Earnings Management from the Bottom Up:  
An Analysis of Managerial Incentives Below the CEO

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Abstract

Performance-based pay is an important instrument to align the interests of managers with the interests of shareholders. However, recent evidence suggests that high-powered incentives also provide managers with incentives to manipulate the firm's reported earnings. The previous literature has focused primarily on Chief Executive Officers, but managers further down in the firm hierarchy—division managers and Chief Financial Officers— are likely to have similar incentives, and perhaps even greater opportunity to influence reported earnings in a manner that maximizes these managers’ personal income. Moreover, previous research focuses on equity incentives and largely ignores other elements of incentive pay. We contribute to this literature by analyzing all forms of incentive pay for several types of managerial positions and include additional measures of earnings manipulation—end-of-year excess sales and class action litigation—in addition to the standard measure of discretionary accounting accruals. We find that the association between high-powered incentives and earnings manipulation varies by both type of incentive pay and position. Our findings have important policy implications and suggest that compensation committees should review pay policies of other managerial positions in addition to CEOs. Importantly, if the committees wanted to weaken incentive pay to get more truthful reporting, diluting the CFO’s bonus and stock options would be one place to start.

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