Dissertation Proposal

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"Essays on Earnings Management, Investment Efficiency, and Managerial Incentives"

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In response to accounting scandals, market control systems (e.g. regulations related to internal control systems) have become more stringent in order to restore investors' confidence in capital markets. Tightening control systems has triggered a fierce debate on its effect on both capital markets and the real economy. My dissertation studies how mitigating earnings management by tightening control systems can affect managerial incentives and a firm's investment decisions. My dissertation also analyzes how the labor union's bargaining power influences a firm's financing choices.

In the first chapter, titled "Earnings Management, Investment, and Managerial Turnover in a Dynamic Agency Model," I develop a model to investigate how the control system influences a firm's investment decisions. Contrary to the view that a strong control system mitigates CEOs' incentives to manage earnings and increases investment efficiency, I find that a moderate control system, that allows appropriate reporting discretion to CEOs, can improve a firm's investment decisions when past performance is poor. The essential mechanism is that, in the optimal contract, costly earnings management can act as an alternative punishment for poor performance and, thus, substitute for the threat of turnover. Because the possibility of turnover leads to an underinvestment problem (e.g. because a new CEO needs to learn about the ongoing projects and there are costs associated with searching for a new CEO.), a moderate control system can effectively improve investment efficiency. Also, an infinite-horizon dynamic model shows a positive relationship between investment and the level of earnings management for a given control system and an inverted U-shape relationship between investment and the control system. Finally, calibration results suggest that shareholders' value under the current level of the control systems in the market is 0.4% higher than that under the counterfactual strongest control system. I propose to strengthen the motivation of the paper and explore empirical implications.

In the second chapter, titled "Earnings Management and Accounting Conservatism in a Dynamic Agency Model," (joint work with Carlos Corona and Jonathan Glover), we examine how earnings management and accounting conservatism can work together to improve investment efficiency and shareholders' value. It has been documented that the conservative accounting system improves contract efficiency in a single period model. In a multi-period model with managerial turnover, however, a conservative accounting system results in more frequent CEO turnover, because it unconditionally makes low signals more likely. Because earnings management can act as an alternative punishment (as discussed in the first chapter), the combination of conservatism and earnings management increases the expected punishment for poor performance and, thus, helps to improve contract efficiency and attenuate ex post inefficient managerial turnover. I propose to finish writing up the second chapter and to extend it with additional analysis on investment efficiency.

In the third chapter, titled “Performance Pay, Labor Union Negotiation, and Financing Choices,” (joint work with Jing Li), we study how unionized labor’s ex ante and ex post bargaining power affect a firm’s financing choices. When a labor union’s ex ante bargaining power is large, debt financing can be used as a bargaining tool against a powerful labor union if a labor union’s ex post bargaining power is small. Creditors not only reduce the labor union’s payment in the event of liquidation but also commit to ex post liquidation in the bad state. Shareholders, however, may actually prefer not liquidate the project at the interim stage when facing a labor union whose ex post bargaining power is strong, and, rather, wait till the end of the project to share the default risk with the labor. Debt financing that induces interim liquidation by creditors may be suboptimal to shareholders. I plan to analyze the conditions under which debt financing is optimal and finish writing the paper.