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LECTURE 8: ECONOMIC CONSEQUENCES OF ACCOUNTING POLICY CHOICE

- Nexus of Contracts – corporations help reduce complexity of multitude of contracts if corporations otherwise did not exist
- Agency theory is a framework – why a firm chooses one accounting policy over another
    - Positive theory.
    - Rather than relying on legal enforcement to align managerial interests with shareholder's interests, apply utility maximiser assumption
    - Rationalization: people are going to act in their own interests, and it is expected that people will act in this way (level of distrust).
    - Manager-shareholder relationship:
        - Manager/owner: shares in all profit and all loss
        - Manager/part-owner: receives all benefit, but only a part share in the loss
- Creditor-Manager:
    - More dividend payments, less money available for creditors
    - When a company is in financial difficulties (risk of collapsing), managers will not invest in positive NPV projects (theorized).
    - Claim dilution:
        - Arises when additional borrowing is at a higher ranking debt
- Bonding – what the agent spends money on (management); monitoring – shareholders spend money on
    - Bonding: agent spends money to convince they are doing a good job (audits)
    - Monitoring: money on analyzing financial statements to review performance
- Forms of Remuneration:
    - At risk (incentive based) – from the perspective of the manager.
        - If company doesn't perform, manager does not get that part of remuneration.
- Management bonus plans:
    - KPI's are what the shareholders want to achieve
    - Shareholders want to see high profits – if you link remuneration to profits, management will want to see high profits too
- Horizon problem:
    - Linking management's interests to the long-term goals of the company (stock options).
        - Want share price to be higher later on.
- Economic consequences of bonus plans:
    - If quite unlikely to achieve bonus, may be a tendency to incur more expenses this year so that profit boosted next year.
    - Otherwise, if close, may choose accounting policies that will boost accounting profit.
- Controlling management:
    - Capital market:
        - More difficult to raise funds in the future if you're doing a lousy job of running the company
    - Labour market:
        - Other managers might be considered to do a better job.

READINGS: CHAPTER 5 – THEORIES IN ACCOUNTING

Types of Theories

- Contracting theory:
    - Suggests that the organisation is characterised as a legal nexus of contracts or as the centre of contractual relationships, with these contracting parties having rights and responsibilities under these contracts.
- Agency theory:
    - Relationship whereby the principal employs the services of another (the agent) to perform some activity on their behalf.
    - Moral hazard: the risk that managers might undertake actions that are detrimental to owners or other principals.
        - Jensen and Meckling have identified three agency costs:
            - Monitoring costs:
                - Incurred by the principal to measure, observe and control the agent's behaviour (audit financial reports)
                - Such costs are initially incurred by the principal but subsequently passed on to the agent (Lenders to charge a higher rate if required to undertake more monitoring of the entity).
                - Price protection: as the costs of monitoring an agent's behaviour increases, the remuneration paid to those agents will decrease or the cost of borrowings will increase.
            - Bonding costs:
                - Price protection means agents will actually bear the costs of monitoring through lower remuneration or higher interest rates – because of this managers are likely to provide some assurance that they are making decisions in the best interests of the principals.
                    - EG. Time and effort involved in producing and providing quarterly accounting reports or linking company performance to remuneration
            - Residual loss:
                - May cost more to monitor agents than the expected benefits from that monitoring.
                - Monitoring the use of business stationary for personal use.
                    - Additional divergence is referred to as residual loss.
- Owner-manager agency relationships:
    - Horizon problem:
        - Managers and shareholders having different time horizons in relation to the entity.
            - Shareholders want managers to make decisions that enhance the future cash flows of the entity over the long term.
            - Managers are interested in the cash flow potential only as long as they expect to be employed by the entity.
        - Problem where managers are approaching retirement, seeking to move to another entity in the short term.
            - More likely to demonstrate the short term profitability of the entity as evidence of effective management: delay undertaking maintenance or upgrades to equipment or plant or reduce research and development expenditure.
            - Has the effect to increase long term costs.
        - Problem addressed by linking management rewards to longer-term performance of the entity.

