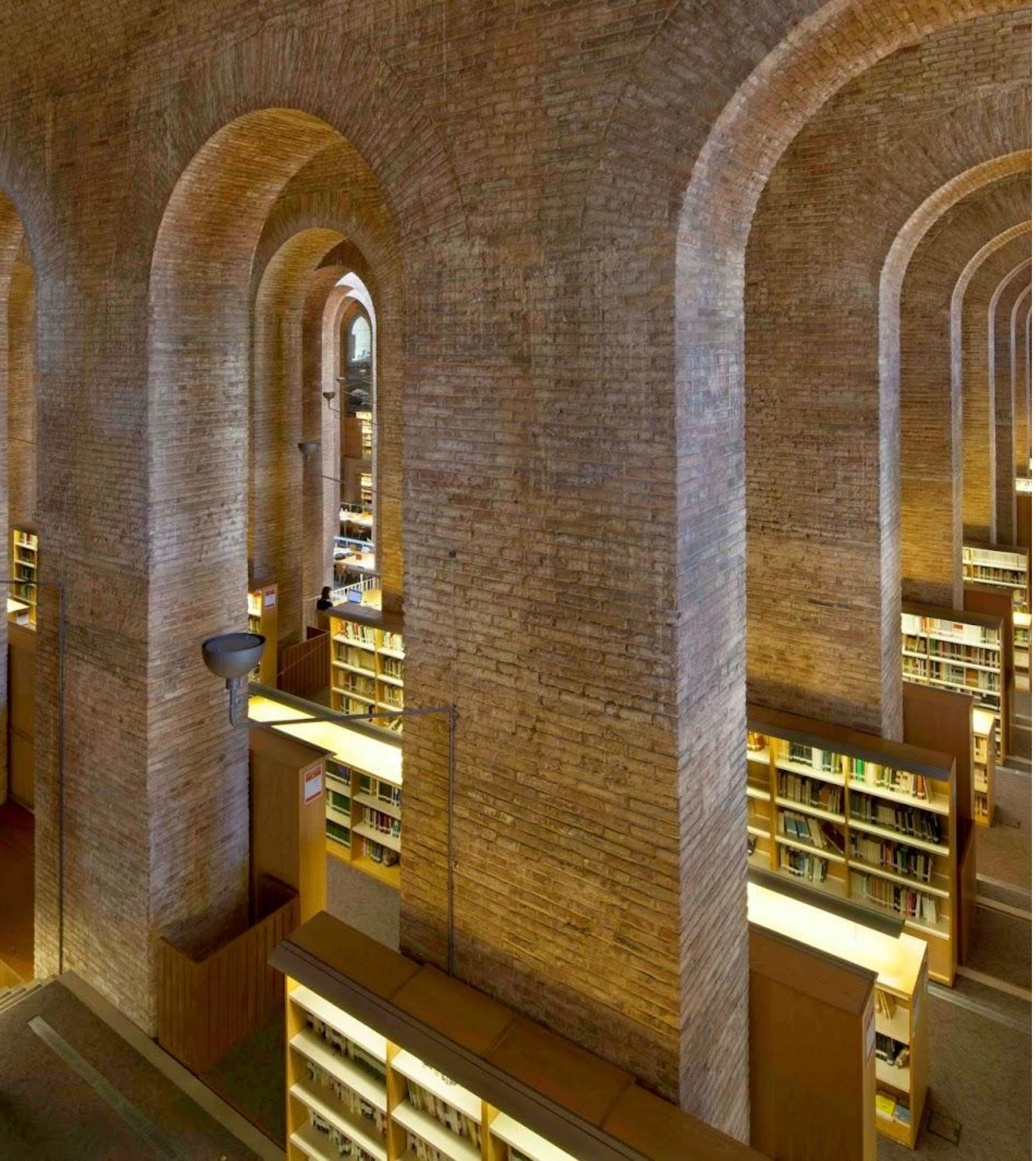

Financial Accounting Information and Corporate Governance

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Summary

Based on a contractual view of the firm, during this class we will review the literature respond one key question:

How financial accounting is used to detect and aliviate governance conflicts?

graph TD A[Employees

- new contracts
- labor negotiation] -->|influences| C(Firm) B[Executives
- compensation
- turnover] -->|influences| C D[Debt holders
- covenants] -->|influences| C E[Government
- taxes
- political risk] -->|influences| C F[Shareholders
- proxy battles
- litigation] -->|influences| C

1) Introduction

Theory of the firm

A corporation can be viewed as a nexus of contracts designed to minimize contracting costs (Coase 1937).

