The RAND Journal of Economics / Volume 38, Issue 3 / pp. 698-713

The economics of earnings manipulation and managerial compensation

Keith J. Crocker, Joel Slemrod

First published: 03 January 2008
https://doi.org/10.1111/j.0741-6261.2007.00107.x

The authors gratefully acknowledge the helpful suggestions provided on earlier drafts by Thomas Gresik, Arthur Snow, and seminar audiences at the Pennsylvania State University, the University of Georgia, and the University of Notre Dame. A particular debt of gratitude is owed to an anonymous referee, whose thoughtful advice and constructive criticism has greatly improved the quality of the final product.

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.

References

Alexander, C.R. AND Cohen, M. Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost. *Journal of Corporate Finance*, Vol. **5** (1999), pp. 1–34.

Web of Science® | Google Scholar

Associated Press . " Settlement over Bonuses Paid before Merger Failed." August 15, 2004.

Google Scholar

Austen, I. Nortel Sues 3 Ex-Officers over Big Bonuses. *New York Times*, February 4, 2005, p. C-2.

Google Scholar

Bagnall, J. Owens Vows to Clean Up Nortel's Books: 'I Didn't Seek This Job, but I Love It.' *National Post*, May 29, 2004.

Google Scholar

Beck, R. Battle Intensifies over Executive Bonuses." Associated Press, September 10, 2004.

Google Scholar

Boyle, M. They Didn't Earn It—They Should Return It. *Fortune*, May 15, 2006.

PubMed | Web of Science® | Google Scholar

Byrne, J.A. How to Fix Corporate Governance. *Business Week*, May 6, 2002, pp. 68–81.

Google Scholar

Cheng, Q. AND Warfield, T. Equity Incentives and Earnings Management. *Accounting Review*, Vol. **80** (2005), pp. 441–476.

Web of Science® | Google Scholar

Crocker, K.J. AND Morgan, J. Is Honesty the Best Policy? Curtailing Insurance Fraud through Optimal Incentive Contracts. *Journal of Political Economy*, Vol. **106** (1998), pp. 355–375.

Web of Science® | Google Scholar

Crocker, K.J. AND Slemrod, J. Corporate Tax Evasion with Agency Costs. *Journal of Public Economics*, Vol. **89** (2005), pp. 1593–1610.

Web of Science® | Google Scholar

Danner, P. Execs Agree to Pay FPL Group. *Miami Herald*, August 14, 2004.

Google Scholar

Dechow, P., Sloan, R., AND Sweeney, A. Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC. *Contemporary Accounting Research*, Vol. **13** (1996), pp. 1–36.

Google Scholar

Dye, R.A. Earnings Management in an Overlapping Generations Model. *Journal of Accounting Research*, Vol. **26** (1988), pp. 195–235.

Web of Science® | Google Scholar

Erickson, M., Hanlon, M., AND Maydew, E. Is There a Link between Executive Compensation and Accounting Fraud? *Journal of Accounting Research*, Vol. **44** (2006), pp. 113–144.

Web of Science® | Google Scholar

Fudenberg, D. AND Tirole, J. *Game Theory*. Cambridge , Mass .: MIT Press, 1991.

Web of Science® | Google Scholar

Gao, P. AND Shrieves, R. Earnings Management and Executive Compensation: A Case of Overdose of Option and Underdose of Salary?" Working Paper, Northwestern University and University of Tennessee at Knoxville, 2002.

Google Scholar

Gresik, T. AND Nelson, D. Incentive Compatible Regulation of a Foreign-Owned Subsidiary. *Journal of International Economics*, Vol. **36** (1994), pp. 309–331.

Web of Science® | Google Scholar

Guesnerie, R. AND Laffont, J.J. A Complete Solution to a Class of Principal-Agent Problems with an Application to the Control of a Self-Managed Firm. *Journal of Public Economics*, Vol. **25** (1984), pp. 329–369.

Web of Science® | Google Scholar

Hanlon, M., Mills, L., AND Slemrod, J. An Empirical Examination of Corporate Tax Noncompliance." In A. Auerbach, J.R. Hines., and J. Slemrod, eds., *Taxing Corporate Income in the 21st Century*. Cambridge , UK : Cambridge University Press, 2007.

Web of Science® | Google Scholar

Holmstrom, B. Moral Hazard and Observability. *Bell Journal of Economics*, Vol. **10** (1979), pp. 74–91.

Web of Science® | Google Scholar

Jewitt, I. Justifying the First-Order Approach to Principal-Agent Problems. *Econometrica*, Vol. **56** (1988), pp. 1177–1190.

Web of Science® | Google Scholar

Johnson, S., Ryan, H., AND Tian, Y. Executive Compensation and Corporate Fraud." Working Paper, Louisiana State University, 2003.

Google Scholar

Ke, B. Why Do CEOs of Publicly Traded Firms Prefer Reporting Small Increases in Earnings and Long Duration of Consecutive Earnings Increases?" Working Paper, Pennsylvania State University, 2001.

Google Scholar

Lacker, J.M. AND Weinberg, J.A. Optimal Contracts under Costly State Falsification. *Journal of Political Economy*, Vol. **97** (1989), pp. 1345–1363.

Web of Science® | Google Scholar

Laffont, J.J. *The Economics of Uncertainty and Information*. Cambridge , Mass. : MIT Press, 1989.

Google Scholar

Mezzetti, C. Mechanism Design with Interdependent Valuations: Efficiency. *Econometrica*, Vol. **72** (2004), pp. 1617–1626.

Web of Science® | Google Scholar

Mirrlees, J.A. The Theory of Moral Hazard and Unobservable Behavior—Part I." Mimeo, Nuffield College, Oxford , 1975.

Google Scholar

Mussa, M. AND Rosen, S. Monopoly and Product Quality. *Journal of Economic Theory*, Vol. **18** (1978), pp. 301–317.

Web of Science® | Google Scholar

Myerson, R.B. Incentive Compatibility and the Bargaining Problem. *Econometrica*, Vol. **47** (1979), pp. 61–73.

Web of Science® | Google Scholar

Myerson, R.B.. Optimal Coordination Mechanisms in Generalized Principal-Agent Problems. *Journal of Mathematical Economics*, Vol. **10** (1982), pp. 67–81.

Web of Science® | Google Scholar

Newman, A. Giving Back the Bonus. *Business Week*, January 24, 2005, p. 46.

Google Scholar

Rogerson, W. The First-Order Approach to Principal-Agent Problems. *Econometrica*, Vol. **53** (1985), pp. 1357–1368.

Web of Science® | Google Scholar

Shavell, S. Risk Sharing and Incentives in the Principal and Agent Relationship. *Bell Journal of Economics*, Vol. **10** (1979), pp. 55–73.

Web of Science® | Google Scholar

Young, S. Qwest Trial Shows that Rank Is No Protection. *Wall Street Journal*, April 2, 2004, p. C1.

Google Scholar