The Bubble and the Media

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Abstract

Most of the research in comparative corporate governance has, implicitly or explicitly, taken the US as benchmark. But recent corporate scandals, such as Enron and Worldcom, question this alleged supremacy. What went wrong? In this chapter we claim that the problem is not just lack of appropriate disclosure or legislation, but a more fundamental one: deficient incentives for the media to expose poor governance practices. We argue that corporate reporters have strong incentives to enter into a quid pro quo relationship with their sources, where they receive private information in exchange for a positive spin on companies’ news. Since the value of this relationship is higher during booms, so, too, will the pro-company bias. We find evidence in support of this hypothesis by looking at Harvard Business School case studies.

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Nothing but a newspaper can drop the same thought into a thousand minds at the same moment. A newspaper is an adviser that does not require to be sought, but that comes of its own accord and talks to you briefly every day of the common weal, without distracting you from your private affairs.

De Toqueville, *Democracy in America*, Vol II, Section II, Chapter VI

**Introduction**

A growing body of literature (e.g., La Porta et al, 1997) compares corporate governance systems across countries by comparing the set of rules and regulations in these countries. Almost invariably the United States comes atop of such rankings. In fact, the United States is often considered the champion of the shareholders’ value model and the example other countries should follow. At least, this was true until recent corporate scandals and the ensuing bankruptcy of corporate giants such as Enron and Worldcom. How could the billions in transactions between Enron and its subsidiaries be hidden? How could the false accounting charges of Worldcom not be revealed by internal and external auditors? Is the system fundamentally flawed? Or does it simply lack appropriate legal and regulatory instruments?

In this chapter we advance a different explanation. While transparency can and should be improved, we do not think that the lack of proper rules is the fundamental problem. Many of the improprieties could have been discovered even under the current disclosure system. Why, then, were they not discovered?

To answer this question we delve deeper into the economics of information collection and dissemination. A simple, but thus far ignored, point is that the incentives to uncover negative information are much smaller during stock market booms, especially those periods of stock market euphoria often labeled as bubbles. The reasoning goes as follows. The primary source of information collection and aggregation in any financial markets is clearly the speculators. After all, one of the advantages of having a stock market is that it motivates people to collect information, because they can personally gain from that information. During a phase of stock market euphoria, however, the incentives to collect negative information are very limited. In
order to profit from negative news a speculator has to take a short position. Short positions, however, are very dangerous during a phase of euphoria. Waiting for the bad news to appear and be incorporated into prices, a speculator has to factor in a great deal of what De Long et al (1990) calls noise trader risk: the risk of the public becoming even more enthusiastic about the stock and driving the price up. Hence, during stock market bubbles short sellers are unlikely to search for negative information.

Even if speculators have little incentive to uncover bad information, why don’t other sources reveal them? The problems with equity analysts are well known and are discussed in the chapter by John Coffee in this volume. The question we focus upon here is, why don’t the media have an incentive to uncover bad news? After all, journalists do not have to take the risk of short selling a stock. Furthermore, they seem to have a career-concern reason to uncover negative news. A scoop will enhance their reputation, increasing their lifetime earnings. And at first glance there appear to be few conflicting incentives.

This reasoning, however, is too simplistic. It ignores the subtle incentives behind information production, collection, and dissemination. In this paper we focus on this aspect. We argue that both the production of information by the company and the dissemination of this information by the media is seriously affected during a stock market bubble.

In a stock market bubble, prices are driven above their fundamental values. But astronomical multiples can be reconciled with standard valuation formulas only thanks to inflated expectations about future growth. In fact, stock market bubbles are generally associated with talk about a “new era.” As a consequence, during a bubble investors (and thus companies) pay much more attention to their growth forecast and thus to news about it. Illustrative accounting studies (eg, Bradshaw and Sloan 2002) reveal that the responsiveness of stock prices to earnings increased more than threefold during the latest period of euphoria of the 1990s. Companies’ incentives to spin news positively and to aggressively challenge bad news are therefore greatest
We argue that a positive spin in corporate reporting arises as a result of a quid pro quo relationship between companies and journalists. An important asset in a journalist’s professional portfolio is the privileged sources of information he or she has access to. After all, the Watergate scandal would have never exploded were it not for a “deep throat” tipping Woodward and Bernstein in the right direction. One former journalist described the situation to us thus, “When I started I thought the client was the public, but I soon learned that in practice my client is the source.” But how do journalists maintain access to these sources? How do they reward them?

We distinguish between two possibilities. One is that the informed insider has an interest in the diffusion of information per se. For example, in the Watergate case, Richard Nixon’s adversaries had political reasons to leak information. They did not need to be rewarded: the diffusion of information was their own reward. The second scenario is a quid pro quo between the source and the journalist. The source repeatedly reveals valuable information to the journalist in exchange for a positive spin on the news being revealed. The first case is more frequent in environments, like the political one, where there are open conflicts of interest. This is relatively rare in the case of corporations, with the exception of contested takeovers or internal fights to succeed a failing CEO. In general, however, all corporate insiders have a strong vested interest in a higher stock price and, hence, in leaking only positive news. For companies, then, the quid pro quo scenario appears more likely. The distortionary effects of this quid pro quo have been recognized by the Securities and Exchange Commission (SEC) when it forced equal access to companies’ conference calls.

