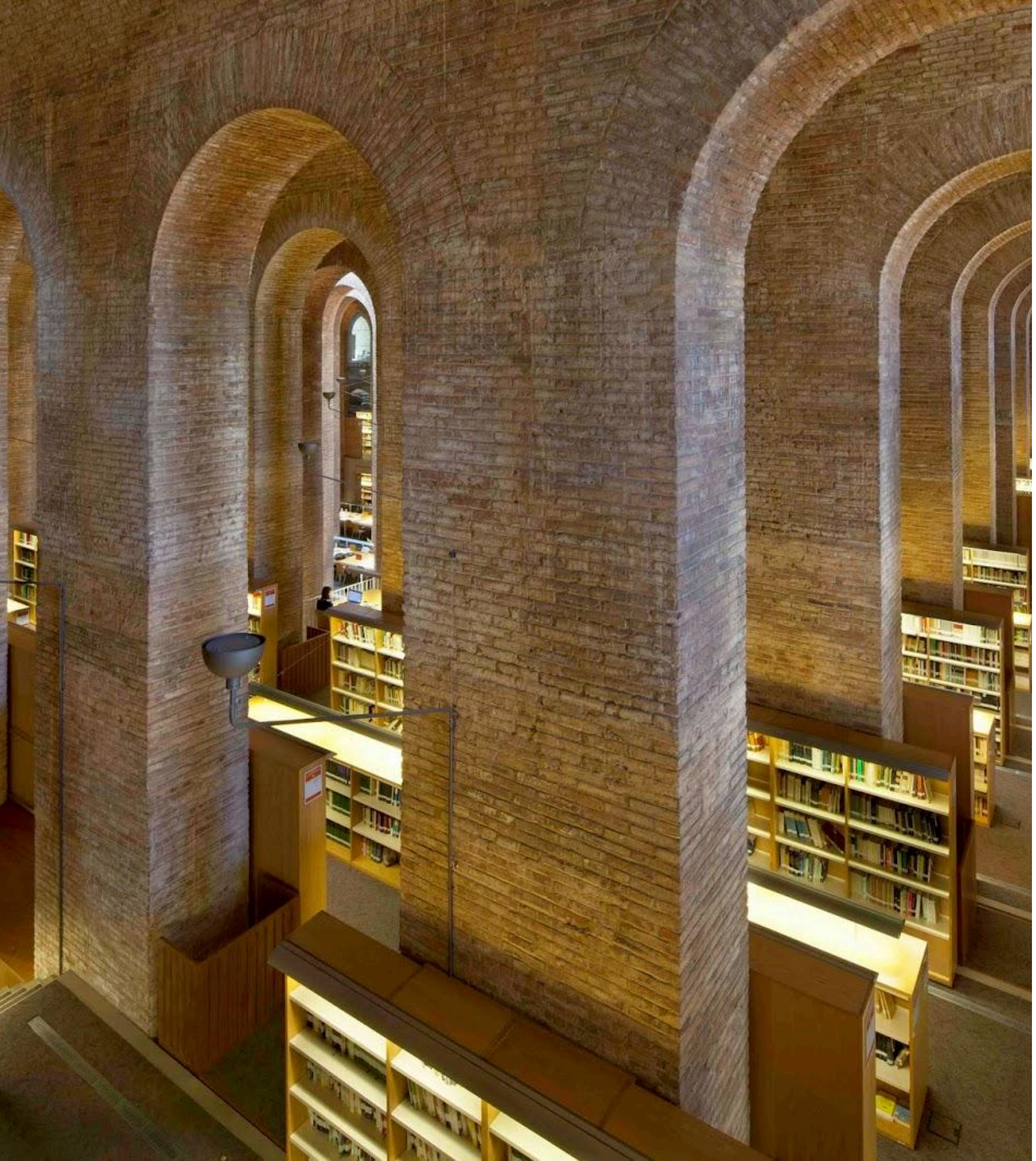

Accounting in Corporate Governance: A Contractual View

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Summary

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

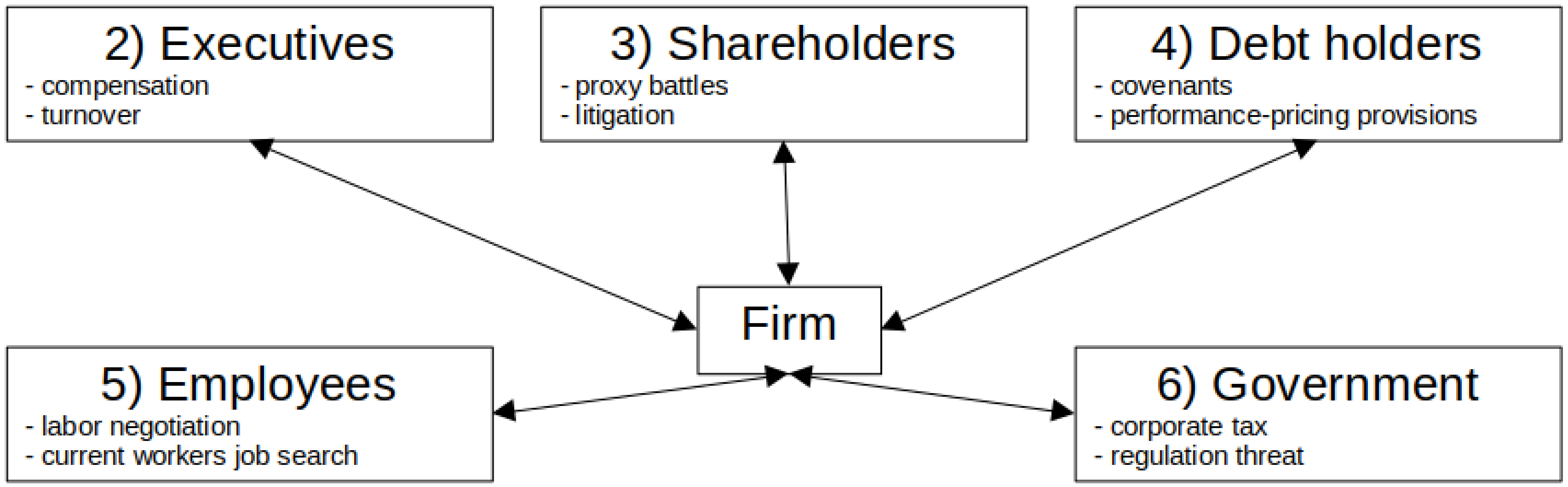
We will review different streams of literature on the role of financial accounting information in corporate governance.

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

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

(2) monitor the fulfillment of the contractual obligations,

(3) to mitigate the conflicts that arise from the contractual relationships.


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
- regulation threat

We will not cover:

- financial accounting & capital markets.
- financial accounting regulation.
- managerial 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 of different corporate stakeholders in relation to rewards and costs (Bechuk & Weisbach, 2010).

