.

The reason why the market is able to generate this level of adaptation is grounded in its institutional framework's capacity to solve in the relatively most efficient way the economic problem of society, which, for Hayek, 'is a problem of the utilization of knowledge' ([1948] 1980, pp. 77-8). In this regard, the main feature of the market's institutional framework is that individuals have a protected sphere of liberty in which they freely and autonomously decide how to use their particular knowledge of time and place in the attempt to achieve their own aims. This decentralised nature of the market's decision-making process enables the potential use of all the dispersed knowledge of time and place, which is individually possessed and cannot be collected and processed in its totality by any individual or collective agent (Hayek, [1948] 1980, p. 77; [1952] 1979, p. 117).

However, at the same time, this decision-making system gives rise to the following question: why does not chaos, but an orderly coexistence, arise when collective outcomes are drawn from the decisions autonomously adopted by a mass of individuals whose knowledge is restricted to their immediate context? That is, the social order which market forces spontaneously bring about could be understood in terms of a problem of co-ordination among the decisions freely undertaken by a high number of individuals. The Hayekian solution to this problem is to be found in the mechanisms and institutions which provide the individual with that amount of extra knowledge which makes it possible for her planned courses of action to be better adapted to others' planned actions. In Caldwell's terms: 'Hayek's overall goal was to elucidate that set of social institutions that least hinders social coordination in a world of fallible human beings' (2004, p. 303).

The mechanisms and institutions which provide individuals with this extra knowledge are the relative price system and the current norms of behaviour to which individuals adapt their behaviour (see Fleetwood, 1996, pp. 741-6; Vaughn, 1999). Nevertheless, although they help to raise the level of compatibility among the courses of action planned by individuals, they cannot prevent some individuals from undertaking courses of action which do not fit into the market process. The selection mechanism of competition will act on these courses of action which are not adapted to the circumstances of the marketplace. As a result, only those individuals who possess the knowledge adjusted to the configuration of circumstances and use it in a correct way—or just those individuals who behave luckily—can be successful. In Hayek's words: 'the generally beneficial effects of competition must include disappointing or defeating some particular expectations or intentions' (1978, p. 180).

In accordance with Hayek's understanding of the market as an exchange network, the solution of the co-ordination problem can be described as a correspondence between individuals' supplies and demands (see, e.g., Boettke and Subrick, 2002, p. 55). This correspondence is not the final stage of a process or a permanent equilibrium where opposite forces are balanced, but a

state of order which, although maintained through time, is constantly modified. Nevertheless, in tune with the role which competition plays in the exchange network, defining the solution of the co-ordination problem as a correspondence between supply and demand does not imply that each and every individual planned supply (demand) will have a corresponding demand (supply). In this sense, if the level at which demand and supply meet increases sufficiently, then 'the expectations of transactions to be effected with other members of society ... can be mostly realised' (Hayek, 1978, p. 184); i.e., co-ordination of planned actions can be (*mostly*) achieved. Nevertheless, at the same time, '[t]he correspondence of expectations is brought about by a disappointment of some expectations' (Hayek, 1976, Section Title in Chap. 10, p. 126) (see, also, Hayek, [1973] 1983, p. 103). Given, therefore, that some expectations are assumed to be unfulfilled, the succession of correspondences between supply and demand on which the continuous resolution of the co-ordination problem rests can be understood as a chain of results which are the brought about by competition expelling from the marketplace unsuited planned supplies and planned demands.

Norm-based material progress

While the exchange network is solving the co-ordination problem, there would be another process going on in the marketplace; namely, society's material progress:

> The best way to understand how the operation of the market system leads not only to the creation of an order, but also to a great increase of the return which men receive from their efforts, is to think of it ... as a game .... It is a wealth-creating game. (Hayek, 1976, p. 115)

The material progress process not only takes place at the same time as the process of solving continuously the co-ordination problem, but it is indistinguishable from the latter in practice. Only in analytical terms, for the sake of expositional clarity and for the relevant conclusions which might be drawn, can they be separately analysed.

Bearing in mind the abstract nature of this split, the notion of *material progress* will be understood, not as an increase in production, but as a rise in the highest level at which the

correspondence between supply and demand can take place. That upper level or, as Hayek (*ibid.*, pp. 117-9) calls it, 'the horizon of catallactic possibilities', probably does not exist. Or more accurately, if it existed, it would be unknown. However, even so, defining it and taking it as an abstract reference point is useful to be able to distinguish analytically between the problems of co-ordination and material progress.

For Hayek ([1952] 1979, p. 176), resources and needs exist for practical purposes only through somebody knowing about them. In tune with this idea, this upper limit (at a certain moment) would correspond to a correspondence between supply and demand which is characterised by two features. First, all the resources and needs known by someone (at that moment) are, respectively, being used and satisfied in the best possible way known by someone (at that moment). Second, there are no unfulfilled planned actions.