Since companies’ valuation are particularly sensitive to news during stock market bubbles, corporate insiders will be particularly careful in selecting their privileged journalist sources during these periods. Stated differently, during good times insiders have an extra
incentive to get the good news out and to limit bad news. On the other side, journalists will find it particularly valuable to be in the good graces of insiders of a glamorous stock. Hence, they will be particularly careful portraying such stocks in a positive way, for fear of losing a valuable source in the future.

Such incentives change in a downturn. First of all, companies might have an interest in revealing bad information when other companies are not doing so well; this type of cycle is emphasized in Rajan (1994). Second, during a downturn the valuation of a stock depends more on its liquidation value, than on its future growth, making it less sensitive to news. A point, again, that seems to be borne out in accounting studies on the responsiveness of stock prices to earnings. Finally, in downturns conflicts inside a company are more likely to arise, leading to leaks in information. Hence, production of negative information becomes more abundant (possibly excessively abundant) during a market downturn.

We provide some indirect evidence of cyclicality in business reporting consistent with our quid pro quo hypothesis by looking at the composition of Harvard Business School cases, which are a widely used source of information about businesses. There are two types of Harvard cases: field cases, which benefit from access to companies’ internal data sources, and so-called library cases, which are compiled using only public sources. Field cases are based in part on private information provided by the company to the Harvard professor who is writing the case. The explicit quid pro quo for this access is that the case needs to be approved by the company before being released.

We expect greater use of field-based cases during expansionary periods. Companies are expected to be more willing to share the data when the picture the case writer will portray is a positive one, that is, during expansionary phases of the business cycle. In downturns, companies are less willing to share their information because the picture the case writer will portray is likely to be more negative.
We find this pattern of cyclicality to be true. As suggested by the raw data presented in Figure 1, in years with strong market returns, such as those we have seen from 1995–2000, there is a high reliance on field-based cases. Market downturns, such as those in 1991, 1995, and 2001, dramatically reverse such trends—in 2001 alone, for example, we see a 62 percent increase in public-source cases. We document this more systematically in the text. While indirect, this evidence suggests a relationship between the type of information used in business coverage and stock market performance.

Figure 1 - Are incentives in uncovering bad news anticyclical? The proportion of field-based HBS Cases and market returns (1986-2001)

Can this cyclical bias in reporting explain dramatic failures in corporate governance such as Enron? We think so. In previous research (Dyck and Zingales 2002; forthcoming), we have shown that the media play a fundamental role in any corporate governance system by imposing large reputational costs on managers and directors of firms that behave against societal norms. That the media has this power, however, does not imply they use it efficiently or effectively. In fact, in this chapter we argue that they do not. This cyclical bias in reporting weakens the outside monitoring of companies during booms, creating the scope for egregious abuses such as Enron.
This far, we have treated the bubble as an exogenous phenomenon. There is, however, a possible feedback loop between the reluctance of the media to release bad information and a stock market euphoria. To be sustained (at least temporarily), stock market euphoria needs to involve a large segment of the investing population. But where do these people gather information to form their opinions on stock prices? The media, of course. Thus, a reluctance by the media to diffuse negative information may fuel investors’ biased expectations, sustaining the bubble a little bit longer. In fact, one can easily conceive of a scenario in which a period of sustained increases in stock prices due to changes in the fundamentals decimates the number of short sellers, leaving the market dependent on the media to form a correct opinion. But the media have few incentives to portray any other than a positive perspective, fueling the bubble. In fact, all of the bubbles followed periods of sharp increase in stock prices due to fundamental reasons (Garber 2000).

The idea that outside monitoring is reduced during an asset bubble is not new. More than a century ago, Walter Bagehot (1873) wrote: “The good times too of high price almost always engender much fraud. All people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity.” Bagehot’s view figures prominently in the accounts of euphorias and panics offered by Galbraith,2 Kindleburger (1989:90),3 Shiller (2000), and Coffee (this volume). These authors, however, assume that investors are completely irrational, or that they at least become so during moments of euphoria. In contrast, our argument does not rely on investors being irrational. Most importantly, we focus on the crucial channel through which euphoria and panics are spread: the media. We show that in reporting corporate news media tend to be biased and this bias is accentuated during booms.

The rest of the chapter proceeds as follows. The first section uses the Enron example to illustrate that much of failure in corporate governance could have been uncovered if the media
had chosen to pursue this information actively, and that they deliberately chose not to. The second section gives an analysis of the incentives behind the production, revelation, and dissemination of companies’ information. The third section provides some empirical evidence of the cyclicality of news spinning by looking at the composition of Harvard Business School cases. In the fourth section we discuss the implication of this cyclicality for corporate governance. Conclusions follow.

An Illustration of the Argument: Enron and the Media

It is interesting to analyze the role played by the media in the demise of Enron. On the one hand, a deputy managing editor of the Wall Street Journal boasted that "without the stories that Smith and Emshwiller (two Wall Street Journal reporters) wrote, Enron would have gotten on fine. There is no evidence that it would have collapsed." On the other hand, Sherman (2002) notes that “to excavate back issues of magazines like Forbes, Fortune, Worth, Business 2.0, and Red Herring is to enter a parallel universe of cheerleading and obsequiousness, a universe where applause obliterated skepticism.” Are the media the savior or are they part of the problem?

