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The Effect of Firms' Depreciation Method Choice on Managers' Capital Investment Decisions

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This study examines whether straight-line depreciation, relative to accelerated depreciation, causes non-executive managers to make non-value-maximizing capital investment decisions. To do this, I conduct experiments in which managers must decide whether to continue using an existing asset or invest in a replacement asset. By design, replacing the existing asset yields higher cash flows and managers are aware of this fact. However, if the asset is replaced, then the greater remaining book value under straight-line depreciation relative to accelerated depreciation causes earnings to be lower. Lower earnings and psychological forces may push managers of firms that use straight-line depreciation away from making the economically efficient capital investment decision. The results suggest that managers of firms that use straight-line depreciation are less likely to invest in a replacement asset than are managers of firms that use accelerated depreciation. Further, the results suggest that managers perceive that an asset depreciated using straight-line depreciation has provided less retrospective utility than an asset depreciated using accelerated depreciation. In turn, I find that depreciation method-induced differences in managers' retrospective utility perceptions influence their prospective utility perceptions, which, in turn, influence managers' asset replacement decisions. By theoretically and empirically linking firms' depreciation method choice to managers' capital investment decisions, I provide evidence that a seemingly innocuous choice made for external financial reporting purposes can cause managers to make non-value-maximizing capital investment decisions.

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