Financial Accounting Information in Contracts

What is the role of financial accounting information in these contracts?

Ex ante: Contracting parties require information to establish the terms of the contract.

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

What information?

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

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

Implicit and explicit contracts rely on accounting information (Watts & Zimmerman, 1986).

Definition of Financial Accounting Information

Bushman & Smith (2003) define it as:

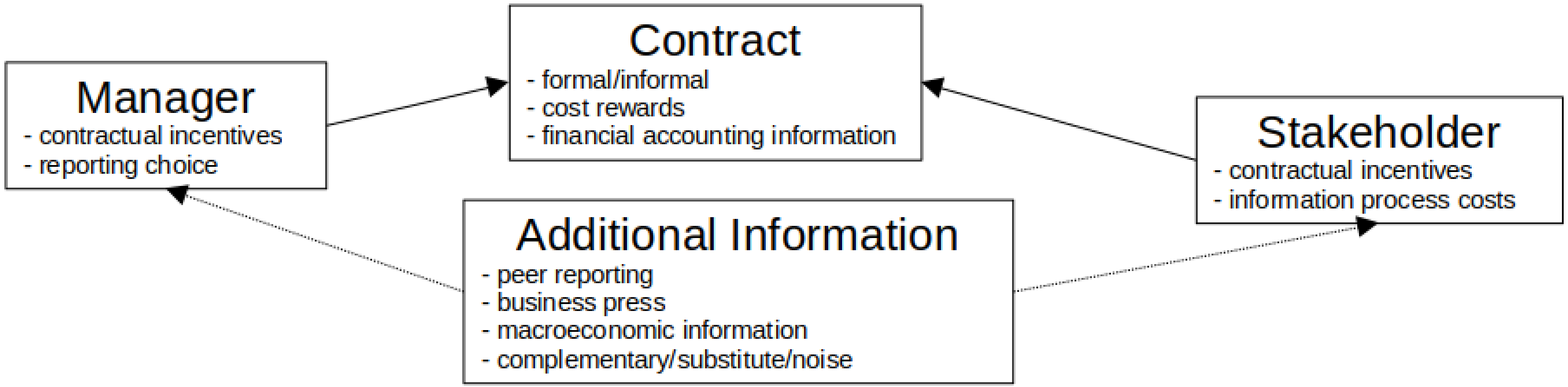
> Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms. Audited balance sheets, income statements, and cash-flow statements, 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 the 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).

