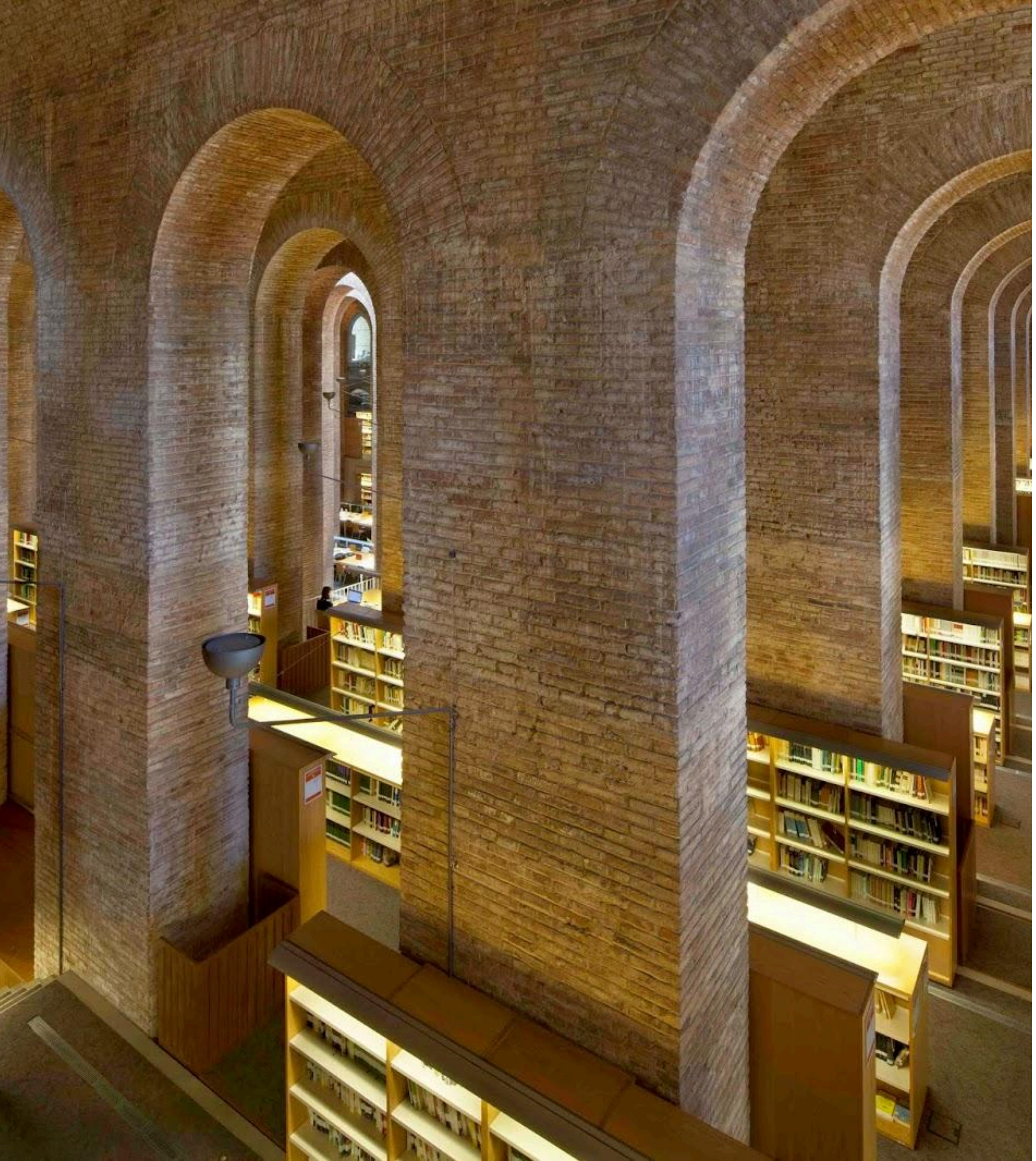

Financial Accounting in Corporate Governance: A Contractual View

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Summary

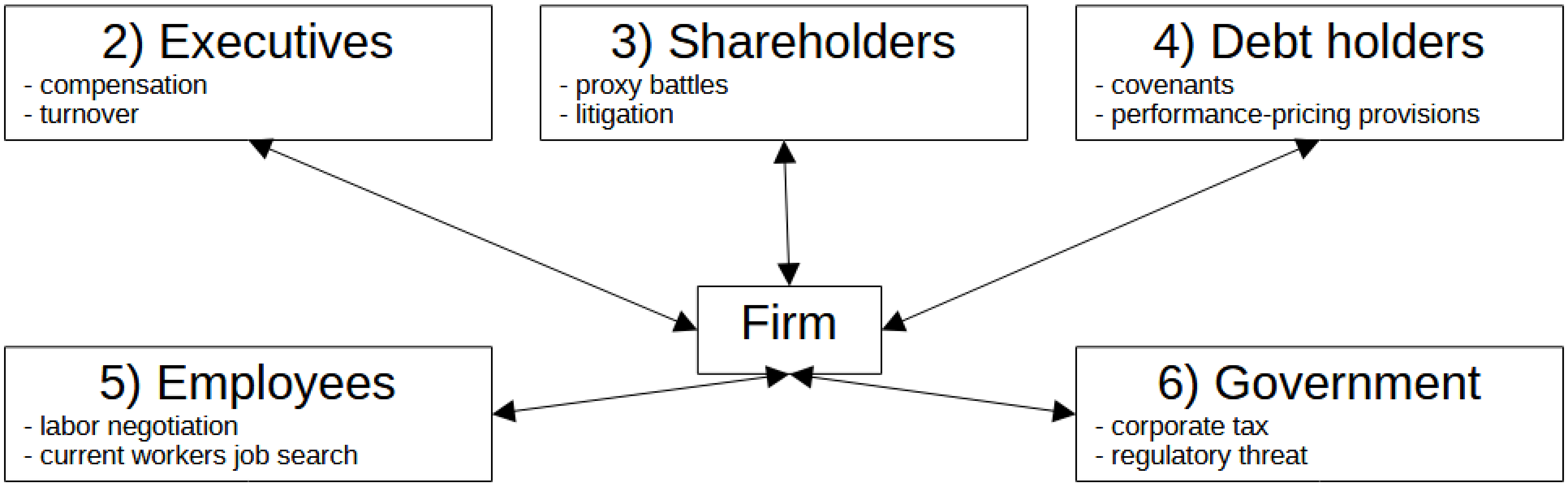
What is the role of financial accounting information in corporate governance?

We will review different streams of literature on the role of financial accounting information in corporate governance.

Our goal is to provide a comprehensive and unified view on how financial accounting information is used to:

(1) define contractual relationships between corporate stakeholders and the firm.

(2) monitor the fulfillment of the contractual obligations.


2) Executives
- compensation
- turnover
3) Shareholders
- proxy battles
- litigation
4) Debt holders
- covenants
- performance-pricing provisions
Firm
5) Employees
- labor negotiation
- current workers job search
6) Government
- corporate tax
- regulatory threat

We will not cover:

- financial accounting regulation.
- financial accounting information and capital markets.
- managerial accounting.

  References available in this Zotero Public Group: Corporate Governance and Accounting

1) Introduction

Theory of the firm

We start by understanding a corporation as a nexus of contracts designed to minimize contracting costs (Coase, 1937).