To answer this question let’s look at some facts, as reported by Sherman (2002). The first inquiry into Enron’s accounting came from an article by Jonathan Weil, then a reporter for the Texas edition of the Wall Street Journal. In a July 2000 piece, Weil writes “what many investors may not realize is that much of these companies' recent profits constitute unrealized, noncash gains. Frequently, these profits depend on assumptions and estimates about future market factors, the details of which the companies do not provide, and which time may prove wrong.” Weil’s piece was never published in the national edition of the Wall Street Journal, but it appeared on the Dow Jones newswire, where it attracted the attention of James Chanos, a hedge-fund manager, who began to scrutinize the company's financial statements. There he discovered cagey references to "related party" transactions involving Enron's senior officers and massive insider
selling. It was enough to induce him to sell short the stock in November 2000. Short sellers, however, only profit when the negative information becomes public. Thus, Chanos tipped off a reporter at Fortune, Bethany McLean, who in March published a story entitled, "Is Enron Overpriced?", in which she questioned how, exactly, Enron made its money. Another short seller tipped off Peter Eavis, of TheStreet.com, who in an article on May 9, 2001 started to mention shady "related entities."

Yet, it took Skilling’s surprise resignation in August for three Wall Street Journal reporters (Friedland, Smith, and Emshwiller) to start an investigation of Enron's financial statements. They quickly realized that "things weren't adding up at Enron" (Sherman 2002). Most importantly, “sources close to Enron began to furnish the Journal with documents” (Sherman 2002).

But it was only after Enron announced a $618 million third-quarter loss that the Wall Street Journal (October 2001) identified the link between earnings and the shady partnerships. The Journal was able to link Enron’s reduction in shareholder equity to the CFO’s mysterious partnerships. Only at this point did other media and the SEC start to investigate.

This brief account of Enron’s demise illustrates several important points about the role of the media. First, while many transactions were concealed, there was enough public information available to raise serious doubt about the credibility of Enron’s earnings. As the former editor of the Financial Times, Richard Lambert, stated: “the Annual Report for 2000 should have raised all kind of questions about the group’s cash flow…about the length and complexity of the footnotes to the account, often a warning that things are not what they appear.”5 This opinion was reiterated by the CEO of Pearson, the group owning the Financial Times, in a recent interview to the Royal Society of Arts Journal: “sometimes I do think that the business press—and I include the FT in this—has not worked hard enough to ferret out these stories.”
The second important lesson is that the media as a whole, instead of scrutinizing Enron’s accounts, acted as cheerleader all the way to the end. According to Jonathan Weil of the *Wall Street Journal*, financial journalists “outsourced their critical thinking skills to Wall Street analysts, who are not independent and, by definition, were employed to do nothing but spin positive company news in order to sell stock. There was hardly a Wall Street analyst covering the stock whose firm was not getting sprinkled with cash in some form or another by Enron.” The day before Jeffrey Skilling resigned, *Business 2.0* featured his photo on the cover with the titles "The Revolution LIVES." In its September 2001 issue, *Red Herring* insisted: "Forget about Microsoft. America's most successful, revered, feared - and even hated - company is no longer a band of millionaire geeks from Redmond, Washington, but a cabal of cowboy/traders from Houston: Enron."6

The third point is that such behavior is not an accident, but the result of reporters’ incentives. Any attempt to report negative information or simply to question the existing optimistic consensus incurs constant harassment from the target company. One UBS PaineWebber analyst was fired three hours after issuing a warning about financial deterioration at Enron, followed by a retraction of the negative statement and UBS PaineWebber’s issuance of an optimistic outlook on Enron’s future.7 During an investor conference call, a caller who criticized Enron’s delays in releasing financial information was labeled an “asshole” by Skilling.8 Similarly, *Fortune*’s journalist McLean was labeled “unethical” by Skilling, who hung up on her. Furthermore, the chairman of Enron, Ken Lay, called *Fortune*’s managing editor Rik Kirkland, implying that McLean’s piece should be cut.9

The last important point is that the incentives to report bad information about a company change dramatically as the company’s stock price deteriorates. One could simply appeal to the journalists’ herding mentality, but we think there is more to it than that. As Sherman’s (2002) account of the Enron story demonstrates, as the stock price falls, journalists start to have access to
more negative information. Short sellers start feeding them and so do company’s insiders, who hope to benefit from a turnaround of the company. These sources were not available when the stock price was booming. When a company’s fortunes deteriorate not only do journalists have access to more negative news, they also have less reasons to hide them. The possibility of a demise of the company reduces the value of an ongoing relationship, increasing a journalists’ willingness to report negative information.

The economics of media reporting is, therefore, not as straightforward as economic models implicitly assume. Thus, to understand the effect of a stock market bubble on the quality and type of media reporting, we need to closely study the incentives to generate, reveal, and disseminate information. This is the task to which we now turn.

Media Incentives and Governance

The economics of media coverage

To understand the economics behind news media we need to start appreciating their role. The main role of news media is to filter and aggregate information, repackaging it with some entertainment value. For example, the dry and prolix prose of police reports is transformed into a thrilling story about the latest murders. As in any other markets, the type of information produced and its quantity depend on supply and demand considerations. While these considerations are similar across topics, some issues are unique to corporate news. Since this is the area in which we are interested, we will confine our reasoning to this case.