The primary qualitative 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).

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

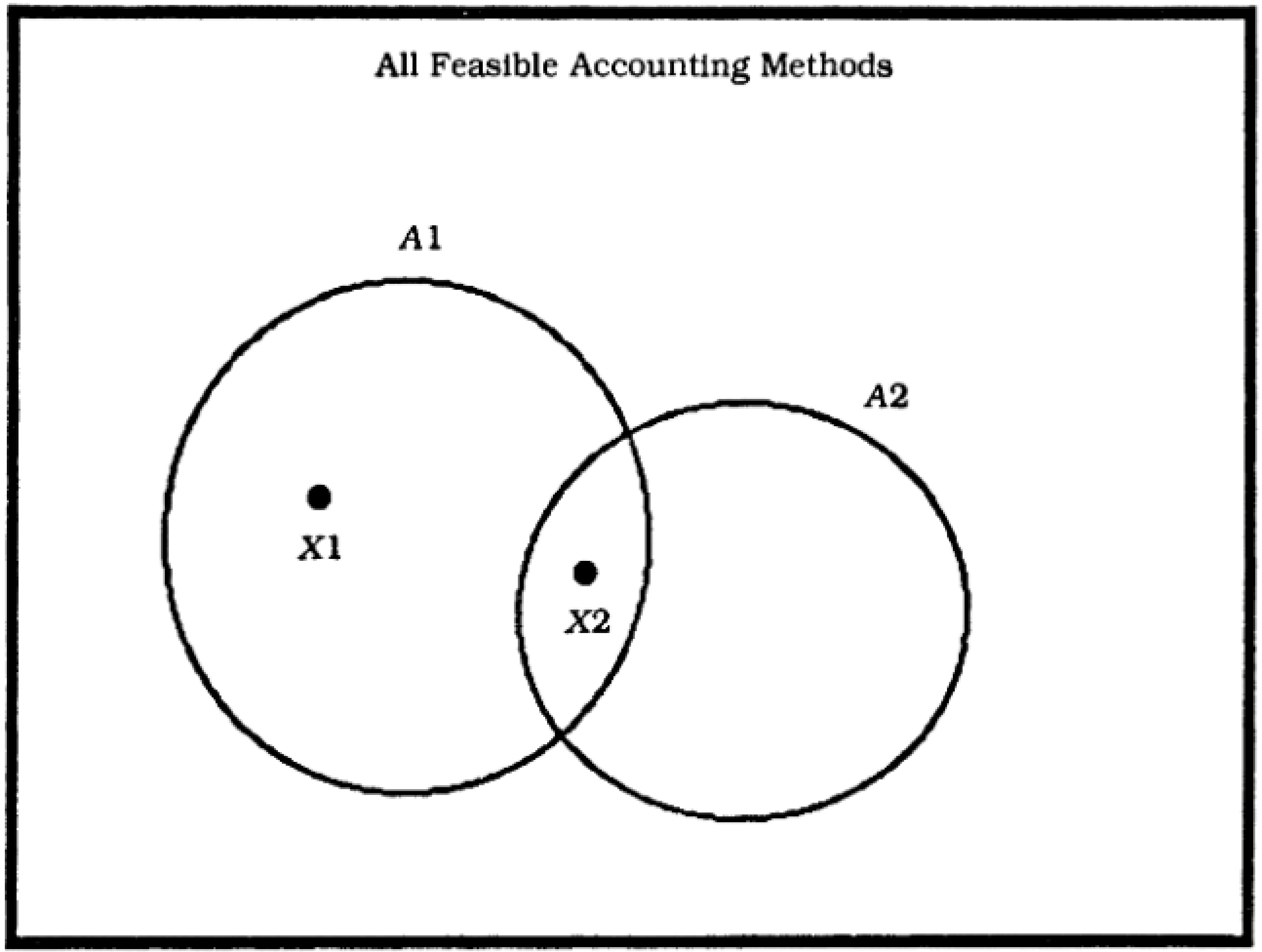
Therefore, choices should be made *within* the legal framework: IFRS, US GAAP, etc.

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 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 to affect the accounting numbers in this definition.
    - Increasing production to reduce the 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)

Not all reporting choices are accepted, and managers have discretion over a subset of choices called "the accepted set" by Watts and 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.

External auditors play a key role in monitoring the firm is accounting for economic events by the accepted set.

Accounting principles and standards (such as IFRS and US GAAP) provide a ground for a commonly accepted set of reporting choices.