Those contracts govern how costs and rewards are allocated among stakeholders (Jensen & Meckling, 1977).

The literature has branched into various sub-disciplines to accommodate the diverse interests and contractual obligations for each type of corporate stakeholder (Bechuk & Weisbach, 2010).

Types of contracts: formal and informal.

Contracting process:

1. establish the terms of the contract.
2. monitor firm's ability to satisfy the terms of contract.

What information?

- Ideally, economic profits: drivers, type, and distribution across stakeholders.

Accounting vs Economic profits:

- Accounting profits act as **surrogates** for economic profits as long as less costly alternative sources do not provide similar or better information on rents.

Definition of Financial Accounting Information

Bushman & Smith (2003) define it as:

> Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose [...] the financial position and performance of publicly held firms.

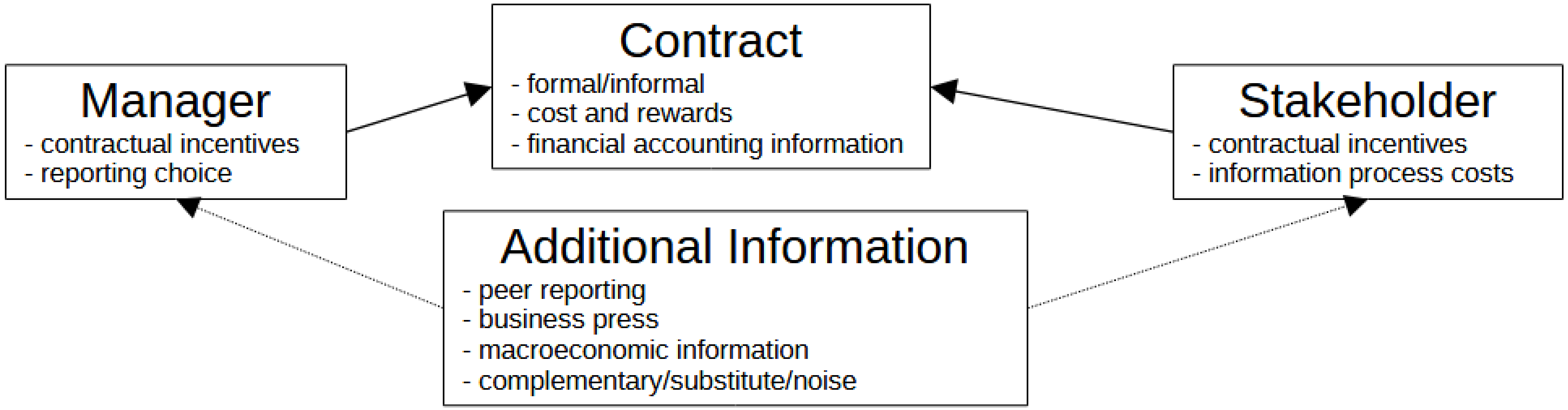
> Audited balance sheets, income statements, and cash-flow statements, along with supporting disclosures, form the foundation of the firm-specific information set available to investors and regulators.