A better resolution of the co-ordination problem would imply—at least in principle—a higher level of production. For more planned supplies would be demanded and more planned demands would find agents willing to satisfy them. Competition, thus, would be expelling from the market a lower number of planned actions. However, this does not entail that the ceiling of the spectrum of possible correspondences between supply and demand has been modified. Indeed, according to the definition of material progress, if this upper limit does not change, the increase in production generated by the improved resolution of the co-ordination problem would take place without material progress. Nevertheless, once again, special emphasis should be put on the fact that separating the problem of co-ordination and the problem of material progress is just an analytically useful argumentative instrument, so much so that, paraphrasing Buchanan and Vanberg (2002, p. 123), it could be said that the horizon of catallactic possibilities is continually being pushed outward by the creative choices of some participants as the co-ordination problem is constantly being solved.

Regardless of alternative ways in which the horizon of catallactic possibilities could expand, attention will be focused, following Hayek, on how spontaneously-emerged norms of

behaviour can modify that upper limit. Norms of behaviour, for Hayek, do not necessarily have to be explicitly known by individuals or consciously followed by them. They do not have to be verbalised or included in the legal system enforced by the state. Individuals behave according to rules when their conduct follows a certain widespread regularity: 'most rules of conduct ... will manifest themselves in a regularity of action ..., but this regularity of action is not the result of the acting persons being capable of ... stating them' ([1973] 1983, p. 19).

Spontaneously-emerged norms are the result of a trial-and-error selection process (see Caldwell, 2001, pp. 549-51). Bearing in mind that '[a]gents do not create or produce structures *ab initio*' (Fleetwood, 1996, p. 735) (see, also, Runde, 2001), the starting point of this selection process would be that pioneering individuals put alternative ways of behaviour into practice. This does not necessarily have to be a completely conscious process. It might be the result, for instance, of 'transmitting from individual to individual an imperfect copy of each habit by an indirect route' (Hodgson, 2003, p. 171). If these innovative ways of acting enable pioneers to achieve a better adaptation to circumstances, the latter would become, by means of a process of imitation or whatever other spontaneous means, a widespread regularity of behaviour—i.e., a norm. Therefore, the ways of acting which have overcome this spontaneous selection process, and hence have been retained, would contain all the knowledge accumulated as a 'result of a past process of tentative exploration' (Hayek, 1976, p. 9) (see Vaughn, 1999, p. 135).

Adding to this the idea of group-based norm selection,[2] the spontaneous mechanism of trial and error sketched above is mainly used by Hayek to explain the emergence of norms, and particularly those norms which protect the sphere of individual freedom. However, if the historical process Hayek refers to had ever happened, it seems to be lost in the mists of time (see Steele, 1987, pp. 173-5). Regardless of the atemporality which characterises the Hayekian theory of evolution, it could be asserted, nevertheless, that the spontaneous norm selection process keeps going on in a market society. Moreover, as far as the marketplace is concerned, the norm selection process and competition are so closely related to each other that they can hardly be

thought of but as mechanisms forming part of the same selection process. In this sense, besides conceiving of competition as responsible, in the last resort, for solving the co-ordination problem, Hayek confers the virtue of discovering good quality knowledge upon it.

Competition would discover and filter which pieces of the individually possessed knowledge of time and place, and which ways to use it, are adapted to the flux of circumstances and, therefore, can reach the exchange network. New ways of using knowledge which pass the test of competition would spread spontaneously throughout the market place. What this means in terms of norms of behaviour is that, if competition rewards pioneering individuals who have developed a new way of acting with success, this new pattern of conduct would become a widespread regularity of behaviour because other individuals would adhere to this successful pattern of using knowledge:

It is difficult to conceive all the combinations of knowledge and skills ... from which arises the discovery of appropriate practices ... that, once found, can be accepted generally .... Who will prove to possess the right combination of aptitudes and opportunities to find the better way is ... little predictable .... The successful combination of knowledge and aptitude is not selected by common deliberation ... it is the product of individuals imitating those who have been more successful. (Hayek, 1960, p. 28)

Accordingly, the fact that a way of acting has passed the competition test and, as a consequence, has become widespread implies that a new way of using good quality knowledge has been disseminated throughout society. As a result of this innovation in the patterns of behaviour which individuals follow, the highest level under which the correspondence between supply and demand can take place would be pushed upward. That is, 'Hayek's faith in the efficacy of social evolution' (Butos and Koppl, 1997, p. 337) entails that spontaneously-emerged norms make society's material progress possible.

Invisible hand explanations and the fallacy of composition

The achievement of society's material progress is understood, therefore, in terms of an invisible-hand type explanation: desirable collective outcomes are brought about by the interrelation between the autonomous actions of many individuals who do not intend to produce those outcomes (see Ullman-Margalit, 1978, p. 267). In invisible-hand explanations, far from being in conflict, the aims of the individual are the means to reach social improvement: 'Hayek brought against the advocates of the "middle way"—Keynes, in particular—the charge of proposing themselves as mediators of a conflict between the individual and society, which, in his eyes, is non-existent' (Carabelli and De Vecchi, 2001, p. 236). Nevertheless, as Nozick has pointed out, '[n]ot every pattern that arises by an invisible-hand process is desirable' (1994, p. 314). In this regard the classical criticism levelled against invisible-hand explanations is that, according to the fallacy of composition, they draw a conclusion about the social whole from the features of its constituent parts. However, social and individual improvement does not necessarily have to be aligned. Indeed, the spontaneous market process, sometimes, might give rise to outcomes which raise doubts about how much trust should be placed on the blind and anonymous forces of the exchange network. The corporate malpractices which have come to light recently can be understood as an example of this possibility.

