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The economics of earnings manipulation and managerial compensation

Keith J. Crocker, Joel Slemrod

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Abstract

This article examines managerial compensation in an environment where managers may take a hidden action that affects the actual earnings of the firm. When realized, these earnings constitute hidden information that is privately observed by the manager, who may expend resources to generate an inflated earnings report. We characterize the optimal managerial compensation contract in this setting, and demonstrate that contracts contingent on reported earnings cannot provide managers with the incentive both to maximize profits and to report those profits honestly. As a result, some degree of earnings management must be tolerated as a necessary part of an efficient agreement.

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