SFB/Transregio 266

ACCOUNTING FOR TRANSPARENCY

Research on Corporate Transparency

Element 10: Biased Reporting

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Motivating question

Why do managers manage earnings and does it pay off?

Intuitive Answer

Short answer: Because they are incentivized to do so and no

Long answer: It depends

Three models

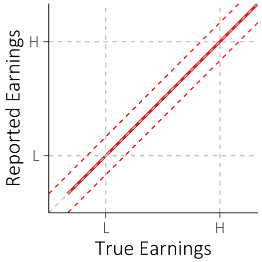
1. Stupid incentives
2. Myopic managers
3. Beneficial earnings management

Stupid incentives: Healy (JAE, 1985)

A manager observing true earnings x_T is facing an exogenous bonus plan with a bonus B depending linearly on reported earnings x_R being within a range $\{L, H\}$. The manager has the option to manage earnings upwards or downwards by an amount k of up to K_t so that $x_R = x_T + k$.

Accountants know that earnings are connected through time so setting k will affect the future $K_{t+1} = K_t - k$.

No incentives - unbiased reporting



Myopic managers: Stein (QJE, 1989)

		Manager	
		Does not manage earnings	Manages earnings
Stock market	Prices low	-10 10	-1 0
	Prices high	0 0	9 -10

Efficient Earnings Management: Demski (CAR, 1998)

A risk neutral investor writes a two-period contract for a risk-averse manager. Earnings $x_{T,t} = e_t + \epsilon_t$ depend on unobservable managerial effort (e_t) and noise ($\epsilon_t \sim \mathcal{N}(0, \sigma_\epsilon^2)$). The manager can bias her earnings report by b in $t = 1$ at zero cost reversing in period $t = 2$ so that $x_{R,1} = x_{T,1} + b$ and $x_{R,2} = x_{T,2} - b$.

The manager suffers a monetary disutility of $e_t^2/2$ from applying effort and has a reservation utility of $\bar{u}$. Her risk aversion is of an exponential constant absolute risk aversion type with

$$U_{M,t} = -e^{-\rho\left(S_t - \frac{{e_t}^2}{2}\right)}$$

where S_t is the salary that she receives from the principal.

We assume the compensation contract to be linear in either x_T or x_R.

The manager likes income smoothing and the investor benefits