In order to provide an interpretation of the origins and spread of these malpractices in terms of behaviour based on spontaneously-emerged norms, the Hayekian norm selection process can be used. This way, Hayek's framework of thought could be helpful for understanding and casting a different light on a perverse norm-based result brought about by the blind forces of the market process. In a certain way, the aim is, to put it in Hodgson's words, 'to address the seeds of potential disorder within every ordered outcome' (2004, p. 298).

Norm-based deception

As Minsky (1996, pp. 362-5) has pointed out, two of the outstanding features of the form currently adopted by capitalism in most industrialised economies are the following. First, corporations are the dominant form of business organisation. Second, the interest of shareholders is dominant in corporate governance. It could be said, consequently, that one of the targets—if not the main one—pursued by those who work in the corporations of this stock market-centred version of the market could be enunciated in the following way:

CORPORATE TARGET: Raise as much as possible the returns to shareholders, whether by increasing equity price or dividends.

Aiming at satisfying this target, certain new ways of acting have emerged and spread spontaneously throughout the marketplace (see, e.g., Leathers and Raines, 2004). That is, a series of norms have been generated by means of an unregulated process which is in tune with the Hayekian norm selection process. Mention could be made, for instance, of the norm of compensating executives with earnings-based bonuses, shares or stock options. Leaving aside the undesirable effects which this performance-based compensation has added to the troublesome separation between control and ownership, it could be said that the spontaneous, wide diffusion of this norm has strengthened a situation in which '[s]hareholder value now sits atop management agenda' (Bratton, 2000, p. 23).

This pre-eminence of shareholder value among the companies' objectives would have given rise to the emergence and spread of other norms by the autonomous adherence of agents to successful pioneering ways of acting. Indeed, it would not be too controversial to state that one of these spontaneously-developed norms which are followed by corporate governance is nothing but a normative translation of the target 'raise the returns to shareholders'. This norm, which will be labelled Norm I, can be set out as follows:

NORM I: Do whatever you can to increase, in broad terms, shareholder value or, in more concrete terms, equity price.

Following this norm not only leads to the accomplishment of the aim of increasing shareholder value, but also helps to achieve, at least *a priori*, the corporations' parallel aims. For instance, it hampers hostile takeovers of the firm in question and, at the same, facilitates the reverse; or it makes it easier to raise additional funding, whether by issuing new equities and bonds or by borrowing capital from the banking system.

In the speculative context of the stock market, showing profits is not a necessary condition for the equity price of any company to rise. The dotcom bubble is illustrative enough in this regard. Nevertheless, empirical studies point out that those firms that report steadily earning increases are valued more highly by the stock market (see Barth *et al.*, 1999). Indeed, Fusaro and Miller (2002, p. 73) state that a far from unusual causal relationship during the nineties was that the stock value of companies which missed their earnings estimates by a minimum amount per share fell over the announcement (see, also, Levitt, 1998). It could be said, therefore, that there is—or that investors seem to assume that there exists—a direct relationship between the equities to be purchased and profits—or, more accurately, a certain concept of *profit*. In brief, 'earnings per share determines whether a company's shares will rise or fall' (Berenson, 2004, p. XXVIII).

According to this relationship, the spontaneously-emerged Norm I would have favoured the emergence of another way of acting which would have become widely followed, making it possible to consider it a norm. Such a norm could be described in the following terms:

NORM II: Do whatever you can to ensure that the profit rate shows growth.

Two remarks concerning Norm II are worth considering. On the one hand, this norm does not describe a behaviour consisting in the firms' traditional aim of *making* profits, but in *showing* a growing profit rate. That is, it entails that shown profit rates, as they stand in companies' accounts, do not have to represent companies' financial performance. On the other hand, a norm, for Hayek, does not need to exist in a verbalised and conscious form. In this regard, regardless of the fact that norms are not just 'observed regularities in the behaviour of some social group' (Runde, 2001, p. 13) (see note 3), there is no inaccuracy in stating that when individuals'

behaviour, whether consciously or not, follow a certain regularity we have a norm: 'To emphasize this we have occasionally spoken of "regularity" rather than of rules, but regularity, of course, means simply that the elements behave according to rules' (Hayek, [1973] 1983, p. 43).