Characteristics of Financial Accounting Information

The characteristics are defined by standard-setting bodies such as the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB).

The primary characteristics are value-relevance, faithful representation, comparability, and verifiability.

The Basic Theoretical Framework



The Manager and the Reporting Choice

Discussion: you are a manager and must decide how to report the following transactions. What would you do?

- A significant sale transaction such that the customer will pay in 6 months and the product will be delivered in 2 months (e.g., tailor-made furniture). Credit risk is high.

Notice that the reporting choice will not only determine the financial statements, but also influence the tax returns and other regulatory filings.

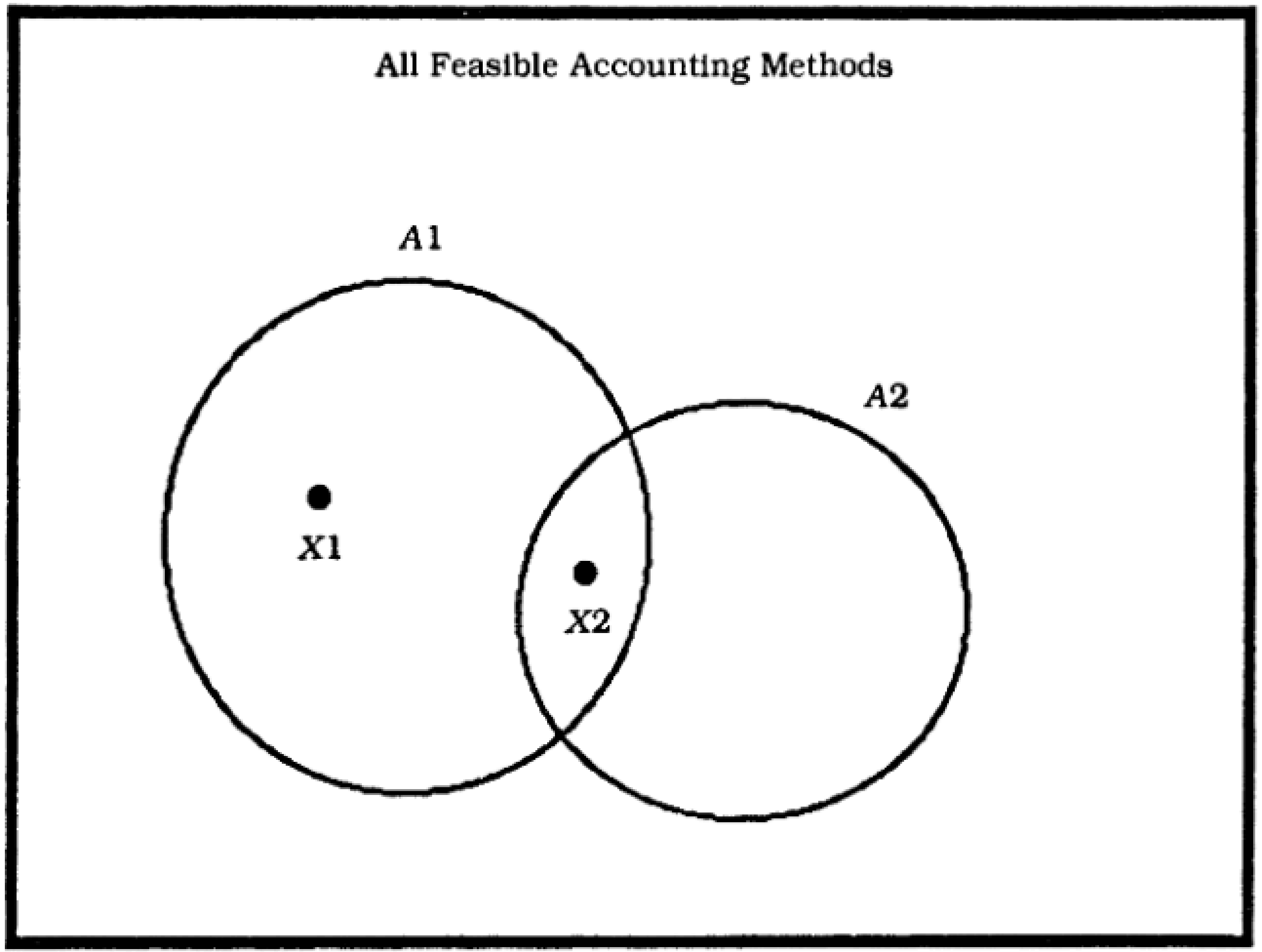
Therefore, choices should be made *within* the legal framework: IFRS, US GAAP, etc.

