

Honesty in Managerial Reporting: Is it Affected by Perceptions of Equity?

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A growing body of published research in accounting, experimental economics and management suggests that non-pecuniary preferences for honesty and equity influence managerial behavior in economically significant ways. This study contributes to this literature by examining whether changes in the perceived equity of a manager's compensation contract and the decision frame influence the degree to which the manager will misreport private managerial accounting information.

The present study extends Evans et al. (2001) and Moser et al. (1995) by considering the effect of equity on honesty in an employment, rather than a tax setting. In a laboratory experiment, participants assuming the role of division managers had private information about costs and an opportunity to increase their personal wealth by reporting costs dishonestly. Changes in compensation were used to manipulate the relative equity of the manager's compensation and the identity of the employee experiencing a change in pay. Three primary research questions were addressed. (1) Are managers willing to sacrifice wealth to report honestly? (2) Do changes in the equity of a manager's relative compensation (compared with the compensation of his peers) affect the degree of honesty in managerial reporting? (3) Are managerial reporting responses affected by the framing of the change in equity? That is, are responses to changes in a manager's own pay the same as responses to changes in the pay of his or her peers, and are responses to the introduction of inequity of similar magnitude to responses to the restoration of equity?

The results were consistent with previous research suggesting that preferences for honesty are economically significant. On average, participants were willing to sacrifice approximately 39% of the available payoff to report honestly. With respect to the second research question, the results were mixed. Changes in compensation from an equitable to an inequitable state were associated with decreases in honesty, regardless of whether they resulted from a pay increase received by a manager's peers, or a pay cut received by the manager herself. However, as suggested by the third research question, responses to changes in compensation from an inequitable state to an equitable state were affected by the framing of the change. There was evidence of an increase in honesty when equity was restored through a pay raise experienced by the manager. However, when the improvement in relative compensation was achieved through a pay cut given to the manager's peers, on average this was not perceived as an increase in the equity of compensation, and the degree of honesty in reporting did not increase. Contrary to predictions, the magnitude of the change in honesty associated with the introduction of inequity was not significantly different than the change associated with the restoration of equity.

The findings of this study have important implications for owners. They suggest that attempts to exploit the honesty preferences of managers may be affected by perceptions of the equity of relative compensation (Mittendorf 2006). Furthermore, they suggest that owners who attempt to mitigate potential losses associated with perceptions of inequitable compensation must be sensitive to both absolute and relative changes in compensation among their managers.