Therefore, in order to back up the statement that what has been called Norm II is really an implicit norm which has been followed in the corporate domain in recent times, it would be sufficient to show that the behaviour described as 'Do whatever you can to ensure that the profit rate shows growth' has been a way of acting to which a considerable number of corporations have adapted their conduct.[3] To show that such a requirement is satisfied, note that the best well-known accounting scandal—namely, that of Enron—is just, as Schroth and Elliott (2002) have described it, 'the tip of the iceberg'. Besides Enron, there are about another twenty major cases of deceptive corporate misbehaviour in the USA (see Benston *et al.*, 2003, p. 3), to which the European cases would have to be added. The number of enforcement actions filed by the SEC for financial reporting violations or fraud in the USA during the period July 1997 to July 2002 reached 515. In terms of the annual amounts of actions which the SEC filed for these reasons, they increased from 91 in the first year of this period to 149 in the last one (see SEC, 2003A, pp. 1-2). In addition, 116 companies needed to correct their financial statements in 1997 in the USA, but the number of firms that did so in 2000 was 233 (see Serwer *et al.*, 2002, p. 74). Indeed, as the SEC has stated in one of its special reports, '[t]he past year [from July 2001 to July 2002] has been marked by a series of restatements of financial statements by prominent corporations resulting in billions of dollars lost by investors' (SEC, 2003A, p. 1). In addition, as Myers and Skinner conclude in their empirical study about the possibility that firms' managers were using their accounting discretion to help them accomplish and maintain a steady growth of earnings through time, 'our evidence suggests that managers of firms that report long strings of EPS [earnings per share] growth practice earnings management to help their firms sustain that growth' (1999, p. 6). Quoting the words of the ex chairman of the US Securities and Exchange

Commission (SEC), Arthur Levitt, in a speech entitled ‘The Numbers Game’ and delivered three years before accounting scandals started, it could be said that:

In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. As a result, ... [m]anaging may be given way to manipulation .... These practices aren’t limited to smaller companies struggling to gain investor interest. It’s also happening in companies whose products we know and admire. (Levitt, 1998)[4]

Finally, note that corporations make a recurring use of pro forma accounts like Ebitda—i.e., earnings before interest, taxes, depreciation and amortisation—which, in the USA, are the first sets of results produced by companies, are not audited and do not follow accounting legislation. Although originally thought to provide additional information concerning the progress of companies to investors, they have become a legal, but vitiated, way to show a better image than that depicted by the balance sheet. Moreover, the great amount of detailed, prescriptive rules which form the American accounting legislation have two perverse, related consequences. On the one hand, what is not forbidden by any rule is permitted. On the other hand, the relevant aspect of the accounting procedure is to obey the letter of the law, but its spirit can be ignored. As the SEC points out, ‘rules-based standards ... can result in financial reporting that is not representationally faithful to the underlying economic substance of transactions and events’ (SEC, 2003D, Exec. Summary).

Both consequences, and the outrageously excessive use of pro forma statements, are just a legal means used by corporations which complement flatly illegal ones to create a deceptive image of corporations. All of them make it possible, however, to observe Norm II: ‘Do whatever you can to show that the profit rate is growing’. According to these data, however, this Norm could be then more accurately verbalised. Particularly, new details could be added about the way in which the expression *whatever you can* might be understood. In this sense, the new version of this norm could be enunciated as follows:

NORM III: Do whatever you can, even deceive about or disguise the potentially disadvantageous aspects you know of, in order to show a growing profit rate.

The specific ways corporations act by which Norm III has materialised are diverse. For, as Hayek suggests, a norm just establishes the substratum of a type of behaviour which can be given concrete form in different ways of acting. In this sense, particular ways of acting embodied by Norm III are, for instance, the abusive use of pro forma accounts which could mislead investors; the creation of special purpose entities in order to keep liabilities off the balance sheet; improper timing of revenue recognition—including those cases in which revenue depends on a contingency which could preclude its realisation; or the creation of fictitious revenues obtained, for example, by means of false trading (see SEC, 2003A, pp. 5-30).

However, regardless of the particular forms adopted by Norm III, the main point is that a norm entailing deceitful behaviours has spread throughout the marketplace. We do not know the details concerning how this came about. We could think, at least, of two main possibilities as far as the process of spontaneous diffusion of Norm III is concerned. The first one would assume that there was a pioneering company called *E* (for Enron, for example; but this should not be taken as implying Enron was really the first company to put the way of acting embodied in Norm III into practice). As a result of its accounting manoeuvres, this corporation *E* was awarded with success by competition. It experienced how its equity price went up; how the business press considered it the most innovative company year after year from 1996 to 2002, or how it rose to fifth on the Fortune 500 in 2002 (see Fusaro and Miller, 2002, pp. 75 and 79); how credit rating agencies rate it a good credit risk—and they continued to do so until four days before *E* declared bankruptcy (see SEC, 2003B, p. 16); how analysts rated it a *strong buy* until almost the last moment (see Fusaro and Miller, 2002, p. 119). As a consequence of other companies observing the success of the pioneering *E* firm, they could have imitated its behaviour to achieve the same level of prosperity. In this regard note that the massaging of accounting numbers was a well-known practice. Evidence of this can be found in the business press. For instance, in the article 'Learn to

Play Earnings Game (And Wall Street Will Love You)', Fox and Rao (1997) tell of the advantages of smoothing or boosting earnings more than four years before the cathartic point of the Enron scandal was reached. Indeed, Levitt explicitly stated in his 'The Numbers Game' speech that '[m]any in corporate America ... know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud' (1998). As a first possibility, it could be supposed, therefore, that Norm III reached widespread diffusion through a process of imitation of deceitfully successful pioneering companies.