Shleifer & Vishny (1997) define corporate governance as the ways in which suppliers of finance assure themselves of getting a return on their investment.

Because returns to shareholders depend on myriad contractual arrangements and the behavior of different stakeholders, the literature has evolved on different governance conflicts (Bebchuk & Weiss, 2009).

Shareholders and the residual claim.

Financial Accounting Information in Contracts

Ex ante: Parties contracting with the firm require information to establish the term of the contract.

Ex post: The parties need information about the firm's ability to satisfy the terms of contracts.

In our context, contracts rely on information linked to the drivers, level, and distribution of economic rents.

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

Contracts are explicitly or implicitely based on accounting numbers, creating managerial incentives for opportunistic accounting choices (Watts & Zimmerman 1986).

Definition of Financial Accounting information

Bushman & Smith (2003):

> Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning 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 detailed in conceptual framework of financial reporting issued by standard-setting bodies such as the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board (IASB).

These characteristics are fundamental to making financial information useful to users, including investors, creditors, and others in making rational investment, credit, and similar decisions.

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

The cost of using Financial Accounting Information

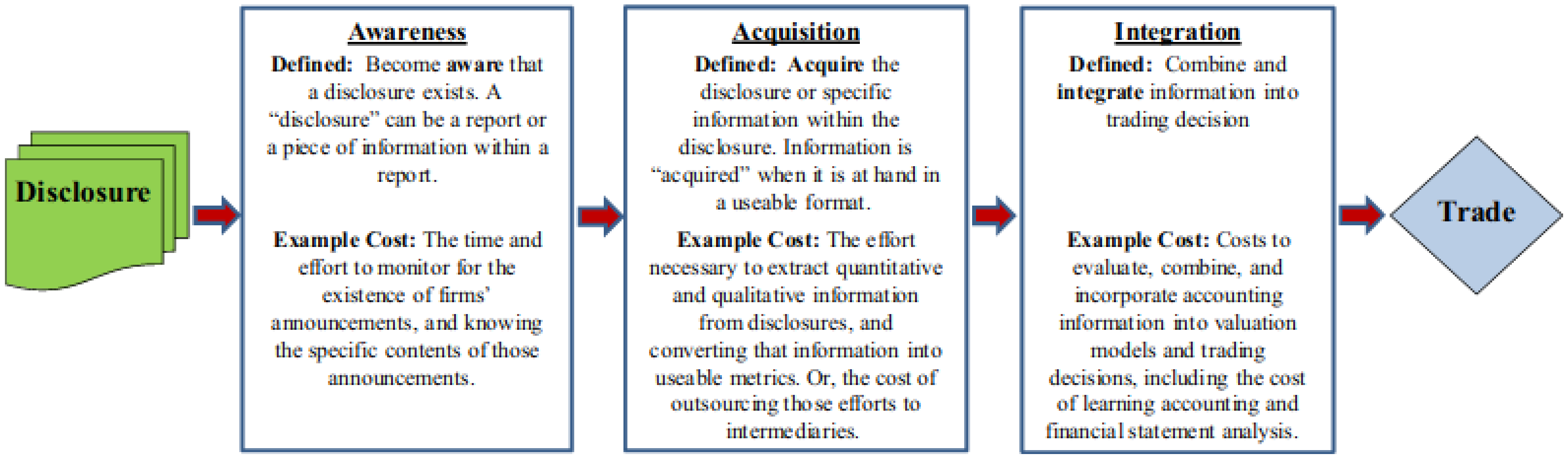


FIG. 1.—Sequential framework of information usage. This figure depicts the three sequential steps for using an accounting disclosure in trading decisions. The lower portion provides examples of the costs of accomplishing each step, any of which could prevent investors from using accounting information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

Source: Blankespoor et al. (2019)

Accounting Choice

Fields et al. (2001) define accounting choice as:

> An accounting choice is any decision whose primary purpose is to influence (either in form or substance) the output of the accounting system in a particular way, including not only financial statements published in accordance with GAAP, but also tax returns and regulatory filings.

