A Model of Principles-Based vs. Rules-Based Standards
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Introduction

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- How does it depend on various features of firm’s environment?
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   - Evidence $t_m$ could be an input for the standard.
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Preferences

- Standard setter designs standard $S$ to minimize

$$q_G \Pr(r = b | \omega = G) \cdot L_G + q_B \Pr(r = g | \omega = B) \cdot L_B$$

expected cost of false alarm

expected cost of undue optimism

where $S$ determines $\Pr(r = b | \omega = G)$ and $\Pr(r = g | \omega = B)$. 

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    - The distribution of $\phi$ depends on $\tau$. 
Reporting Standards

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- A Hybrid Standard

  \[ S(t_m) = \begin{cases} 
  g & \text{if } t_m > T_2, \\
  p & \text{if } t_m \in [T_1, T_2], \\
  b & \text{if } t_m < T_1.
  \end{cases} \]
Equilibrium

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- Given manager's optimal evidence management and reporting strategies, standard setter chooses the optimal standard, $S^*(t_m)$. 
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- Given manager’s optimal evidence management and reporting strategies, standard setter chooses the optimal standard, $S^*(t_m)$.

- All optimal decisions are consistent with each other in the sense of rational expectations.
Optimal Standard

Optimal standard $S^*(t_m)$ is fully characterized by a unique threshold $T^*$:

$$S^*(t_m) = \begin{cases} p & \text{if } t_m > T^* \\ b & \text{if } t_m \leq T^* \end{cases}$$

where $T^*$ will be characterized later.
Intuition for Shape of Optimal Standard

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  - they can be controlled via $T$ and optimized against undue optimism errors.
Implications

- If evidence is sufficiently favorable, rely on professional judgement. Otherwise, use a strict rule.
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- If evidence is sufficiently favorable, rely on professional judgement. Otherwise, use a strict rule.
  - Higher hurdle for favorable treatment relative to unfavorable treatment.
Equilibrium

- Reporting Decisions

\[
\begin{align*}
    r^*(t_m < T, \omega, \phi) &= r^*(t_m \geq T, B, \phi \geq \delta) = b, \\
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- Ex ante (i.e., before \( \phi \) is realized) probability that the manager abuses discretion is \( K(\phi^*; \tau) \) where \( \phi < \phi^* = \delta \).
Evidence Management

- For any $t < T$, expected incremental benefit is

$$\Delta(t) = \Pr(\omega = G | t)\delta + \Pr(\omega = B | t) \int_{0}^{\phi^*} (\delta - \phi) dK(\phi; \tau)$$
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- Evidence management strategy characterized by a unique threshold \( \hat{T}(T) \):
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- The manager’s optimal evidence management strategy is:
  \[
  m^*(t; T) = \begin{cases} 
  T - t & \text{if } t \in (\hat{T}(T), T) \\
  0 & \text{otherwise}
  \end{cases}
  \]
Optimal Threshold

- At $t = 1$, standard setter chooses $T$ to minimize

$$L = q_G L_G \int_{-\infty}^{\hat{T}(T)} f^G(x) \, dx + q_B L_B K(\phi^*; \tau) \int_{\hat{T}(T)}^{\infty} f^B(x) \, dx$$

where $\hat{T}(T)$ satisfies

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Optimal Threshold

Optimal threshold $T^*$ solves:

$$
\left( q_G L_G f^G(\hat{T}(T)) - q_B L_B K(\phi^*; \tau) f^B(\hat{T}(T)) \right) \frac{\partial \hat{T}(T)}{\partial T} = 0
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where $\frac{\partial \hat{T}(T)}{\partial T} > 0$. 
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  - The less severe the conflict between insiders and outsiders: \( \frac{dT^*}{d\delta} > 0. \)
  - The more costly evidence management is: \( \frac{dT^*}{dC} < 0. \)
  - The lower (higher) the cost of undue optimism error (false alarm error): \( \frac{dT^*}{dL_B} > 0 \) and \( \frac{dT^*}{dL_G} < 0. \)
Conclusion

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Conclusion

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- We show that optimal standard takes a simple form:
  - To get favorable treatment, need *both* professional judgement and favorable evidence. But for unfavorable evidence, apply a strict rule.

- We simplified the enforcement mechanism and captured it by the exogenous cost $\phi$:
  - $\phi$ could be endogenized as a transfer made from manager to an auditor to negotiate a favorable treatment.