Accounting choices can be broadly categorized into several groups: Accounting Policies, Accounting Estimates, Disclosing Policy, and Real Decisions.

1. Accounting Policies: These are the specific rules applied by an entity in preparing and presenting financial statements.
    - Revenue recognition methods (e.g., accrual/cash basis, percentage of completion)
    - Inventory valuation methods (e.g., FIFO, LIFO, weighted average)
    - Depreciation methods (e.g., straight-line, declining balance)
    - Capitalization versus expensing of certain costs
2. Accounting Estimates: These involve judgment in preparing financial statements, where it is difficult to measure the exact amount accurately.
    - Allowance for doubtful accounts.
    - Useful lives and residual values of depreciable assets.
    - Provisions for warranties or litigation.
    - Fair value estimates for financial or non-financial assets.

3. Disclosing Policy: These are the choices made by management in determining the extent and nature of disclosures in the financial statements and related notes.
    - Level of transparency: (e.g., segment reporting, related party transactions).
    - Timing of disclosing: (e.g., timing of going concern, new standard adoption).
4. Real Decisions: These are made primarily for reporting purposes, but they also have real economic consequences (beating earnings forecasts or avoiding debt covenant violations).
    - Postpone Q4 investments to increase current year's earnings.
    - Anticipating marketing campaign to boost next year's earnings.
    - Increasing production to reduce the cost of goods sold by reducing per unit fixed costs.

Relation Between the Accepted Set of Accounting Methods and the Choice of Method from within the Accepted Set



Source: Watts & Zimmerman (1990)

Managers have discretion over a subset of choices called "the accepted set" (Watts & Zimmerman, 1990).

This accepted set varies considerably across industries, as the nature of their business converts some choices into more or less informative signals about the firm's performance to other stakeholders.

The accounting choice should follow the most fundamental accounting principles:

1. Accrual Principle
2. Matching Principle
3. Consistency principle
4. Historical Cost Principle
5. Conservatism Principle
6. Full Disclosure Principle

Important: The accounting principles are not specific enough to avoid managerial discretion regarding accounting choices.

For example, the matching principle allows for different methods of depreciation. Similarly, the historical cost principle allows for different methods of inventory valuation.

Once the manager has made the accounting choices, the economic events ("transactions") are processed accordingly in the accounting information system.

Then, the outputs, i.e., the financial statements or earnings announcements, are publicly disclosed.

Stakeholders face severe challenges in undoing the manager's accounting choices.

- even though reporting regulation requires informing about accounting choices and their changes, other stakeholders do not have the same initial information set as the manager for re-computing the financial statements assuming alternative choices.

The Stakeholders and the Cost of Processing the Financial Accounting Information

Learning from disclosures is an active economic choice:

- trade-off between the cost (benefit) of processing (learning from) the information.