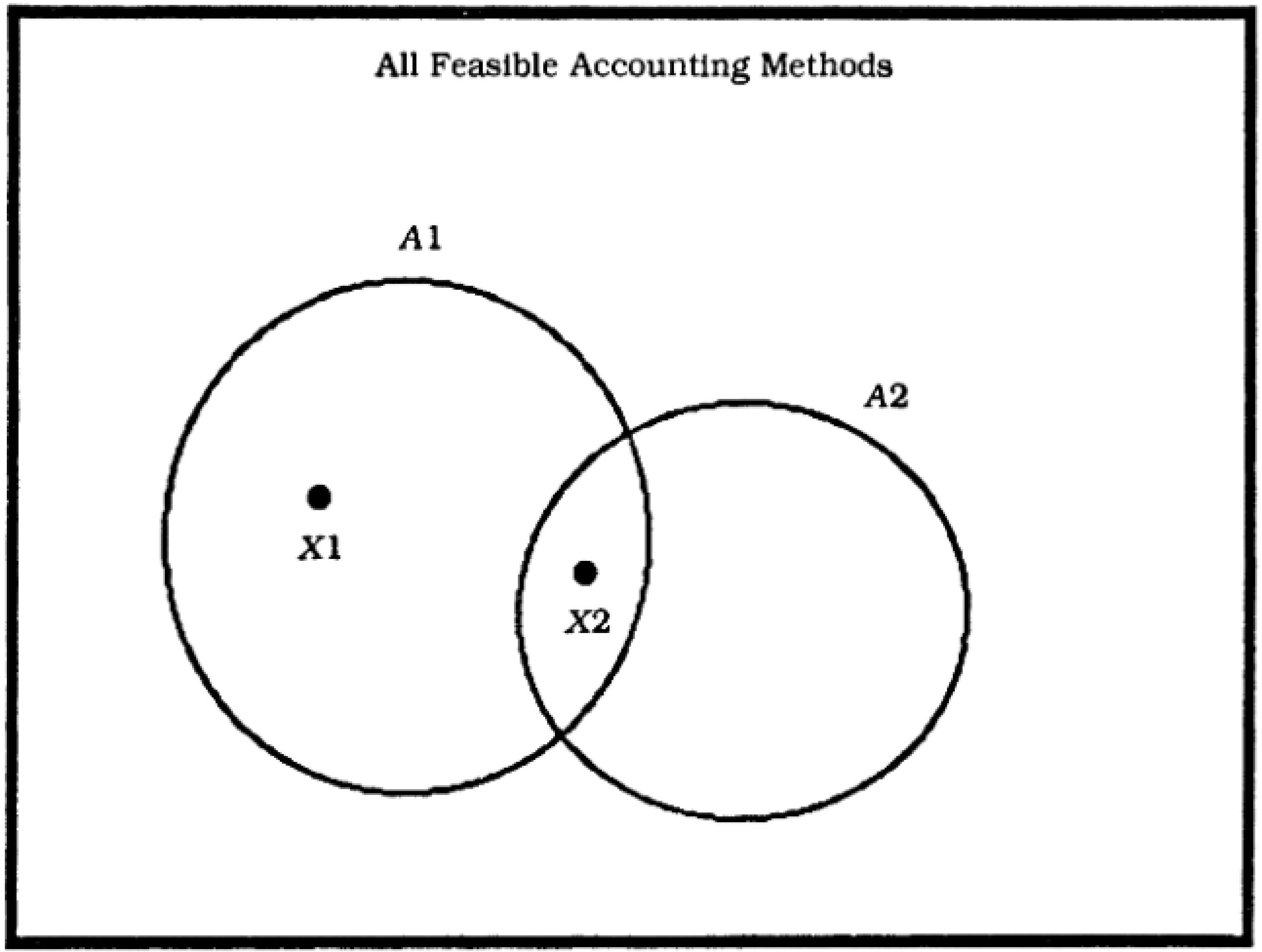
These choices are made *within* the legal framework: IFRS, US GAAP, etc.

