

**Department of Economics**

**Course: Economics of Organization and Information**

Exam. March 16, 2011

Max. duration: 4 h

*Use of calculator, and dictionary allowed*

---

Answer (in English or Swedish) all questions below! Answers should be *short and to-the-point*.

1. Define in a few sentences the following concepts, as they have been used in this course:

- |                                 |       |
|---------------------------------|-------|
| a. risk premium                 | (2 p) |
| b. efficient market hypothesis  | (2 p) |
| c. end-game problem             | (2 p) |
| d. collateral                   | (2 p) |
| e. equal compensation principle | (2 p) |

2. The following text is taken from the News service firm Bloomberg (text by Karen Freifeld and Linda Sandler - Dec 22, 2010):

*New York Attorney General Andrew Cuomo sued Ernst & Young LLP, accusing the firm of facilitating a "major accounting fraud" by helping Lehman Brothers Holdings Inc. deceive the public about its financial condition.*

*For more than seven years before Lehman declared bankruptcy in 2008, the investment bank engaged in transactions approved by Ernst & Young whose purpose was to move debt off its balance sheet and make it appear less leveraged, Cuomo said in a statement. This was done through what are known as "Repo 105" transactions.*

*"This practice was a house-of-cards business model designed to hide billions in liabilities in the years before Lehman collapsed," Cuomo said today in one of his last cases as attorney general. "Just as troubling, a global accounting firm, tasked with auditing Lehman's financial statements, helped hide this crucial information from the investing public."*

*The state seeks to recover more than \$150 million in fees collected by Ernst & Young for work performed for Lehman from 2001 to 2008, plus investor damages and equitable relief, Cuomo said.*

Apply a principal - agent framework to the role of Ernst & Young (henceforth: EY), the accounting firm, in the events that lead to Lehman Brother's bankruptcy in 2008.

- a. If EY is the agent, who are the principals that EY should have been working for? (2 p)
- b. What is the general term for the type of problems that tend to appear in principal agent relationships, that the above case exemplifies. (2 p)
- c. Looking at the interests of the principals, why did EY's interests fail to align with these principals' interests (4 p)

- d. Give two (no more than 2) suggestions for simple measures that would have reduced the likelihood of the type of problems discussed in the article. (2 p)
3. Traditional banking consists of taking deposits from the public, deposits that can be withdrawn by the depositor on a relatively short notice, and granting loans with relatively long maturity. When these types of traditional banks expand their activities to new countries they usually start by acquiring a local bank, rather than setting up a new unit (green field operation) from scratch in the country.
- Explain why the banking operations could be worth more to the acquiring foreign bank than to local shareholders (implying a value increasing deal). (3 p)
  - Use theory that we have covered in this course to explain why an acquisition of an existing unit is likely to be a better choice than setting up a green field operation. (7 p)

4. Assume that a person who has received several job offers of around 40 000 €s a year (use 40 000 ), receives an offer of as much as 50 000 €.

- a. How large is the rent promised to the person that received this offer? (1 p)

Let us assume (for simplicity) that the person plans to work for one year only for this employer, and that a one time opportunity for the worker to gain 1000 €s by shirking at the very beginning of the relationship will arise. The probability that the person will get caught if shirking is 0.08. If caught he will not receive the job.

- Will shirking be worthwhile in strict economic terms for this person? Justify your answer. (6 p)
- What is the minimum salary that the employer would have to pay this person to make him conclude that shirking would not be in his best interests in strict economic terms? (3 p)

$$1000 > 0,08(50\,000 - 40\,000) \cdot 1$$

$$1000 > 800$$

$$1000 < 0,08(x - 40\,000) \cdot 1$$

$$1000 < 0,08x - 3\,200$$

$$4\,200 < 0,08x$$

$$x > \frac{4\,200}{0,08}$$

$$x > 52\,500$$