The positive externality of media for corporate governance

The presence of an active press can increase expected penalties for improper behavior through at least two channels. In the conventional reputation story (eg, Fama 1980), managers’ wages in the future depend on shareholders’ and future employers’ beliefs about whether the
managers will attend to their interests in those situations where they cannot be monitored. Managers, however, care about their reputation not only vis-à-vis future employers, but also vis-à-vis society at large. Commenting on the recent legal reforms in US corporate governance, Robert Mills, managing director of UBS Warburg, recently argued that for him a tougher punishment than the threat of jail time would be explaining the story about it in the *Wall Street Journal* to his son.10

The strength of reputation as a corrective device, however, depends upon the extent to which information about past behavior is disseminated. As the opening quote from De Toqueville suggests, and as we develop in Dyck and Zingales (2002), the media play a pivotal role in communicating information about managers to the public. For instance, in Dyck and Zingales (forthcoming) we show that the diffusion of information by the press affects the amount of corporate value that insiders appropriate for themselves, the so-called private benefits of control. Across 39 countries, a higher rate of diffusion by the press is associated with lower private benefits of control, and this influence persisted even controlling for differences in laws and legal regimes.11 This evidence is consistent with many statements by executives. As William Browder, managing director of Hermitage Capital, the largest public equity fund in Russia claims, “The court of public opinion is much more effective than the Russian legal system and much fairer.”12

**The economics of information production**

Arguing that the media has a positive externality for corporate governance does not imply that the news media will provide the optimal amount of coverage to address all governance problems. To answer the question of why the optimal coverage is not likely to be provided, we need to focus on the incentives to uncover bad information. Consider, first, the supply side. Collecting information about companies is very costly. Digging through annual reports, questioning the validity of different accounting practices, and so on require both time and expertise. Most important, it is a very risky activity. Without a lead, a random investigation will
turn out to be fruitless most of the time. Unless he or she uncovers a major fraud, a journalist who spends a lot of time digging through annual reports has little to show for it. According to Sherman (2002), it took two months for Jonathan Weil to prepare the Enron article, and this article did not even make it to the national edition of the *Journal*.

A much easier (and safer) alternative for a journalist is to rely on companies’ press releases. In fact, the stated goal of these releases is precisely to help journalists quickly absorb a great quantity of facts. Of course, these releases are not unbiased: they try to spin the story in the direction that is most favorable to the company. While expert reporters can easily see through the spin, a complete undoing of the built-in bias requires time and effort. Whether the market will adequately compensate journalists for this time and effort depends upon the structure of the demand for information, a question we will return to soon.

From a reporter’s point of view the real downside of relying on press releases is the lack of any competitive edge. A reporter wants to differentiate his or her product, wants to report critical information before other reporters. What constitutes critical information, however, depends upon what other reporters write. It is a game similar to Keynes’ famous beauty contest, where everybody tries to guess what everybody else prefers. In this game the real competitive edge is personal contacts. Sources inside or very close to the company that will tip on major coming news ahead of the rest of the crowd.

These contacts are extremely valuable for reporters, who cultivate them actively. But they do not come for free. News sources generally have a reason to leak information. They want to scare off a competitor, reassure shareholders, prevent a board coup, and so on. In the political arena, it is the fierce competition between opposing parties with different agendas that generate a relatively unbiased set of information sources. But in the corporate world, such competition is lacking. Except for short sellers, all informed parties have a vested interest in a high stock valuation: managers, who hold stock options; employees, whose jobs depend on the company
doing well and whose retirement accounts depend on its stock doing well; and analysts, whose fortunes are very often linked to the success of the stock they analyze. If all the sources have an interest in a positive spin, the news coming from them will be clearly biased.

Once again, a reporter could potentially undo this bias, but in addition to the problems discussed above, he or she faces an additional constraint: the need to reward sources. And since all these sources have a vested interested in a high stock price, the way to reward them is to spin the story in a positive direction. The last thing reporters want to do is develop a reputation for writing negative articles—they will find it extremely difficult to develop and maintain their own sources and they will face constant harassment in doing their job (as happened to the journalists writing about Enron). A possible remedy for a media outlet is not to disclose the name of writers (as the Economist does). Hiding their identity makes it easier for reporters to write negative stories about companies. But even this device is imperfect. Most companies know which journalists are assigned to their case and they can easily infer who is writing. Hence, it is impossible to remove completely reporters’ positive bias toward the companies they cover.

Thus far, we have also argued that producing negative news is much more costly than producing positive news about a company. This does not necessarily mean that in equilibrium less bad news will be produced—it depends on the price attached to one type of news versus the other. Will negative news be rewarded more than positive news? Will the premium be sufficient to reward the additional costs negative news involves?

We doubt that. While a scoop benefits a reporter, the benefits she receives are not different if the scoop reveals bad information or good information about a company. The costs the reporter receives, however, do depend on the type of scoop. In fact, negative scoops are more dangerous, because in some countries they expose a reporter to the risk of being sued for defamation by the company. Even if the article is correct, the cost of the trial can easily break a reporter both emotionally and financially. By contrast, no such a risk exists for a positive scoop.
Even if the scoop turns out to be false, the reporter is not sued by the myriads of investors who bought the stock on the basis of the false scoop. Hence, positive scoops are more rewarding for a reporter than negative ones.