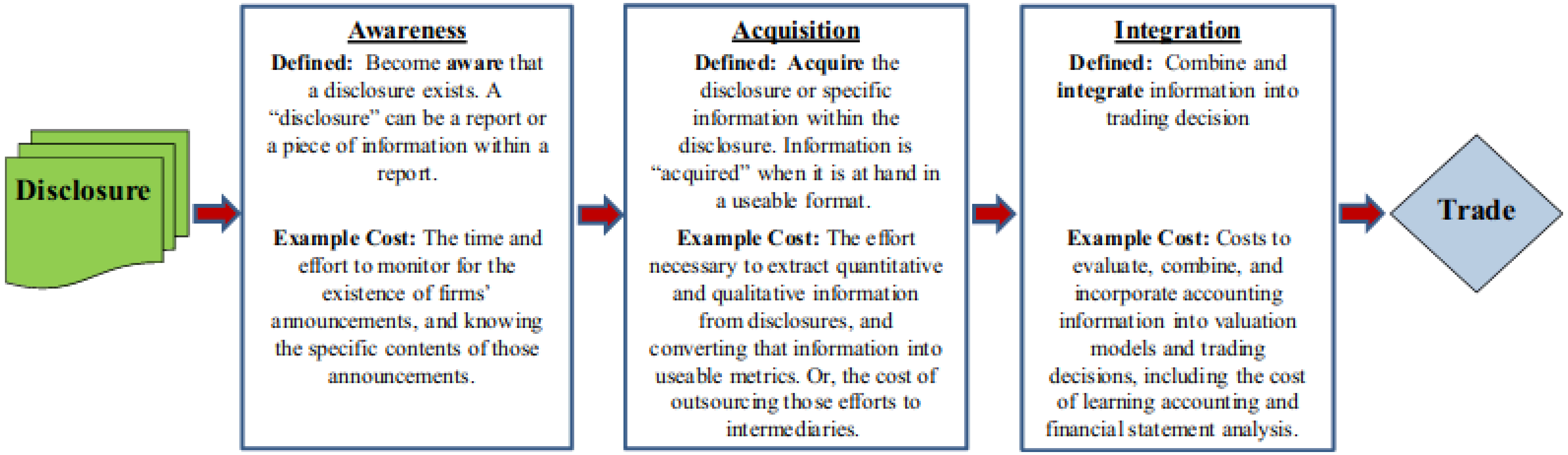


FIG. 1.—Sequential framework of information usage. This figure depicts the three sequential steps for using an accounting disclosure in trading decisions. The lower portion provides examples of the costs of accomplishing each step, any of which could prevent investors from using accounting information in trading decisions.

Source: Blankespoor et al. (2019)

1. Awareness costs are the costs necessary to improve the stakeholder's probability of knowing that a particular disclosure exists and the information it contains.
2. Acquisition costs: the costs of converting the disclosure into a signal that is ready to use for analysis: Compustat or Commercial databases fees, obtaining, understanding, and cleaning the data. Detect disclosure quality.
3. Integration costs: the costs of integrating the information into the decision-making process. It is called *financial statements analysis*, which is required to map the accounting information with the firm's economic dimension of interest: profitability, liquidity, solvency, etc.
4. Opportunity costs: resources could be allocated to processing other information or other activities.
    - Budget and capital constraints.

Not all disclosures are equally costly to process.

- more complex business models generate disclosures that are more costly to process (Hoitash & Hoitash, 2018)
    - Coca Cola vs SpaceX
- similarly, complex organizational structures also increase the cost of processing the disclosure (Cohen & Lou, 2012).
    - conglomerates vs single business firms.
- disclosure design choice also matters.
    - Example on two papers with the same RQ.
    - obfuscation or transparency?

The presence of processing costs means that disclosures are not public information as traditionally defined but are instead a form of private information.

Analytical theory has typically focused on capital markets.

- classic rational models: Grossman & Stiglitz (1980), Verrecchia (1982).
- behavioral models: DellaVigna & Pollet (2009); Hirshleifer et al. (2011).
- rational inattention models: Sims (2003); Veldkamp (2011).

The evidence is overwhelming in showing that even the most sophisticated investors in capital markets struggle to process the information in financial statements. See the survey in Blankespoor et al. (2019).

Research opportunities

- Accounting choice: opportunistic or altruistic?
  - dissecting benevolent and agency-driven earnings management.
- As accounting standards and regulations have become more complex, real earnings management has become more prevalent (Bertomeu et al., 2020).
  - What are the macroeconomic consequences of this shift through real earnings management?

Suggested recent studies

- Beyer, Guttman, & Marinovic, (2019). Earnings management and earnings quality: Theory and Evidence. **The Accounting Review**, 94(4), 77–101. https://doi.org/10.2308/accr-52282
- Terry, Whited, & Zakolyukina, A. A. (2023). Information versus Investment. **The Review of Financial Studies** (Forthcoming). https://doi.org/10.2139/ssrn.3073956

Additional information channels

Some stakeholders may be more aware of other sources of information that are less costly to process than the financial disclosures.

- financial analysts's reports
- business press articles

Research Opportunities:

- peer reporting
- peer litigation
- social media
- corporate fake news

Suggested recent studies

- Huang, Li, & Markov (2020). What Do Employees Know? Evidence from a Social Media Platform. **The Accounting Review** , 95 (2): 199–226. https://doi.org/10.2308/accr-52519
- Dube, S. & Zhu, C. (2021), The Disciplinary Effect of Social Media: Evidence from Firms' Responses to Glassdoor Reviews. **Journal of Accounting Research**, 59: 1783-1825. https://doi.org/10.1111/1475-679X.12393

2) Stakeholder: Executives

(a) Accounting and Executive Compensation

Managerial compensation typically consists of base salary and incentive compensation.

Accounting measures, especially measures of profitability, are extensively used in executive compensation contracts (Murphy 1999; Ittner et al. 1997).

