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ACCOUNTING FRAUD AND THE PRICING OF CORPORATE LIABILITIES
Structural models with garbling

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Abstract. We provide a method for modelling accounting distortions and their impact on the value of corporate liabilities. Our model is able to account for both small noise (estimate errors) and large mis-representations (deliberate fraud). Such a methodology is then applied to structural pricing models, in the spirit of Merton (1974). It turns out that accounting distortions may be a relevant factor in the pricing of corporate securities: indeed, they are able to explain why credit spreads are actually larger than implied by traditional structural models, particularly on short maturities. Simulations show that such an effect is stronger for safer firms, namely those with lower leverage and asset volatility.

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