A second possibility would be that the origin of Norm III, the cause of its diffusion, and the sense of immunity of the companies which followed that norm could be looked for in auditing firms. This is no more than a hypothesis. However, it could be supported by the fact that auditors inappropriately attested to deceitful financial statements (see Benston *et al.*, 2003, pp. 42-6). In addition, they seem to have had a more active role in certain cases, as Arthur Andersen's behaviour in the Enron affair may suggest. In fact, it shredded evidence when the company's trouble came to light (see *The Economist*, 2002, p. 11) and there was a shifting of accountants from this auditing firm to Enron (see Fusaro and Miller, 2002, pp. XI-XII).

Nevertheless, although the particular details of the process can only be guessed at, a norm which verbalises deceitful behaviour was spread by means of an unregulated, endogenous process where market mechanisms define the way of acting which fails or succeeds. There were several factors which enabled the spontaneous forces of the exchange network to produce this controversial Norm III. In general terms, one of them is that there does not exist anything like a corporation's real situation which can be perfectly reflected by accounting statements. Accounting is much more a matter of conventions, which often implies estimates, and therefore a certain arbitrariness is assumed as a matter of principle. Indeed, flexibility in accounting is necessary in order to keep pace, for example, with business innovation. Problems arise when this pliability is used in a trickery way—let alone in an openly illegal one. For then accounting reporting transforms the impossibility of exactly reflecting the companies' real performance into

the practice of providing deceitfully self-seeking disclosures. Then, far from the hypothesis of efficient financial markets, there would be no criterion available for investors—pure speculation aside—to compare the companies' performance and, therefore, to adopt sensible investment decisions (see SEC, 2003D, Sect. I.B.). In brief, a problem of confidence arises (see, also, Benston *et al.*, 2003, p. 20; Berenson, 2004, p. XXXII):

If companies fail to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken ... and the trust that is the bedrock of our capital markets is severely tested. (Levitt, 1998)

Besides the inherent arbitrariness of accounting, the diffusion of Norm III has been favoured, in the particular US case, by the detailed nature of the accounting legal system. This feature has helped to create an accounting culture where what is not forbidden by accounting laws is assumed to be permitted and what is relevant is to follow the letter—not the spirit—of the law. In addition, institutions set up to ensure proper disclosure fail to fulfil their duties (see Benston *et al.*, 2003, p. 19). As regards the SEC, which is the main public *gatekeeping* institution in the US, this failure was particularly grave. However, it did not happen by accident. As Berenson (2004, Ch. 9) shows, the SEC is understaffed, its staff is inexperienced and the gap between its workers' salaries and what they could earn in the private sector is untenable. One of the reasons for this situation is to be found in the fact that '[l]ibertarians and conservative Republicans had never really accepted the agency's existence .... Markets could and should regulate themselves. End of story' (Berenson, 2004, p. 137).

In accordance with the way in which the Hayekian problem of material progress is solved, the horizon of catallactic possibilities moved outward as a result—other possible causes aside—of companies adhering to Norm III. If deceiving behaviour is the means to put the best image on companies' finances, the blind process of competitive struggle is in charge of awarding those deceitfully *well-favoured* companies with an increasing equity price. At the same time, whilst companies use deception whenever necessary and deceitfully successful companies are not

punished, a rising equity price opens more possibilities either to make profits or to increase individual wealth by investing in the stock market. Besides the range of opportunities provided to companies because of the increasing value of their stock, those possibilities attract investors who would not have invested in the stock market otherwise. That is, the line drawn by the horizon of catallactic possibilities rises. For, after passing the profit-and-lost test of competition, an alternative way of making known resources more profitable has spread through a spontaneous process.

Nevertheless, besides the corporations themselves which practice deceit and, obviously, their stock-rewarded executives, there were more agents who benefited from Norm III. Auditing firms, investment banks and financial analysts obtained extraordinary earnings as compensation for the services they provided to deceitful firms—contributing this way both to the success of these companies and to hide the basis on which that success was grounded. Auditors, for instance, by attesting to dubious accounting statements, not only ensured the fidelity of their customers as far as auditing work is concerned, but also that they would be contracted to provide them with nonaudit services such as consulting or legal services (see, e.g., Berenson, 2004, p. XXXII). As regards investment banks, they raised lucrative fees from making loans to the companies in question, underwriting bond and equity issues, advising them on mergers and acquisitions and selling on loans to other investors. To ensure that these fees would still be collected, investment banks just had to keep on covering those corporations' financial needs and to encourage 'their research analysts to "hype" the shares of companies the banks marketed' (Benston *et al.*, 2003, p. 16) (see, also, SEC, 2003C). To put it in the first-hand words of the ex chairman of the SEC: 'Too many corporate managers, auditors and analysts are participants in a game of nods and winks' (Levitt, 1998).