        - Bonuses to share price, or paying a proportion of managerial remuneration as shares or share options.
  - Risk aversion:
    - Managers generally prefer less risk than shareholders.
      - Shareholders diversify risk by investing across multiple investments.
      - Managers have more 'skin in the game' as their remuneration is their primary source of income; divergence potentially substantially impacting personal wealth.
    - Linking bonuses partly to profits can encourage managers to consider more risky projects that have the potential to increase profits.
    - Increasing managerial share ownership increases a manger's risk aversion as it further decreases a manager's ability to diversify risk. (personal income + share investment).
  - Dividend retention:
    - Managers, compared to shareholders, prefer to maintain a greater level of funds within the entity and pay less of the entity's earnings to shareholders as dividends.
      - 'empire building'.
    - Paying a bonus which is linked to a dividend payout ratio will likely encourage managers to enhance dividend payouts to shareholders.
- Manager-lender agency relationships:
  - To avoid higher interest costs being imposed by lenders, managers have incentives to contract to show they are acting in a way that is not detrimental to lenders.
  - Excessive dividend payments:
    - Could lead to a reduction of the asset base securing the debt or leave insufficient funds within the entity to service the debt.
    - Agree to covenants that restrain dividend policy and restrict dividend payouts as a function of profits.
  - Underinvestment:
    - Where manages have incentives not to undertake positive NPV projects if the projects would lead to increased funds being available to lenders.
      - Particularly when entity is in financial difficulty.
      - Creditors rank above owners in order of payments in liquidations
  - Asset substitution:
    - Funds are lent on the assumption that managers will not invest in assets or projects of a higher risk level than agreed. Lenders bear the risk of managers investing in alternative, higher-risk assets in the likelihood that it will lead to higher returns to shareholders, as they are subject to the downside risk (failure) but not the upside of the investment decision (payoff of the riskier investment).
  - Claim dilution:
    - When entities take on debt of a higher priority than that on issue.
      - Increases funds available to the entity but decreases the security to lenders, making the lending more risky.
    - Implement debt covenants; restrict working capital ratios; leverage covenants
- Information asymmetry:
  - Managers have an advantage over investors and others as they have more information about the current and future prospects of the entity, and can choose when and how to disseminate this information.
  - Managers can use accounting disclosure and other forms of disclosure and announcements to the market, to signal expectations about the future.

    - Adverse selection: if entities did not provide information when other entities in the market did so, it would be assumed they had bad news to report and the share price would suffer as a result.

Contingency Theory

- Proposes that organisations are all affected by a range of factors that differ across organisations.
    - Organisations need to adapt their structure to take into account a range of factors such as external environment, organisational size and business strategy if the organisation is to perform well.
    - Galbraith formulated theory to propose that there is no one best way to organise, as organisational effectiveness is contingent on context.
- Central proposition is that organisational performance depends on the fit between organisation context and structure.
    - Organisational effectiveness is achieved by matching organisational characteristics to contingencies.
- Cadez and Guilding find support for a contingency theory proposition that there is no universally appropriate strategic management accounting system, with factors such as entity size and strategy found to impact on the successful application of strategic management accounting systems.

READINGS: CHAPTER 9 – EARNINGS MANAGEMENT

Earnings Management

- Range of earnings management as white, grey or black.[1]
  - White, or beneficial earnings management enhances the transparency of financial reports
  - Black involves misrepresentation, reducing transparency or even fraud.
  - Grey defines earnings management as choosing an accounting method that is either opportunistic (maximises wealth of managers) or could be economically efficient for the entity concerned.

Methods of Earnings Management

- Accounting policy choice:
  - Choosing between the available acceptable accounting policies within the framework of applicable accounting standards.
    - EG. Straight line and accelerated depreciation choices, FIFO or weighted average, etc.
  - Occurs where management have flexibility in making accounting choices in line with accounting standard requirements.
  - Difficult to determine if these choices are made because they reflect the economic nature of the underlying transactions, or if management is seeking to delay expense recognition to a later date.
  - Provided the entity can put a case forward to the auditors that a change in accounting principle is more practical or preferable, it is free to change this policy.
    - Must justify the decision if the result is a material change.
- Accrual accounting:
  - Attempts to reflect the effects of transactions and other events and circumstances that have cash or other consequences for an entity's resources and the claims to them in the periods in which they occur or arise.
  - Generally have no direct cash flow consequences and can include under-provisioning for bad debts expenses, delaying asset impairments, adjusting inventory valuations and amending depreciation and amortisation estimates and adjustments.
  - DeAngelo model to determine earnings management by comparing the accruals component of earnings in one year to accruals the previous year as an estimate of 'normal' accruals.
    - AC = NPAT – CFO
      - AC = the accruals component of earnings in year t
      - NPAT = net operating profit after interest and tax in year t
      - CFO = cash flows from operations in year t
    - To calculate earnings management through accruals accounting, unexpected or discretionary accruals are calculated as the difference between the change in net operating profit after interest and tax and the change in cash flow from operations from year t-1 (previous) to year t (current).
      - Change in ACt = ACt – ACt-1
- Income smoothing
  - Shifting earnings from peak years to less successful periods.[2]
- Real activities management:
  - Managing earnings by managing operational decisions, not just accounting policies or accruals.
    - Accelerating sales, offering price discounts, altering shipment schedules and delaying R&D and maintenance expenditures.