But even if negative scoops were rewarded more, the incentives to seek such a scoop could remain excessively low. The risk involved in a negative scoop is such that a risk-averse reporter might not seek one even in the presence of a premium.

Cyclicality in the media’s bias

Thus far, we have simply described how the economics of information production lead the media to report, on average, a positive image of a company. We have said nothing about possible variations in the magnitude of this bias over time. Now we will argue that this pro-company bias is stronger during a boom and weaker, to the point of being reversed, during a downturn.

The first reason for the bias discussed is the cyclicality in the availability of different sources of information. As argued above, speculators are the primary source of information collection and aggregation in any financial market because they can personally gain from that information. During a phase of stock market euphoria, however, the incentives to collect negative information are very limited because of the dangers of noise trader risk: the risk of the public becoming even more enthusiastic about the stock and driving the price up. During the dot-com frenzy Lamont and Thaler (2001) document deviations from the fundamental value of more than 30 percent even when it was possible to perfectly hedge a short position (as in the case of Palm Pilot and 3Com). One can only imagine what happens when such a perfect hedge does not exist. Hence, during stock market bubbles short sellers are unlikely to search for negative information or to tip off to the media. Similarly, no insiders want to rock the boat when the company is doing well and it trades at high multiples. As Sherman’s (2002) account describes, Enron insiders started to leak internal information only after the resignation of Skilling. Before, nobody dared to.
The second reason for this cyclicality is the asymmetry in the value of the quid pro quo relationship over the business cycle. When a company is doing well it has a lot of positive news to leak to the media. Hence, antagonizing a successful company with a negative report can be very costly for a journalist. The “uncooperative” reporter will be denied access to companies’ data, a loss to the reporter of a valuable source of privileged information. By contrast, in a downturn a company will have very little information it wants to share with reporters. Therefore, antagonizing it with a negative report and being cut off from access to company data will not be so costly. If, in addition, the company is on the verge of bankruptcy, the scope of the quid pro quo relationship with reporters is reduced and the temptation for the reporter to deviate and report bad information increases.

The third reason why negative reports about companies are anticyclical is that the effort companies put into preventing them is procyclical. During a boom phase, a lot of the value of a stock depends on a company’s prospects for future growth. And these prospects are highly influenced by the information released by the media. In contrast, in a market downturn, the value of a stock is more driven by the value of its asset in place, which is more tangible and thus less affected by any story reported in the media. Hence, the effort companies might devote to spinning news for the press is going to be much more intense during a boom phase than during a downturn.\textsuperscript{13}

Similarly, it is more costly for a reporter to antagonize a company when he or she is the only one doing it, than when many others are doing so. Questioning the integrity of a company’s numbers when the company is doing well is very dangerous. A single pundit or reporter can be easily harassed or even sued, since the company can hope, with this strategy, to prevent others from following the first’s example. But when a company is openly questioned by multiple sources, the aggressive strategy becomes self defeating and each reporter runs little risk of being harassed or sued. This asymmetry can, by itself, generate a herding behavior among reporters.
Illustrative of the strong forces to suppress “bad” information is the reception that Alan Greenspan received for the rather mild criticism he offered on December 6, 1996 when he asked, "How do we know when irrational exuberance has unduly inflated asset values, which then become subject to unexpected and prolonged contractions…?" Immediately, he was criticized as being not only out of touch with the economy, but for jeopardizing the economic boom. That Greenspan, one of the most independent of market commentators and who had a well established reputation, was subject to severe criticism hints at the ferocity with which bad news is greeted by those with less independence and reputation, such as the equity analysts and newspaper reporters described above in the Enron example.

This phenomenon is not unique to the 1990s. Paul Warburg (a banker) and Roger Babson (a statistician) were exposed to public condemnation for their early criticism of speculation in 1929 (Galbraith 1990). Galbraith himself received death threats for his mild criticism of the speculative buildup in 1955: “The postman each morning staggered in with a load of letters condemning my comments, the most extreme threatening what the CIA was later to call executive action, the mildest saying that prayers were being offered for my richly deserved demise” (Galbraith 1990:9). And in 1986 the New York Times refused to publish an article it commissioned to him when he concluded that a crash was inevitable.

A more elaborate version of such bias coming from the consumers of business news is suggested by Mullanaithan and Shleifer (2002). They assume that readers believe more articles that confirm prior articles, while they discount the others. With such behavior it pays for reporters to follow the herd. During boom periods, they will accentuate positive news, while in downturns they will emphasize negative ones. While this behavior is sufficient to generate cyclicality in media reporting, it cannot fully account for some of the evidence we will discuss later.

**Extensions**
In all the above discussions we have implicitly assumed that individual reporters have full discretion in their choices. In fact, which topics are investigated and how much time is dedicated to single investigations is decided in part by media headquarters. Much of the analysis, however, carries through at that level as well. In fact, at that level the pressure to please companies can be even more severe, since companies’ advertising is a major source of revenue.

