Paper Title:

Effect of Accounting for Fixed Assets on Investment Efficiency in the Real Options Framework

Abstract:

This paper studies the benefits of accounting for fixed assets in a setting with privately informed managers who care about investment profitability and their company's short-term share price. In a perfect world, a manager's investment in fixed assets should increase with the assets' profitability. However, managers of less profitable firms face temptations to overinvest to pool with strong firms. This creates pressure on strong firms to overinvest to the point where weak firms cease to find it worthwhile to mimic strong firms. I show that, when firms have abandonment options, the willingness of a weak firm's manager to mimic depends on the expected future resale value of the fixed assets. An impairment policy (prohibiting write-ups) reduces the value of abandonment options, which are particularly important to weak firms. The reduced value of the abandonment options decreases the amount of overinvestment required by strong firms to separate from weak firms. In an extension of the baseline model, I show that allowing firms to choose depreciation schedules improves investment efficiency; strong firms choose faster depreciation in equilibrium. These findings rationalize the current accounting standards for fixed assets and contribute to related policy debates on accounting measurement.