Effects of Accounting Conservatism on Investment Efficiency and Innovation*

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ABSTRACT: We study how biases in financial reporting affect managers’ incentives to develop innovative projects, and to make appropriate investment decisions. Conservative reporting practices impose stricter verification standards for recognizing good news and reduce the chance that risky innovations will lead to favorable future earnings reports. Holding all else constant, more conservative reporting therefore weakens the manager’s incentive to work on innovative ideas, consistent with informal arguments in the extant literature. However, all else does not stay constant because the manager’s pay plan will change in response to changes in the accounting system. We show that under optimal contracting, more conservative accounting does not stifle innovation in organizations, but increases incentives for innovation.

Keywords: Optimal contracting, Innovation, Accounting conservatism, Investment efficiency.

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