Department of Accounting
College of Commerce
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Ph.D. Qualifying Exam- Financial Accounting
September 20, 2007

PART 1

1. (35%)

Bagnoli and Watts (2000, JAPP) provide a link of earnings management with performance evaluation.

(1) (5%) Describe the performance measurement in Bagnoli and Watts (2000).

(2) (10%) Discuss the effect of performance evaluation on managers' disclosure in Bagnoli and Watts (2000.

(3) a. (10%) Propose any other performance measurement(s) and then, discuss its/their potential effect on managers' disclosure.

b. (10%) Based on your discussion above, what will you suggest for shareholder to choose performance metrics?

2. (15%)

(1) (5%) Describe the signaling equilibrium in Huang and Litzenberger (1988).

(2) (10%) Bhattacharya et al. (2007, AR) investigate who trades on pro forma earnings information. Their intraday investigation of transactions around earnings announcements containing pro forma earnings information reveals that less sophisticated investors' announcement-period abnormal trading is significantly positively associated with the magnitude and direction of the earnings surprise based on pro forma earnings. In contrast, they find no association between sophisticated investors' trading and manager-reported pro forma information. Overall, the segment of the market that relies on pro forma earnings information is populated predominantly by less sophisticated individual investors. This evidence is particularly relevant to standard-setters and regulators given that Section 401 (b) of the Sarbanes-Oxley Act of 2002 and subsequent SEC regulations are specifically designed to protect ordinary investors from misleading pro forma information.

Managers and other advocates of pro forma reporting argue that these disclosures provide a clearer picture of companies' core earnings. On the other hand, regulators, policymakers, and the financial press often allege that managers' pro forma earnings disclosures are opportunistic attempts to mislead investors. Recent evidence suggests that while many pro forma earnings disclosures are altruistically motivated, some may represent managers' attempts to portray overly optimistic financial performance. If this is the case, then less wealthy, less sophisticated, individual investors are arguably the most at risk of being misled.

Contrast to the findings in Bhattacharya et al. (2007), discuss the criteria of the existence of the signaling equilibrium in Huang and Litzenberger (1988).