There was, therefore, a dense net of individuals who, driven by their interests, contributed to the spontaneous diffusion and maintenance of a way of acting consisting in accounting deception. The idea was left behind that reputation would prevent corporations, auditing firms,

rating agencies or investment banks from adhering to the irregular regularity in conduct which has been labelled Norm III. Moreover, shareholders have been depicted as the great losers of the succession of recent accounting scandals. However, while scandals did not break, they profited from the surging price of deceitful companies' equities, either by speculating or observing how the value of their net assets was increasing.

Norm-based crisis

The reversal of the material progress achieved through Norm III took place when the Enron affair came to light. After that moment, scandals leaped from company to company at a bewildering rate. As a result, a crisis of confidence broke in which 'a majority of agents los[t] faith in the convention that sustains the expectation-generating process' (Crotty, 1994, p. 124).

Nevertheless, in the situation brought about by corporate malpractices, the convention which sustained the expectation-generating process was rather more complex than the idea that today's prosperity will probably continue tomorrow. Indeed, this convention could be understood in two different senses. For those agents who were following or consciously underpinning deception, the convention which sustained the formation of optimistic expectations was based on Norm III. Whilst deception could be practiced, they did not need to estimate prospective yield. What they had to figure out was what profit rate should be shown to ensure that equity prices increase. This was, for them, the means to sustain the expectation-forming process. As a result, investors who did not know how widespread Norm III was, but were not speculators, found themselves gambling in a casino whose rules were, not only unknown, but different to what they were told and trusted. Among this type of investor, mention could be made, for instance, of Enron's workers, who had invested their pension funds in the firm's stock (see Fusaro and Miller, 2002, p. XII). As regards these investors who did not know what was happening behind accounting reporting, faith was lost in the conventional assumption that accounting data was, not the reflection of reality, but at least a reliable reflection of financial performance which could be

used as a criterion for comparing different companies' performance and, therefore, for adopting investing decisions. That is, they started doubting whether the trend of profits which companies were 'showing by whatever means' was related to their financial performance at all. As far as these investors are concerned, trustworthiness was called into question, the trustworthiness on which the operation of the stock market-centred version of capitalism rests.

In this sense, Keynes's words become even more eloquent: 'When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done' ([1936] 1973, p. 159). The consequences drawn from Norm III after scandals came to light could be explained, indeed, as a wave of pessimism or even as 'an error of pessimism' in a speculative market in which it is not sensible to pay *x* for an investment if you believe that the market will value it at less than *x* or even at 0 after trustworthiness has been shaken. Under the state of confidence created by these consequences, the horizon of catallactic possibilities collapsed from the level which it has reached by means of a rule of behaviour which emerged through a spontaneous process of norm selection. That is, the material progress spontaneously achieved turned into its reverse, showing that socially advantageous outcomes do not necessarily follow from what is individually beneficial:

In a matter of months, that confidence disappeared. During the spring of 2000, dozens of cases of serious accounting gimmickry came to light at ... Fortune 500 companies .... Whole sectors of the market ... found themselves unable to sell new stock or bond issues at any price .... Between March and October of 2002 ... $ 4.3 million in stock market ... simply evaporated. (Berenson, 2004, p. XXXV)

This crisis of confidence, therefore, finds its origin in a deceitful way of acting which becomes a widespread norm of behaviour through a spontaneous process driven by 'the anonymous and seemingly irrational forces of the market'. In this regard it could be said that deceiving is economically rational and profitable for all the participants in the exchange network. Problems only arise when this behaviour is discovered. For, when scandals came to light, the fallacy of composition became apparent, showing that what was individually advantageous for

companies, shareholders, auditors, analysts and investment banks not only was self-destructive in the medium-run, but damaging for society. In fact, Norm III produced an undesirable result, which, this time, adopted the form of a crisis of confidence.

The idea that the collective outcome brought about by a process based on individuals pursuing their own interest is an undesirable or non-optimal result has been expounded in game theory by means of the prisoner's dilemma. Indeed, one of the main criticisms which has been levelled against Hayek's use of an invisible-hand explanation in his theory of norm selection rests upon this game-theory situation (see Bianchi, 1994, pp. 239-41; Vanberg, [1986] 1991, pp. 191-4). Nevertheless, although the prisoner's dilemma illustrates the conflict between individual and collective outcomes, it does not reflect accurately the spontaneous process of adherence of corporations to Norm III and how this provoked a crisis of confidence. For it does not take time into consideration. However, the passing of time, i.e., the understanding of market as a process, besides the widespread diffusion of Norm III, is a key factor in order to explain why the deceitful mode of behaviour followed by corporations has culminated in a crisis of confidence.

In order to take time into consideration, the prisoner's dilemma could be transformed into an iterated game. However, in this case, the problem is not solved. It probably becomes worse. For in an iterated prisoner's dilemma game, reciprocity (or reputation) would give rise to strategies with survival value—like a Tit-for-Tat strategy—which recover the compatibility between individual aims and desirable collective outcomes (see Axelrod, 1984; Sugden, 1986, ch. 6; Whitman, 1998, p. 62). However, these abstract game-theory arguments are in contrast with what has happened in recent accounting scandals. For neither reputation nor reciprocity have prevented companies from adopting a type of behaviour which led to the worst collective result.