- short-term bonus contracts are often tied to reported accounting performance measures such as net income, ROA and ROE.
- longer-term incentive compensation is often tied to stock performance.
- similar evidence, but far less extensive, about the use of accounting measures in divisional managers' compensations (Bushman et al. 1995, Keating 1997).

Why compensation contracts give room for accounting discretion?

- More informative signals about firm performance (Dye & Verrecchia (1995)).
- The discretion can increase share value by, for example, reducing the probability of bond covenant violations.

Healy (1985), Guidry et al.(1999): upper and lower band. Managers choose current discretionary accruals to maximize both this period’s bonus and the expected value of the next period’s bonus.

Elliott & Shaw (1988); Strong & Meyer (1987): 'big bath’ behavior. When earnings are already below expectations, some managers allegedly write off (perhaps prematurely) as many costs as possible in that period to claim they are ‘clearing the decks’ to facilitate improved future performance.

Bushman, Engel, Milliron, and Smith (1998) document that since the mid 70s firms have substituted away from accounting earnings ratio toward equity-based plans.

Does this mean that accounting information has become less important for CEOs' compensation?

1. Reliable accounting information is a precondition for a well-functioning stock market and, thus, stock-based compensation.
2. Stock price is not a sufficient statistic for managerial performance (maybe just for firm value, Grossman & Stiglitz 1980).
    - We observe analysts pouring over the details of financial statements, such as margin analyses, expense ratios, and geographic and product line segment data.
3. Stock price is, by definition, forward-looking, based on market expectations and risk, and therefore, very limited in its ability to evaluate managers' past performance.

(b) Accounting and Executive Turnover

Compensation is not the only incentive for managers: threat of dismissal.

Several studies have found a negative relationship between accounting performance and CEO turnover (Weisbach (1988); Murphy & Zimmerman (1993), Lehn & Makhija (1997))

- Weisbach finds that accounting performance appears to be more important than stock price performance in explaining turnover.
- Murphy and Zimmerman find a significant inverse relation between both performance measures and turnover.

Research Opportunities:

- how to disentangle luck vs skill based on accounting information.
- financial reporting and executive labor market
- Roles behind accounting/reporting choices: Board, CEO, CFO, etc.

Suggested recent studies:

- Rhodes & Russomanno (2021). Executive Accountants and the Reliability of Financial Reporting. **Management Science**, 67:7, 4475-4504 https://doi.org/10.1287/mnsc.2020.3697
- Ma, Pan, & Stubben (2020) The Effect of Local Tournament Incentives on Firms' Performance, Risk-Taking Decisions, and Financial Reporting Decisions. **The Accounting Review**; 95 (2): 283–309. https://doi.org/10.2308/accr-52506

3) Stakeholder: Shareholder

Shareholders are the residual claimants of the firm's profit, and they have the right to vote in the general assembly of shareholders.

The general assembly has the power to appoint and dismiss top management and to approve the financial reports.

- But, if all shareholders are dispersed and diversified, they may not have the incentives to monitor the firm, even if the information is perfect and available at no cost.
- Admati, Pfleiderer, & Zechner (1994)
    - Ownership structure affects the payoffs of firms since it affects optimal monitoring efforts.

Evidence/Theory of accounting information moderating conflicts with shareholders:

- Proxy battles
- Proposal at shareholder meetings
- Litigation

(a) Accounting and Proxy contests:

- DeAngelo's (1988) study of the role of accounting information in proxy fights. She documents the heightened importance of accounting information during proxy fights by providing evidence of the prominent use of accounting numbers.
- She presents evidence that dissident stockholders typically cite poor earnings performance as evidence of incumbent managers' inefficiency (and rarely cite stock price performance) and that incumbent managers use their accounting discretion to portray a more favorable impression of their performance to voting shareholders.
- DeAngelo suggests that accounting information may better reflect incumbent managerial performance during proxy fights because stock price anticipates potential benefits from removing underperforming incumbent managers.

(b) Accounting and Litigation:

Typical accounting-related motives for suing: dissemination of optimistic information or omission of relevant adverse information.

Loss causation is an essential element in securities litigation. According to the law, loss causation is established in three parts:

1. identifying a ‘corrective disclosure’ (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company’s fraud).
2. showing that the stock price dropped soon after the corrective disclosure.
3. eliminating other possible explanations for this price drop.

Debate on disclosing early warnings

Skinner (1994) argues that because shareholders tend to sue only over EAs with large negative returns, managers have an incentive to disclose bad earnings early to reduce both the probability of being sued and the magnitude of estimated damages.

- This would imply that at-risk firms would be more likely to disclose bad news voluntarily than other firms.

Howerver, Francis et al. (1994) find that litigation is based on earning forecast or a preemptive disclosure of bad news, but not on the actual EA.