We have also ignored the possibility of outright corruption, where companies pay reporters or newspapers to spin their versions of the facts and/or suppress bad information. We have done so because in the United States (but not necessarily in other countries) this is extremely rare. Kindleburger (1990), under the heading, “venal journalism,” cites numerous examples of the press being bought by speculators during the South Sea Bubble in the United Kingdom and on the Continent in the 19th century, but suggests that the United States has been much less open to such problems.

This is not to say that there have been no charges. Journalist Phillip Longman contends that in the US, “business publications, especially those celebrating the boom, were growing fat from dot-com ads…at any publication, there is, of course, a tension between the need to please advertisers and the need to please readers. … at business publications in the 1990s, it [this tension] was resolved in a manner that favored advertisers—and worse, advertisers, who, it has turned out, were selling shoddy products.”15 In the case of Enron, questions have been raised about the conflicts many journalists faced as a result of direct or indirect payments from Enron through speeches and positions on Enron’s advisory board. Josh Lipton (2002) reports Andrew Sullivan’s challenge to journalists: "Exactly how many pundits have been on Enron's payroll? How many of them have disclosed that fact in their relevant publications? How much was each paid?" In this respect, conflicts may be at least as severe for academics writing about business issues, through their multiple contacts with companies through consulting engagements and board and advisory positions.
Of course, allowing for that possibility will only strengthen our reasoning, both in terms of the average bias and in terms of its time series variation. Companies will have both more resources with which to bribe and more benefits from a positive spin in a boom than in a downturn, hence they will end up bribing reporters more.

**Empirical Evidence on the ‘Spin’ of Business Coverage and Stock Market Cycles**

What evidence is there that companies try to spin information to make their performance look stronger? And what evidence is there that the media is more inclined to take or exaggerate this spin during booms than downturns?

**Companies spinning information**

Existing research on press releases of company financial information shows efforts by companies to spin. It is often the case when companies reveal information that they also reveal information from a previous year to facilitate comparisons. Reflective of strategic spinning of information, Schrand and Walther (2000) report that companies systematically tilt these comparisons to make current performance look stronger. They are much more likely to remind readers of extenuating reasons for strong performance in previous years than to remind readers of extenuating circumstances for poor information.

Bradshaw and Sloan (2002) provide complementary evidence based on what firms’ define and emphasize in their press releases surrounding mandatory filing of earnings. The traditional definition of earnings is that required by generally accepted accounting principles (GAAP). But there are alternatives, variously called pro forma earnings, operating earnings, or, most commonly, “street earnings.” These alternatives are suspect, at least according to the chief accountant of the SEC, as the Wall Street Journal reported: “Mr Turner said it appears as if some companies are intentionally trying to ‘spin investors’ by issuing news releases highlighting
pro forma earnings, which tend to omit items that would reduce reported earnings. Mr Turner jokingly called such earnings figures ‘everything but the bad stuff.’

Bradshaw and Sloan (2002) report that looking at the average of all US equities, street earnings have exceeded GAAP earnings every year since 1987. And again, consistent with spinning, companies have been in the lead in defining and emphasizing these earnings, with the typical press release announcement emphasizing street earnings earlier than GAAP earnings when this interpretation would put the company in a better light. In 1998–1999, for instance, a buoyant market, this spin was put on the numbers 43.5 percent of the time.

**Business coverage open to spin and stock market cycles**

Now we turn to evidence that business coverage is more open to spin in boom times than downturns. Our empirical evidence comes from another source of business information—case studies prepared by Professors at Harvard Business School. This is not the traditional business press; in fact the business school has as a disclaimer on all cases: “Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.” Nonetheless, the case studies are an important source of information on business: Harvard Business School case studies are sold all over the world, they form the basis of the curriculum at many business schools, and they are used as sources in many news articles.

We focus our analysis on the two most common types of Harvard cases: field cases, which benefit from access to companies’ internal data sources, and the so-called library cases, which are compiled using only public sources. Field cases are the most typical type of case study. They are based in part on private information provided by the company to the Harvard professor who is writing the case. The explicit quid pro quo is that field cases require approval by the company before release. In fact, the most objective way of classifying a case study as a field or library case is whether the case writer has felt compelled to get a “green card” for the case; that is,
a green document that a company representative has to sign to release the case study that contains private information.

That field cases, which are subject to companies' approval, might be more influenced by the companies involved than are cases from public sources, is illustrated by the following episode. "I learned that Enron was upset with my public-source case on the conflict surrounding the company's investment in India," recalls Harvard Business School professor Louis Wells. "After the second time the case was taught, someone from the administration approached me, told me of the company's concerns, and asked if anything could be done about it. Another faculty member was, I was told, writing a field-based case on the same subject. It was suggested that I might consider teaching the more rich field case, if it fit my teaching objectives. Meanwhile, I sent my public-source case to Enron for comment. In the end, I removed the public-source case from the system and adopted a shortened version of the field case, which was indeed richer in information and enabled me to accomplish the original teaching objectives."  