Other problems arise when the Hayekian norm selection process is supposed to take place at the group level. That is, when the leading role of the competitive struggle is supposed to be played by groups and the spontaneously selected norms are assumed to be those which enable the group that adopted them to be more successful than others. In a group-grounded selection

process, Norm III would not be considered a spontaneously selected norm. For the group of corporations which followed it failed in the end. This norm, as a result, has not survived. The problem with this group-focused argument is that it entails the risk of underestimating the consequences which competition among groups could have during the period in which they are competing. In recent corporate malpractices, among the consequences which could be underestimated by this type of analysis, we have a crisis of confidence and the enormous amounts of money lost by investors.

Conclusion

Although cyclical fluctuations were the main subject of Hayek's early work, 'he never came back to discussing the business cycle from the point of view of his theory of spontaneous order' (Witt, 1997, p. 54). The discussion above can be considered a contribution to the attempt at filling this analytical gap. That is, it shows how crises or just undesirable results can be explained in terms of the elements which characterise the Hayekian conception of spontaneous processes. Nevertheless, this discussion has not been grounded in an abstract situation like, for instance, the prisoner's dilemma, but in recent corporate misbehaviour. Two aims are thus satisfied. On the one hand, the possible conflict between individual behaviour and desirable collective outcomes does not depend on an abstract situation whose conclusions rest on the assumptions adopted. On the other hand, Hayek's theoretical framework is shown to be useful to illustrate problems concerning the way in which the market might sometimes operate. In contrast with Vanberg's ([1986] 1991) arguments, the point is not, therefore, that the Hayekian view can be criticised due to the type of conclusions it can lead to. The point is, by contrast, that this view provides a framework within which the undesirable results produced by the market process can be interpreted.

In this sense, accounting scandals can be interpreted in terms of a handful of unprincipled executives whose remuneration depended on the equity price of the companies they worked for.

Nevertheless, in the light of how widespread deceitful conduct has come to be, there exists the possibility that this way of acting could be considered a regularity of behaviour. That is, a norm of behaviour spontaneously emerged and maintained through an endogenous selection process led by the forces of the market process.

In contrast with the latter, this second interpretation provides a system-wide explanation based on the mechanisms which characterise the operation of the market and the relations established among the economic agents related to companies' accounts and stock. In addition, it puts forward a norm-based view of corporate misbehaviour which widens the way in which market failures might be understood. Indeed, if this norm-grounded explanation casts some new light on the 'epidemic of corruption'—in Krugman's (2004) words—in corporate America, new doubts arise as regards the collective results which the operation of the market process might bring about. There would be renewed reasons, accordingly, to be aware that those outcomes might sometimes be undesirable. Corporate malpractices are just an illustration of this need. Their origin can be found in a spontaneous process, and their result was—as Hayek suggests in relation to this type of process—material progress. However, when the scandals broke this material progress turned into the collapse of the horizon of catallactic possibilities. The upper limit beneath which the correspondence between supply and demand can take place rose by means of deception, and deception itself made it fall again. Deception is not, obviously, the only variable to be considered in order to explain the behaviour of the agents who participate in the stock market or are related to companies' accounts. However, it is one of the variables which might contribute to explain accurately recent economic events and the crisis of confidence in which they have resulted.

American capital markets and the public institutions related to them are far from a helter-skelter market in which 'anything goes'—or at least, can 'keep going' indefinitely. Indeed, the robustness of those institutions has been proved in how they have reacted to avoid the crisis of confidence going any deeper. Nevertheless, it is worth considering that the medicine given

depends on the diagnosis made. If accounting problems had been caused by the conjunction of a few agents and some loopholes in accounting legislation, the correct solution would lie in punishing the former and correcting the latter. However, if these problems required a broader explanation which involves the analysis of the relationships among corporations, investment banks, auditors, analysts and shareholders, solutions should take into consideration that the question 'Can "it" happen again?' would probably yield a positive answer. For Norm III, then, would be in tune with, and the result of, the logic of the market, particularly of speculative markets. Accordingly, the attempt to avoid the emergence and spread of something like, say, a new version of Norm III would require more than just redressing those loopholes. It would call for questioning how much trust can be placed in the operation of the market after those flaws have been corrected. That is, it would require the adoption by public institutions of a level of alertness adjusted to this calling into question of market outcomes and to the related conflict between public and private interests: 'Remedies to the intrinsic conflict between individual and social interest ... are only social: provided by public institutions' (Carabelli and De Vecchi, 2001, pp. 232-3).

This paper is focused not so much on the measures to be adopted, but on the diagnosis of the sickness. It could be said, however, that a policy directed at patching up, *ex post*, discovered loopholes by means of new legal rules, although necessary, might prove insufficient. By way of illustration of this insufficiency, two examples can be mentioned. As a result of the extent of large auditing firms' involvement in corporate scandals, the Sarbanes-Oxley Act has established that auditors cannot perform non-audit work for their corporate clients. However, as Benston *et al.* point out, '[a]uditors who might be suborned by the prospect of ... gaining consulting fees are just as likely to be suborned by similar concerns about audit fees. The result of this prohibition, we fear, is higher audit fees and less effective audits' (2003, p. 13). The second example is the mandatory rotation of auditing firms at regular intervals, another measure introduced by the Sarbanes-Oxley Act. This measure, as necessary as it is, might be insufficient too. Note in this

regard that such a rotation was already required by Italy's accounting legislation. In compliance with it, Parmalat switched from Grant Thorton to Deloitte & Touche as main auditor in 1999. However, the former became the auditor of Bonlat, a Parmalat subsidiary. The scandal at the dairy-products group broke when a strategy purported to show big cash balances within Bonlat was discovered (see *The Economist*, 2004A, pp. 45-6; 2004B, pp. 50-2).