- furthermore, they find that early disclosure increases the probability of a lawsuit.

Field et al. (2005) find no evidence that disclosure triggers litigation and argue that previous inconsistent findings are driven by the endogeneity problem in the relation between disclosure and litigation among firms with high legal exposure.

Debate on reporting structure

Files et al. (2009) show that managers providing minimal disclosure when announcing restatements are less likely to be suited than those providing more prominent disclosure.

Roger & Buskirk (2009) find no evidence that the firms respond to the litigation by increasing their disclosures to investors. In fact, they find that firms reduce the level of information provided post-litigation, suggesting that the litigation process encourages firms to decrease the provision of disclosures for which they may later be held accountable.

Research Opportunities:

- settlement as a information protection mechanism (Haslem 2005).
- the informative/strategic role of the disclosure of legal contingencies.

Suggested recent studies:

- Bliss, Partnoy, & Furchtgott (2018). Information bundling and securities litigation. **Journal of Accounting and Economics**, 65(1), 61–84. https://doi.org/10.1016/j.jacceco.2017.11.013
- Donelson, Flam, & Yust (2022). Spillover Effects in Disclosure-Related Securities Litigation. **The Accounting Review**; 97 (5): 275–299. https://doi.org/10.2308/TAR-2020-0386

4) Stakeholder: Creditors

Manager(shareholders)-Creditors conflicts:.

- dividends payments
- debt overhang
- asset substitution
- refinancing and restructuring
- bankruptcy and liquidation preferences

Type of creditors and information frictions

- lower: bank
- middle: bondholders (most of research on this group)
- high: trade creditors

Financial reporting systems can play at least two important roles in reducing agency costs:

- enabling monitoring: existing and potential creditors (Watts, 2003).
- inputs (or parameters) in the formal contract between the firm and its lenders (Smith & Warner, 1979):
    - accounting-based covenants.
    - performance-pricing provisions that adjust interest rates based on accounting measures.

(a) Public debt: Accounting and Covenants

Managers may select or change an specific accounting method to avoid debt covenant violations.

This has been tested among firms that are close or have reached debt covenants (Healy & Palepu, 1990; Sweeney, 1994; DeAngelo et al. 1994).

- arguably, the same happens with the use of accounting-based performance pricing provisions, but there is no empirical evidence of this.

Big empirical concern: firms breaching covenants may be renegotiating many of their contracts simultaneously, so it is difficult to associate any evidence of accounting choice to an specific contractual concern.

Recent approaches look at **set of accounting choices**, such as conservative accounting:

- Unlike banks, public bondholder lack timely inside information and have weaker incentives to monitor for expropriation.
- Covenants that limit such behavior only become binding if the accounting system recognizes the deterioration of a company's economic position.
- Timely loss recognition is expected to improve the efficiency of covenants because covenants are more likely to be become binding.
- Nikolaev (2010) finds that firms whose public debt contracts employ more covenants exhibit timelier recognition of economic losses.
- Christensen & Nikolaev (2012) find that the use of P-covenants relative to C-covenants increases as borrowers become more financially constrained.

Research Opportunities:

- crowfundings and other non-traditional financing contracts (crypto).
- bank and trade credit, leases.

Suggested recent studies:

Cascino, Correia, & Tamayo (2019). Does Consumer Protection Enhance Disclosure Credibility in Reward Crowdfunding? **Journal of Accounting Research**, 57(5), 1247–1302. https://doi.org/10.1111/1475-679X.12289

Bourveau, De George, Ellahie, & Macciocchi (2022). The Role of Disclosure and Information Intermediaries in an Unregulated Capital Market: Evidence from Initial Coin Offerings. **Journal of Accounting Research**, 60(1), 129–167. https://doi.org/10.1111/1475-679X.12404

5) Stakeholder: Employees

(a) Accounting and Labor Negotiation

The initial labor contracts define the fraction of economic rents distributed to labor. However, some firms have regular renegotiation: collective agreements or labor union contract negotiation (Liberty & Zimmerman, 1986).

- Managers are predicted to make opportunistic income-decreasing reporting choices to limit the expectations of labor representatives.

Accounting information:

- In most countries, regulations request the employer to furnish accounting data relevant to the negotiation: "bargain in good faith" (Cooper & Essex, 1977).
- Sensitive sales or production information can be kept secret if it affects the firm's competitive position.
- The objective is establishing the company's "ability to pay" (Goggans, 1964).

Notice that labor representatives are considered external stakeholders from a financial reporting perspective; they do not have the same information set as the manager.

- they are not able to re-compute the financial statements considering alternative accounting choices.
- their individual information set relates to their specific job position.
- they also likely lack access or knowledge about their employers' broader accounting systems to personally investigate the overall financial performance.

Labor representatives vary in their level of sophistication in processing the accounting information.