The advantage of looking at Harvard Business School cases is that it is possible to identify when the quid pro quo takes place. By looking at the composition of case studies over time we can see if the proportion open to spin is influenced by the market. If our hypothesis about cyclical behavior is correct, we expect greater use of field-based cases during expansionary periods. When the case to be written is meant to portrait a positive image of the company (ie, during expansionary phases of the business cycle), the implicit price to be paid for access to privileged information is lower. Hence, companies will be more willing to share their information and Harvard Business School professors will be more willing to engage in the quid pro quo with a company. As one of the authors attests, during the recent stock market boom there were more unsolicited offers by companies to support case studies than in the period before the boom. In
downturns, unsolicited proposals for case studies are fewer; companies are less willing to share their information as the picture the case writer will portray is likely to be more negative.20

Our test of the theory is a simple one, does the proportion of field-based cases move positively with the stock market? Empirically, we regress the proportion of field-based cases against a measure of market returns (and a time trend to account for any changes in the approach to collecting information about companies over time at Harvard Business School). To test this we collected data from Harvard Business School on the number of field and library cases published each year since 1970. With this information, we calculated the proportion of field-based cases in any year.

The summary statistics of our sample are provided in Table 1. The typical case study is field-based, with the average proportion of field-based cases equal to 82 percent with significant variation, from 69 to 94 percent. Visual inspection of the data also shows a trend to reduced reliance on field cases over these 30 years, so we will account for this possibility in our empirical analysis. The remainder of the table simply summarizes well-known trends in real market returns and in real GDP over this time period, with an average real market return of 4.9 percent and an average increase in real GDP of 3.1 percent. As the Business School has grown, so has the number of case studies, with an increase over time from 56 case studies in 1971 to 406 case studies in 2001.

Table 2 confirms what was suggested by Figure1—business coverage that relies on sources prone to spin is cyclical. The positive and significant coefficients on market returns in columns 1 and 3 show that over the whole sample (1971–2001) and, particularly, in the latter half of the sample (1986–2001) field-based cases are sensitive to market returns. The results suggest that a one standard deviation improvement in market return brings forth a 1.6 percent increase in field-based cases in general, and that this sensitivity is increasing, with an estimated 3.3 percentage point increase in field-based cases for a one standard deviation increase in market
returns during the mid-1980s and 1990s. The effect of stock market downturns appears particularly important. As an illustration, in the stock market downturn of 2001, field-based cases account for just 75 percent of all cases, a full 10 percent drop from the good times of 2000. The same was true in the last significant market downturn in 1991, where field cases accounted for just 68 percent of all cases, while two years earlier in better times they accounted for 82 percent.

Columns 2 and 4 show that the sensitivity is not only to market returns, but also to the state of the macroeconomy, and that again, the sensitivity is highest in the latter half of the period. Our regression estimates suggest that over the whole sample period (the latter half) a one standard deviation change in the economy brings forth a 1.7 percent (5.5 percent) increase in field-based cases.

**Does this matter?**

Now that we have (hopefully) convinced the reader that media are biased in their reporting and that this pro-company bias is stronger during booms than during recessions, we can ask the more fundamental question: does it matter?

In a frictionless world, where speculators are free to short a stock and they are not afraid to do so, this media bias will have no serious consequence on prices. Speculators have no bias in one direction or the other and hence they will force prices to their fundamental values.

In the real world, however, short sales are not as easy as long positions. Hence speculators find it more difficult to correct overvaluations than undervaluations. As a result, overvaluations can persist. Unfortunately, the described bias in media reporting does nothing to reduce this problem. In fact, it exacerbates it. When the force of speculation is crippled by short-sell constraints, the media, instead of convincing the public-at-large that the prices are above
fundamentals, will tend to feed the exuberance. In other words, while the media are probably not responsible for the rise of bubbles, they clearly play a part in sustaining them.

Even if this cyclicality in media does not affect prices, however, it does have important effects on corporate governance. As we show in Dyck and Zingales (forthcoming), the pressure exerted by the media is an important component of a good corporate governance system. When such pressure weakens, abuses are inevitable. “The press blithely accepted Enron as the epitome of a new, post-deregulation corporate model,” stated Business Week in an unusual mea culpa, “when it should have been much more aggressive in probing the company's opaque partnerships, off balance sheet maneuvers, and soaring leverage.” Unfortunately, our analysis suggests that this is not an occasional lapse, but a systematic problem that emerges during stock market booms.

That media’s incentives to uncover negative information are weakened during booms does not mean media play no role in corporate governance. As the Enron episode illustrates, the press still played an important role in stopping abuses at Enron, and has played a very important role in imposing penalties long before any legal penalties are introduced. The point we want to stress here is that during booms the monitoring provided by the media is less than that provided during normal or bad times. The fact that the weakening of media’s incentives to uncover bad news could lead to such egregious behavior such as Enron emphasizes the importance of the media. After all, the quality of the legal system did not change over the stock market cycle. For what other reason should corporate behavior have changed?

**What can be done?**

If this problem is indeed so severe, what can be done to attenuate it? Our analysis of media incentives suggests one possible solution. The reason why reporters engage in quid pro quo relationships with companies is to reduce the cost of collecting information. Thus, the higher this cost is, the stronger these relationships will be. After all, the percentage of public information cases is higher in accounting and finance (where case writers have access to better public sources)
than in entrepreneurship and strategy, where public sources are lacking. Thus, to weaken these ties between reporters and companies, enhanced corporate disclosure can be useful. Our analysis suggests, however, that the presence of the information in the public domain is not sufficient; the cost of gathering is also very important. The higher this cost, the bigger will be the incentive for a journalist to skip this cost and rely on direct company sources. Consider, for instance, the accounting treatment of stock options. Many have argued that disclosure in the footnotes is sufficient (i.e., what is required under current accounting provisions), since sophisticated investors can calculate the implied costs of options and restate financials. Our perspective suggests otherwise. This indirect form of disclosure raises the costs for journalists to use this information to uncover or communicate corporate misdeeds.