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[1] Ronen and Yaari.
[2] Copeland.

    - Negative outcome could be a reduction in entity value because actions taken in the current accounting period to increase earnings can have a negative effect on cash flows in later periods.
        - Aggressive price discounting to increase volume of sales to maximise short term earnings can lead customers to expect the same discounts in the future, which will lead to lower margins on future sales.
            - Auditors less likely to question actual pricing and production decisions than accruals management.
- Big bath write-offs:
    - Situations when management are required to significantly restructure the organisation, such as selling off subsidiaries or operational units, resulting in a large loss being reported against income.
    - Often used when there is a change in the management team, with the need to write off assets or operational units being blamed on the outgoing managers' poor management of resources.

Why do entities manage earnings?:

- Two motivations:
    - Earnings are managed for the benefit of the entity for a number of reasons including: to meet analysts' and shareholder expectations and predictions; to maximise share price and company valuation; to accurately convey private information; or to avoid violating restrictive debt covenants.
    - Earnings are managed to meet short-term goals which lead to maximizing managerial remuneration and bonuses.
- Management may use to convey their own expectations of future cash flows.
- Can be disproportionate responses to the share price if analyst expectations are not met.
- Entity valuation:
    - Dechow: share prices are more highly aligned with net income than operating cash flows.
        - Value is effectively the present value of future income discounted at a risk-adjusted discount rate, which is usually the cost of capital.
        - Because determining entity value relies on some measure of risk, entities with more volatile patterns of earnings are likely to have a higher risk measure and therefore are likely to have a lower entity value. Earnings volatility could be an indication of an increased chance of insolvency.
            - As a result of this, managers are more likely to engage in income smoothing to reduce volatility and therefore risk of investment.
- Earnings quality:
    - Relates to how closely current earnings are aligned with future earnings.
        - Current earnings which are highly correlated to future earnings are said to have high earnings quality and lead to a more accurate future earnings forecast.
        - Vice versa
    - Consider:
        - Trend in profit results:
            - Consistency, variation/fluctuations
        - Operating/non-operating mix:
            - What part of the business generated profits? Operating business or abnormal items
        - Earnings base:
            - Spread of earnings through different regions and markets?
    - Non-discretionary accruals are the 'normal' part of earnings that result from applying accounting rules in a neutral way
    - Discretionary accruals are those that result from conservative or aggressive accounting policy choices.
        - Large discretionary accruals to total accruals considered to be low earnings quality.

Managerial Compensation and Change in CEO

- Healy observed that managers will manage earnings in such a way that they maximise their bonus.
  - If earnings are so low that they are unlikely to meet their targets, they are likely to engage in big bath write-offs to ensure they meet earnings targets the next year.
- Long term bonus plans in addition to short term ones helps mitigate earnings management and leads to higher annual returns.
- Research examining equity-based compensation generally supports the existence of earnings management that is intended to inflate earnings.
- CEO departure:
  - Whether the departing CEO used earnings management to mask poor performance, which can lead to a higher bonus upon leaving
    - Forced departure generally follows poor entity performance, which is likely to lead to upwards earnings management to reduce the appearance of this poor performance.
  - Whether the incoming CEO used earnings management in the form of a big bath write off to blame poor performance on his or her predecessor and in turn increase earnings the following year.
    - Initial downwards earning management with upwards management the year after the CEO change.

Consequences of Earnings Management

- Depends upon the nature and extent of earnings management that has taken place.
- Market reacts negatively to the disclosure that there has been fraudulent manipulation, implying that investors were surprised and interpret the information as negative news.

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SQ 1. Excessive dividend payments – reduction in asset base securing the debt, or leave insufficient cash available for creditors. Asset substitution - Funds are lent on the assumption that managers will not invest in assets or projects of a higher risk level than agreed. Lenders bear the risk of managers investing in alternative, higher-risk assets in the likelihood that it will lead to higher returns to shareholders, as they are subject to the downside risk (failure) but not the upside of the investment decision (payoff of the riskier investment). Claim dilution – When entities take on debt of a higher priority than that on issue. Increases funds available to the entity but decreases the security to lenders, making the lending more risky.

