Dissertation Proposal

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"Essays on Accounting Conservatism, Investment Efficiency, and Managerial Incentives"

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388 Posner Hall

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

In the first chapter, titled "Literature Review on Accounting Conservatism", I provide an extensive literature review to motivate my dissertation. I focus on reviewing three streams of the theoretical and empirical research on conservatism: (1) the literature on asset impairment policies, (2) the literature related to the effect of accounting conservatism on investment efficiency, and (3) the literature explaining the rationale of accounting conservatism in managerial contracts. I propose to extend Chapter 1 by (1) writing a discussion about the similarity and difference between the asset impairment policy and accounting conservatism modeled in the literature, and (2) conducting a more extensive literature review.

In the second 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. I propose to extend Chapter 2 by analyzing conditions under which the fully-revealing system or the historical cost system would dominate.

In the third chapter, titled "Timely Loss Recognition and Long-term Incentive", (joint with Jonathan Glover and Haijin Lin), we study the optimal design of the accounting system which generates a noisy signal correlated with the agent's fitness. A full information system facilitates the principal to trim unfit agents but leads to too much firing from an ex-ante perspective and, thus, diminishing the efficiency of managerial contracts. We show that the conservative system, which withholds good news, fosters the long-term relationship between the principal and the agent and thus increases the agent's incentive to work in long run. This finding provides a new insight about why conservatism improves efficiency in management compensation contracts. I propose to extend Chapter 3 by finishing writing and conducting additional analysis about an alternative assumption that the manager privately observes the interim accounting signal.