Conclusions

In this chapter we advance a new explanation for the severe lapses in corporate governance experienced by US companies in the last few years. This explanation focuses on the role of the media, an ignored, but we think important, institution in determining governance outcomes. We argue that during stock market booms the healthy pressure exerted by the press on companies is weakened, because reporters find it more convenient to buy into companies’ spin. We provide some indirect evidence of this effect by looking at the percentage of Harvard Business School cases that are field-based, that is, that rely on companies’ internal sources. Consistent with our quid pro quo theory, this percentage increases during booms and drops during recessions.

We suggest that greater availability of ready-to-use public information can reduce reporters’ incentive to enter into quid pro quo relationships, maintaining greater independence of the press even during booms.
Table 1
Summary Statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Median</th>
<th>Standard Deviation</th>
<th>Min.</th>
<th>Max.</th>
<th>Number of Obs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of field-based cases</td>
<td>0.816</td>
<td>0.816</td>
<td>0.052</td>
<td>0.686</td>
<td>0.935</td>
<td>31</td>
</tr>
<tr>
<td>Real market return</td>
<td>0.049</td>
<td>0.070</td>
<td>0.17</td>
<td>-0.367</td>
<td>0.35</td>
<td>31</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>0.031</td>
<td>0.035</td>
<td>0.022</td>
<td>-0.020</td>
<td>-0.073</td>
<td>31</td>
</tr>
<tr>
<td>Number of Harvard Business School cases</td>
<td>245</td>
<td>276</td>
<td>108</td>
<td>56</td>
<td>406</td>
<td>31</td>
</tr>
</tbody>
</table>

Table 2
Is There a Cyclical ‘Spin’ in Business Coverage?

The dependent variable is the percentage of Harvard Business School case studies that are field-based by publication year (1971–2001). This is defined as the ratio of the number of field-based case studies (field-based cases require written approval from firms before use) to the total number of field-based and library cases (library cases do not require firm approval before use) in a given publication year. (Source: Harvard Business School Publishing.) In column 1 and 2 we regress the percentage of field-based case studies against the real market return and real GDP growth respectively using the whole sample period of 1971–2001 and including controls for a time trend and a constant. In columns 3 and 4 we repeat this analysis restricting ourselves to 1986–2001, the second half of our sample period. The real market return is the percentage change in the end of year Dow Jones index less the percentage change in the Consumer price index in that year. (Sources: Dow Jones, Economic Report of the President). Real GDP growth is the percentage change in real GDP. (Source: Economic report of the President). A positive coefficient on real market return and/or real GDP growth indicates a sensitivity of use of field-based cases to market and macroeconomic performance.

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Dependent Variable: Percentage of Field-Based Case Studies by Publication Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Real market return</td>
<td>0.095*</td>
</tr>
<tr>
<td></td>
<td>(0.054)</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Time trend</td>
<td>-0.003***</td>
</tr>
<tr>
<td></td>
<td>(0.001)</td>
</tr>
<tr>
<td>Constant</td>
<td>6.75***</td>
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<tr>
<td></td>
<td>(2.05)</td>
</tr>
<tr>
<td>Number of years</td>
<td>31</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.18</td>
</tr>
</tbody>
</table>

Notes: *** denotes significant at 1%; ** denotes significant at 5%; * denotes significant at 10%.
References


Endnotes

1 Jonathan West, interview with author, November 17, 2002.
As Galbraith argues in *The Great Crash 1929* (Boston: Houghton Mifflin, 1979), "In good times, people are relaxed, trusting and money is plentiful. ... under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and *bezzle* increases rapidly.”

“In a boom, fortunes are made, individuals wax greedy and swindlers come forward to exploit that greed.”

Quoted in Sherman (2002).


All quotes in this paragraph are from Sherman (2002).


Quoted in Sherman (2002).


In this chapter we use differences across countries in the diffusion of the press to identify the impact of the press. Because the press cannot be important if their reports are not read, diffusion is clearly a rough indicator of media importance, but one of the few available in a large cross-section of countries.


On the other hand, a CEO facing a downturn might be particularly interested in protecting his public image.


16 Bradshaw and Sloan (2002:45) report that these definitions exclude supposed nonrecurring items such as restructuring charges, merger and acquisition costs, goodwill amortization, certain results of subsidiaries, stock-based compensation costs, and even, in the case of Amazon, interest expense on long-term debt.


18 Based (in each period) on a random sample of 200 earnings press releases where the street numbers exceeded the GAAP numbers.

19 Louis Wells, in an interview with the author, November 15, 2002.

20 The Mullanaithan and Shleifer (2002) herding theory does not predict any push from the supply side. Hence, this episode, as well as Enron’s sharing of data sources in exchange for a better spin of the case, is only consistent with the quid pro quo theory.