

Dissertation Defense

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“Essays on Accounting Conservatism, Managerial Incentives, and Investment Efficiency”

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Accounting conservatism is a long-standing principle that requires firms to anticipate possible future losses but not future gains. My dissertation studies how accounting conservatism affects optimal managerial incentive contracts and long-term investment in fixed assets.

The definition of accounting conservatism gives guidance on how to record uncertain events and estimates. Although this definition is not controversial, the literature has incorporated or has modeled conservatism in different ways. My dissertation models conservatism as delayed reaction to uncertainty -- bad news (signal below a threshold) is fully disclosed on a timely basis while uncertain information (signal above the threshold) is delayed. In the first chapter, titled “Literature Review on Accounting Conservatism”, I provide an extensive literature review to link my model with models in the literature, and discuss the similarity and difference between different modeling methods. Also, by linking to an old definition of accounting conservatism in Devine (1963), my dissertation provides some new insights of why conservative accounting is beneficial.

In the second chapter, titled “Timely Loss Recognition and Long-term Incentive”, (joint with Jonathan Glover and Haijin Lin), we show that the principal prefers the conservative system which commits to less firing, even when the principal finds it valuable ex ante to commit to a threat of firing. A credible threat of firing motivates the manager, who intends to reduce the chance of losing future rent, to work hard in the first period. However, the conservative system can substitute for the threat of firing without increasing the first-period incentive cost, if conservatism also blurs the manager's information in the good times. This result emerges because motivating the incumbent manager in the second period is less costly than motivating a new manager, due to the complementary effect between the incumbent's efforts in two periods. Thus, the conservative system allows the shareholders to reduce the incentive cost over two periods. In an extension in which the manager obtains private information, we show that conservatism can still be optimal when firing is explicitly costly (e.g., a requirement of minimum severance pay). Intuitively, a positive severance pay rewards shirking, thus the conservative system, which commits to less firing, saves both the direct cost (severance pay) and the indirect cost (counter-incentive caused by a positive severance

pay). In sum, our findings suggest that conservative accounting could be beneficial as it fosters long-term relationship by committing the principal to less firing, and thus makes motivating the manager less expensive in long run.

In the third chapter, titled “Effect of Accounting for Fixed Assets on Investment Efficiency in the Real Options Framework”, I study the benefits of accounting for fixed assets in a setting with privately informed managers who care about investment profitability and their company’s short-term share price. In a perfect world, a manager’s investment in fixed assets should increase with the assets’ profitability. However, managers of less profitable firms face temptations to overinvest to pool with strong firms. This creates pressure on strong firms to overinvest to the point where weak firms cease to find it worthwhile to mimic strong firms. I show that, when firms have abandonment options, the willingness of a weak firm’s manager to mimic depends on the expected future resale value of the fixed assets. An impairment policy (prohibiting write-ups) reduces the value of abandonment options, which are particularly important to weak firms. The reduced value of the abandonment options decreases the amount of overinvestment required by strong firms to separate from weak firms. In an extension of the baseline model, I show that allowing firms to choose depreciation schedules improves investment efficiency; strong firms choose faster depreciation in equilibrium. These findings rationalize the current accounting standards for fixed assets and contribute to related policy debates on accounting measurement.