SQ 2. Claim dilution; asset substitution; excessive dividend payments; underinvestment.

SQ 3. Horizon problem: Shareholders are interested in the future cash flows of the entity. Managers are more interested in short term performance as they may not be at the entity to reap the benefits of long term performance. Mitigation: link management rewards to longer-term performance of the entity; bonuses linked to share price, or paying a proportion of managerial remuneration as shares/options. Risk aversion – shareholders have a larger appetite for risk and expect management to take on riskier projects in order to maximise returns. Shareholder risk is diversified amongst many investments. Managers on the other hand, are more risk averse as they do not wish to negatively influence their remuneration by missing performance targets due to the failure of risky projects. Linking bonuses partly to profits can encourage managers to consider more risky projects to boost profits; increase managerial share ownership. Dividend retention – managers prefer to maintain a greater level of funds within the entity and pay less of the entity's earnings to shareholders as dividends (empire building). Paying a bonus linked to a dividend payout ratio will likely encourage managers to enhance dividend payouts to shareholders.

SQ 4.

- Income smoothing – where profits are greater in one year than expected, and unlikely to meet expectations in the next. Allowances for doubtful debts may be increased to offset the rise and in the subsequent period, the allowance may be reduced so as to prop up profit again.
- Real activities management - Managing earnings by managing operational decisions, not just accounting policies or accruals. Accelerating sales, offering price discounts, altering shipment schedules and delaying R&D and maintenance expenditures. Negative outcome could be a reduction in entity value because actions taken in the current accounting period to increase earnings can have a negative effect on cash flows in later periods.
- Big bath write-offs – Situations when management are required to significantly restructure the organisation, such as selling off subsidiaries or operational units, resulting in a large loss being reported against income. Often used when there is a change in the management team, with the need to write off assets or operational units being blamed on the outgoing managers' poor management of resources.

TQ 1.

a) Nexus of contracts view of the firm:
   a. An entity is comprised of a number of contracts between contracting parties who have rights and responsibilities relating to the entity under these contracts.
   b. Corporations help to reduce the complexity of a multitude of contracts if corporations otherwise did not exist (between each and every individual).
b) How does this view help us understand the behaviors of firms:
   a. Each party to the contract is self-interested, which creates agency issues.
c) Why might the concept of ownership be irrelevant?
   a. .
d) What are the implications of this view of the firm for accounting policy choice:
   a. Consider the agency relationships between managers, shareholders and creditors.

TQ 2.

- Organisations divide managerial remuneration packages so as to align shareholder's risk appetite with that of management. The salary of management is their sole income and so they are risk adverse as they cannot diversify this salary. However, if the remuneration is divided between salary, stock and options, the interests of management will become more closely aligned to that of the shareholders as management will also wish to see an appreciation in share value – something which is facilitated by the increase in risky projects undertaken. Furthermore, management bonuses may be awarded if certain profit levels are achieved. Management may thus be more likely to take on some more riskier projects so as to receive those bonuses, something that is in the interests of shareholders. Therefore, organisations balance the consideration of good performance of shareholders and adequate risk appetite of management by giving management shares and options as a part of their remuneration policy so as to align their interests with that of shareholders.

TQ 3

1. How debt covenants used to reduce agency problems between entities and lenders
    a. Where lenders give out money, they face the risk of claim dilution. That is, the risk that entities take on debt of a higher priority than that on issue. This has the effect of increasing funds available to the entity, but decreasing the security of lenders over those funds, making such lending riskier than initially considered. By implementing debt covenants, entities contract not to take on more debt than a predetermined amount. This prevents claim dilution as entities cannot continue to dilute the primary lender's claim by taking on further debt without being in breach of the debt covenant. If breached, the lender is entitled to the balance outstanding and interest owing immediately, thereby protecting their interests.
2. Why would a company choose to enter into a lending agreement which contains a covenant that puts a restriction on the maximum debt to assets that a company can take on.
    a. This aligns the interests of both the entity and the lenders. With the agreement in place, lenders have greater security and are therefore more likely to give the entity a lower interest rate to reflect the de-risked nature of the loan. Conversely, the entity has an interest in entering into such an agreement so as to secure a lower rate of interest.