

Accounting Research Workshop (ARW) - WT2016/2017

Speaker: Lin Nan
University: Associate Professor with tenure, Purdue University
Research: Agency Problems, Accounting Regulation, Operational Decisions
Date: November 8, 2016
Topic: Optimal Penalty Level, Manipulation, and Investment Efficiency

Abstract: In this study we examine whether it is efficient to impose a penalty based on an earlier optimistic signal and a bad outcome, and what should be the optimal penalty level to maximize the overall efficiency. We find that imposing a penalty helps firms with good projects to stand out from bad firms, thus helps to improve the investment efficiency, but it also brings a “signalling” cost for good firms to deter bad firms’ mimicking. We show that when a good firm has a much larger chance to achieve a good outcome than a bad firm or when a large proportion of the penalty can be reimbursed to the investor, imposing the penalty to achieve the leastcost separating equilibrium is optimal, because the benefit from eliminating the investment inefficiency outweighs the expected signalling cost. On the other hand when even a good firm has a high chance to get bad outcome and there is not a big difference between good and bad projects, and when the reimbursement proportion is very small, imposing no penalty and allowing a pooling equilibrium become optimal, because the benefit of distinguishing firm-types is small while the cost of distinguishing firms is high. We also consider introducing an ex-ante direct cost of manipulation besides the ex-post penalty. We show that with the introduction of the direct cost, the initial information quality before manipulation becomes relevant and plays a role in determining the optimal penalty level. In addition, imposing a sufficiently-high penalty has one more benefit of reducing the expected direct manipulation cost because the penalty dampens the firm’s manipulation.



We are very pleased that we had the possibility to take part in the interesting presentation of Prof. Nan who we invited in our Accounting Research Workshop. We wish her all the best for his research project.