Never Seek that by Foul Means - Monitoring-, Which You May Have by Fair - Financial Reporting: An Experimental Study

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Abstract

We consider a principal-agent model in which a Creditor (principal) can monitor managers (agents) during the first stage of a lending relationship. Monitoring is motivated by the need to measure the economic viability of distressed firms in order to select reliable managers. Monitoring too much during the beginning of the lending relationship provides incentives to unreliable managers to invest in truthful reporting. In that case, rational cheaters can mimic reliable managers and the creditor monitors too much for nothing. However, no monitoring induces high cost of splitting with unreliable managers in a long-term relationship. Consequently, the creditor bears a long war of attrition. We provide experimental evidence based on this principal agent model. We study the hypothesis of a crowding out effect induced by an excessive monitoring.

Keywords: Incentives – Monitoring – Reporting - Screening –Experiments - Crowding-out effect.

JEL classification: D2, G3, M4, C9.

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