The types of accounting choices and their classifications can be broadly categorized into several groups: Accounting Policies, Accounting Estimates, Disclosing Policy, and Real Decisions.

1. Accounting Policies: These are the specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements.
    - Revenue recognition methods (e.g., point of sale, 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 the preparation of financial statements, where it is difficult to measure the exact amount with certainty.
    - 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 the purpose of affecting the accounting numbers in this definition.
    - Increasing production to reduce cost of goods sold by reducing per unit fixed costs.
    - Reducing R&D expenditures to increase earnings.

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



Source: Watts & Zimmerman (1990)

Watts and Zimmerman (1990):

> The set of accounting procedures within which managers have discretion is called the "accepted set." It is voluntarily determined by the contracting parties. Managerial discretion over accounting method choice (i.e., the "accepted set") is predicted to vary across firms with the variation in the costs and benefits of restrictions.

> These restrictions produce the "best" or "accepted" accounting principles even without mandated accounting standards by government. The restrictions are enforced by external auditors.

> Reacting to the incentive of managers to exercise accounting discretion opportunistically, the accepted set includes "conservative" (e.g., lower of cost or market) and "objective" (e.g., verifiable) accounting procedures .

Once the manager decided a set of accounting choices, the output (financial statements) is available to the stakeholders.

- awareness, acquisition, and integration costs.

Importantly, other stakeholders face serious challenges for undoing the manager's accounting choices.

- even though reporting regulation may require disclosing accounting choices and their changes, other stakeholders do not have the same information as the manager for re-computing the financial statements assuming alternative choices.

Hence, Managers' expected accounting choices are not adjusted completely from the reported numbers by other stakeholders because of the information costs.

This does not mean that other stakeholders are silent players.

Their influence is exerted through governance mechanisms, regulatory oversight, and market reactions.

Other governance mechanisms might be more costly, but are needed to compensate the inadequences of the financial accounting information.

Accounting standards and other governance mechanisms creates boundary conditions that shape the manager's accounting choices.

The Covernance Consequences of Accounting Choices

Managers' accounting choice influence to transfer of rents across contracting parties: shareholders, employees, lenders, tax authorities, and other stakeholders.

Mechanisms:

1. managers take the firm's observed contracts as given and then determine the accounting choice.
2. managers write the contracts based on the discretion they have over accounting choices.

2) Labor Negotiations

- The fraction of economic rents that are distributed to labor is defined initialy in the respective contract.
- For some firms, there are regular negotiation: collective agreements or labor union contract negotitation (Liberty & Zimmerman 1986).
- Product-market competition from nonunion companies and foreign companies.

Accounting information:

- Most of the labor regulations request to the employeer to furnish accounting data relevant for the negociation: "bargain in good faith" (Cooper & Essex 1977).
- Sensitive sales or production information is allowed to dont be shared if affect the competitive position of the firm.
- The objective is to establish the "ability to pay" of the company (Goggans 1964).

Reporting Incentinves

- Rationale in Liberty & Zimmerman (1986): unions want information regarding the firm's economic rents, and accounting earnings provide information about economic rents. It is then asserted that the benefits to managers of depressing earnings during contract talks exceed the costs.
- Managerial incentive for reduce reported earnings:
    - benefit: reduction in operating expenses.
    - costs: risk of thecnical default amd managerial compensation (if it is linked to reported earnings).
- But, manager's strategy might be innefficient if labor oficial can, to some extent, undo the accounting manipulation (low information costs), or can learn from repeated negotiations.

How?