Not surprisingly, they usually rely on external sources of information (e.g., peer reporting, industry experts).

- Liberty & Zimmerman (1986): They find no evidence of lower-than-expected earnings during negotiations among US unionized companies from 1968-1981, relative to similar firms.
- DeAngelo & DeAngelo (1991) argue that accounting earnings manipulation is more likely when the manager needs to negotiate in adverse scenarios. In the 1980s, US steel producers faced increased competition from subsidized imports, the technological obsolescence of aging plants, and a decline in steel demand due to a worldwide recession. Interestingly, the losses reported **before negotiation** were substantiated by **one-time special charges** that reflect managers' real restructuring decisions but whose timing was discretionary.
- Osma et al. (2015) argue that managers and employees are likelier to sign an agreement **when firm profitability and liquidity are low**. The reason is that any accounting earnings management would eventually become evident to unions, who would refuse to cooperate in the next negotiations.

(b) Accounting and Current Employee Job Search

The literature have started to focus on rank-and-file employees'use of financial accounting information to evaluate their job prospects.

deHAAN et al. (2023) evaluate whether current employees are more active in job search after Earnings Announcements (EA).

- EAs provide information about firms' financial conditions, which can affect future job security, raises, promotions, and fulfillment of implicit commitments.
- EAs are more informative when employees face more significant within-firm information frictions and more outside job opportunities.
- Using weekly counts of Glassdoor reviews by current employees as a proxy for new job searchers, they find significant increases in reviews around EAs.

Research Opportunities:

- disclosing strategies aiming the labor market of rank-and-file employees.
  - best place to work awards, inclusivity and diversity reports.

Suggested recent studies:

deHAAN, Li,, & Zhou (2023). Financial Reporting and Employee Job Search. **Journal of Accounting Research**, 61(2), 571–617. https://doi.org/10.1111/1475-679X.12469

Dube, & Zhu ,(2021). The Disciplinary Effect of Social Media: Evidence from Firms' Responses to Glassdoor Reviews. **Journal of Accounting Research**, 59(5), 1783–1825. https://doi.org/10.1111/1475-679X.12393

Choi, Pacelli, Rennekamp, & Tomar (2023). Do Jobseekers Value Diversity Information? Evidence from a Field Experiment and Human Capital Disclosures. **Journal of Accounting Research**, 61(3), 695–735. https://doi.org/10.1111/1475-679X.12474

6) Stakeholder: Government

(a) Accounting and Taxation

The state, thanks to its tax claim on earnings, is *de facto* the largest minority shareholder in almost all corporations.

Most transactions aimed at diverting corporate value toward controlling shareholders also reduce corporate tax liabilities.

A higher tax rate increases the return to expropriation by insiders and worsens governance outcomes.

By contrast, increased tax enforcement reduces the amount of private benefits these controlling shareholders can enjoy.

Taxable income and accounting income

Book-tax differences are driven by a wide variety of factors.

The two systems have very different objectives, leading to different rules.

Tax rules are politically driven: raise revenues, discourage certain activities, encourage others, and redistribute wealth. Location of earnings matters.

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Google shifted $23 billion to tax haven Bermuda in 2017: filing

Starbucks pays just £5m UK corporation tax on £95m gross profit

'Administrative expenses' of £78m, including royalties, utilities and maintenance, helped bring taxable profits down to £13m

Public financial reports provides additional data to tax authorities that can be used in tax enforcement to complement tax filings.

- Recent research analyzes the downloads of firms’ financial reports from EDGAR and allows us to observe the timing, type, frequency, and breadth of the IRS’s retrieval of these reports.
- Bozanic et al. (2017) find that the use of public information increased following the implementation of FIN 48, which required firms to disclose tax reserve information.
- Fox & Wilson (2023) evidence suggest that financial restatements as potentially useful signals to the IRS of poor information quality or management integrity. They find that restatements are associated with a significant increase in the likelihood of an IRS audit.

7) Evidence of Peer reporting as the external governance mechanism

CEO performance evaluation and labor market

Ortiz et al. (2024) argue that industry reporting reduces information asymetries in the CEOs labor market. Consistently, they find that industry reporting increases top executive replacements and:

- boosts the careers of overperforming CEOs.
- increases the probability of forced removal of underperforming CEOs.
- effect is pronounced in industries with meritocratic-based evaluation (as opposed to loyalty-based).

Shareholder and the market of corporate control

Ortiz et al. (2023) find that industry reporting facilitates the screening and foster the acquisitions of hidden champeons.

Labor Negotiations

Aobdiaa & Cheng (2018) argue and find that non-unionized firms have an incentive to disclose more information when their unionized rivals are engaged in labor renegotiations; that is, to weaken them.

Thank you!

Updated version:

Check it on my Github.