In brief, the relationship between a certain deceitful behaviour and a flaw in accounting legislation becomes more complex if Norm III is understood as the result of the logic of the market. In this case, as the examples above suggest, legal modifications directed to correct particular loopholes might give rise to a new or modified loophole. Flaws in the accounting legal system and corporate malpractices shall be understood, therefore, in terms of how and why market relationships make a certain legal flaw be a flaw. This does not mean that accounting laws are useless or that discussing which norms are best is worthless.[5] To operate properly, the economic system needs an adequate legal framework. However, what accounting misbehaviour shows is that there are ways to bend or circumvent rules. Thus, besides the relevance of this legal framework, a fundamental issue is to guarantee that economic agents are satisfying, not just the letter of the law, but the general principle that corporations' accounts reflect their financial performance. In this regard, one of the special reports prepared by the SEC staff points out that '[r]ules-based standards often provide a vehicle for circumventing the intention of the standard. As a result of the study, the staff recommends ... [to] develop standards on a principles-based or objectives-oriented basis' (SEC, 2003D, Exec. Summary). In tune with this principle-based system, accounts are required to be, not an impossible description of corporations' *real* situation, but an accurate report of where they are and where they are going. Nevertheless, this report adds that 'the existence of a strong and consistently applied enforcement mechanism is a necessary component of an objectives-oriented system' (SEC, 2003D, Section III.J.). That is, the conflict between collective and individual interests cannot be solved. Hence, it requires an enforcement mechanism and an accurate level of alertness by the public authorities. In this sense, besides

particular legal modifications *ex post*, public gatekeepers should be aware that there are situations in which, as a result of this contradiction between public and private interests, the operation of the invisible hand cannot be blindly trusted.

The fact that the failure of deceitful agents has been based on a widespread way of acting is what makes this behaviour a matter of concern as regards reputation, trustworthiness and collective outcomes. At the same time, the fact that so many agents were involved in deceptive behaviours compels us to reflect upon what the consequences might be when 'faith in the efficacy of social evolution' drives us to disregard the undesirable results which might be brought about by the market process. Moreover, perhaps we should rethink the idea that '[i]t is usually agreed that casinos should, in the public interest, be inaccessible and expensive' (Keynes, [1936] 1973, p. 159). Given what has happened, for instance, with the pension funds of Enron's workers, it might well be advisable to bring this about.

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Notes

[1] In this regard, given that most of the accounting scandals have taken place in the United States, mention should be made of the Sarbanes-Oxley Act, which came into force on July 30th, 2002. It has introduced changes to the regulation of financial practice and corporate governance.

[2] The hypothesis of group-grounded selection is, even for Hayek's advocates, one of the most controversial and ambiguous aspects of his theoretical legacy (for a critical analysis of this idea, see Barry, 1994, pp. 144-5; Hodgson, 1991; 1995, ch. 12; Kulessa, 1997; Steele, 1987; Whitman, 1998, pp. 60-3; Witt, 1994, pp. 183-7). As Vanberg (1991, pp. 182-3) has stated in this regard, there are arguments in Hayek's work which imply an individualistic interpretation of the idea of cultural evolution. However, those arguments co-exist in his writings with others which assert that rules come to be observed because they are advantageous to the group. Here, given this paper's aim, only in the last section will a brief reference be made to the idea of group-based selection.

[3] Runde states that '[r]ule-breaking is often cited by proponents of CR [Critical Realism] in support of their view that social structures are irreducible to events (human actions) or patterns between events" (2001, p. 13). I share this view. However, it should not be confused with this paper's argument, which is focused on the fact that corporate malpractices have been so widespread that—whether they have entailed breaking certain moral or legal norms— they can be considered the *opposite* of a rule-breaking behaviour. To put it flatly, since they became a regularity of behaviour, they can be considered norm-based or norm-constituting behaviours. In this regard, the norm they were helping to create is Norm II. As Berenson states in this regard, '[l]ike any town ..., the market is bound to have its share of grifters and shoplifters. However, the deception at [for instance] Computer Associates was dangerous precisely because it "wasn't" an aberration. By January 2001, all manner of companies were abusing accounting rules to mislead their investors, seemingly without fear of being caught' (2004, p. XXIII).

[4] Given that the speech delivered by Arthur Levitt at the New York Center for Law and Business on September 28th, 1998, has been taken from the web, references to it will not include page number.

[5] On this matter, see Leathers and Raines's (2004) discussion regarding the need to regulate the use of financial derivatives.