- Accruals decisions, not accounting procedures (very visible).
    - Obsolete inventories can be written off.
    - Allowances for uncollectible receivables can be increased unexpectedly.
- Negotiation in Quarters without Auditing.

- Liberty & Zimmerman (1986): US unionized companies over the period 1968-1981. We find no evidence of lower than expected earnings during negotiations
- Osma et al (2015): US firms that engage in firm-level labor bargaining during the period 1994-2007, we provide evidence consistent with the hypothesis that managers and employees are more likely to sign an agreement when firm profitability and liquidity is low. In a second set of analyses we study whether the coincidence of low corporate income and collective agreement negotiations is driven by accounting choice. The results provide evidence in favor of the hypothesis that managers accelerate the recognition of losses and delay the recognition of gains in years surrounding collective bargaining. However, the evidence suggests this choice is informative rather than opportunistic. We do not find conclusive evidence of accounting accruals manipulation, consistent with the results found by prior research.

3) Executive Compensation

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).

The compensation contracts allow managerial accounting discretion. Why?

- More informative signals about firm performance (Dye and 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 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 with the intention of claiming they are 'clearing the decks' to facilitate improved future performance.

- Bushman, Engel, Milliron, and Smith (1998) document that over the 1971-95 period, firms have substituted away from accounting earnings toward equity-based plans.

That this means that accounting information has become less important for the governance of firms?

1. Reliabale accounting information is a precondition for a well-funcioning stock market and thus, the use of 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 proce is by definition forward-looking, based in market expectations and risk, therefore, very limited in its ability to evaluate managers' past performance.

Accounting and Executive turnover

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

Several studies have found a negative relation 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.

4) Shareholder rights and activism

- Shareholders are the residual claimants of the firm, and they have the right to vote in the general assembly of shareholders.
- The general assembly of shareholders 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.

Mechannisms:

- Proxy battles
- Proposal at shareholder meetings
- Public campaigns
- Litigation
- Negotiation with management

Financial reporting and shareholder activism

Proxy contests:

- DeAngelo’s (1988) study of the role of accounting information in proxy fights. She documents a 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.

Litigation:

- Francis, Philbrick, and Schipper's 1994 study, "Shareholder Litigation and Corporate Disclosures," examines the relationship between shareholder lawsuits and the quality of corporate financial disclosures. They find that firms subject to litigation tend to improve the transparency and quality of their financial reporting.
- Douglas J. Skinner's 1994 paper, "Why Firms Voluntarily Disclose Bad News," explores the strategic disclosure of financial information in the context of shareholder litigation. Skinner suggests that firms may voluntarily disclose adverse information to manage litigation risk, highlighting an interaction between corporate disclosure practices and governance through litigation.

4) Creditor rights and debt contracting

Creditor rights in corporate governance encompass the legal and contractual protections and mechanisms that safeguard the interests of lenders and bondholders. These rights are fundamental to the governance framework of corporations, as they directly influence corporate financing decisions, risk management practices, and the overall alignment between the company's actions and its obligations to creditors.

The protections for creditors are typically enshrined in law (such as bankruptcy laws) and detailed within the contractual agreements of debt instruments (like covenants in loan agreements).

As in the previous case, information frictions and control rights give rise to agency problems between shareholders (manager) and creditors. (La Porta et al., 1997).

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

Accounting choice and debt contracting

Managers may select or change accounting methods to avoid debt covenant violations.

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

Findings suggest that firms make accounting decisions in response to potential covenant violations only when there is no lower cost solution.

Additionally, firms breaching coventants may be renegotiating many of their contracts simultaneusly, so it is difficult to associate any evidence of accounting choice with any one contractual concern.

5) Taxation and Financial Reporting

6) Peer reporting as external governance mechanism

Labor Negotiations

ver el paper en JAE

CEO compensation:

DeFond and Park (1999) and Parrino (1997), examining CEO turnover probabilities, posit that in more competitive industries, peer group comparisons are more readily available, creating opportunities for more precise performance comparisons.

Ortiz et al (2021)

Shareholder rights and activism

- Ortiz et al (2023): peer reporting foster the acquistion of low-performing firms.