Some of the most fundamental accounting principles/standards :

- **Accrual Principle**: Recognizes economic events regardless of when cash transactions occur. This principle ensures that financial statements reflect all the revenues earned and expenses incurred during the period.
- **Matching Principle**: Directs that expenses be matched with the revenues they help to generate, ensuring that income statements reflect the correct net income for the period.
- **Consistency principle**: Stipulates that companies should consistently use the same accounting methods and principles from period to period, allowing for comparability across periods.
- **Historical Cost Principle**: Assets and liabilities are recorded at their original purchase cost and are not subsequently adjusted for changes in market value, except for certain specific assets for which revaluation is permitted or required

- **Conservatism Principle**: In the face of uncertainty, this principle guides accountants to choose the method that least overstates assets and income, providing a safeguard against potential future losses
- **Full Disclosure Principle**: Requires that financial statements provide all necessary information to understand a company's financial condition and performance, ensuring transparency and aiding decision-making

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 decided on a set of accounting choices, the economic events ("transactions") can be processed and then the output (financial statements) is publicly disclosed.

Stakeholders face severe challenges in 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.

The Stakeholders and the Cost of Processing the Financial Accounting Information

Learning from disclosures is an active economic choice: trade-off between the cost of processing the information and the benefits of learning from information.

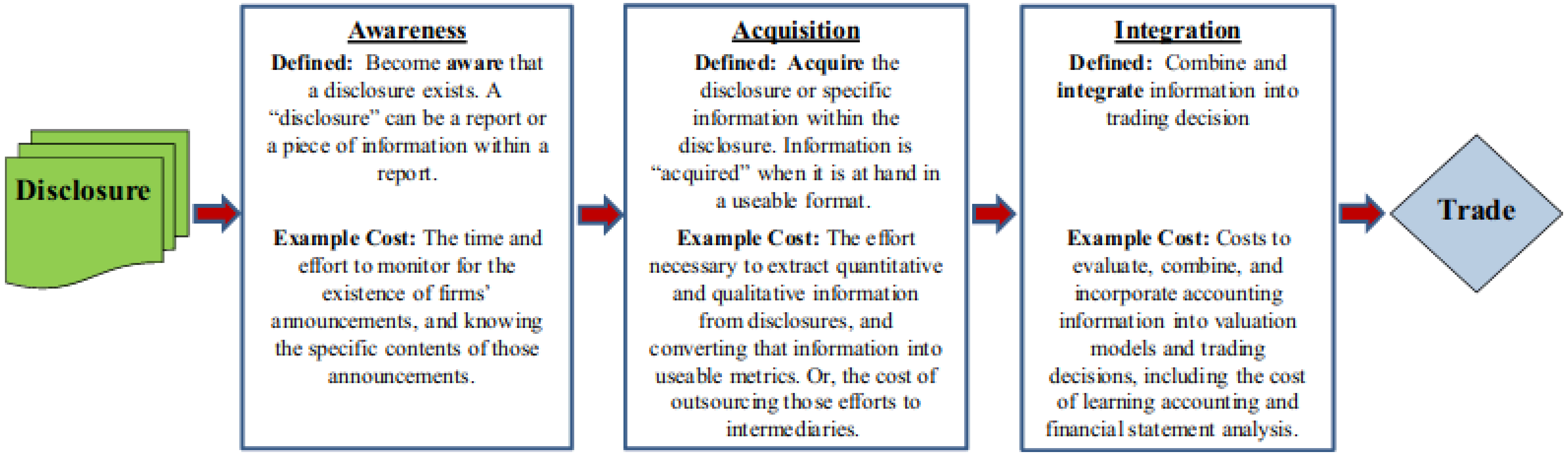


FIG. 1.—Sequential framework of information usage. This figure depicts the three sequential steps for using an accounting disclosure in trading decisions. The lower portion provides examples of the costs of accomplishing each step, any of which could prevent investors from using accounting information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

Source: Blankespoor et al. (2019)

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, not stakeholders.

- 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).

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.

Additional information channels

- peer reporting.
- macroeconomic indicators.
- business press.
- private information.
- social media.

This information could be a substitute or a complement for financial accounting information.

... Or it could also be costly noise.

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).

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 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 over the 1971-95 period, firms have substituted away from accounting earnings toward equity-based plans.

Does this mean that accounting information has become less important for the governance of firms?

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

(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.

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 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

(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 courts, 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, Bliss et al. (2018) use a 2005 U.S. Supreme Court decision that increases the requirements for class-action loss causation. They find that positive bundling (mixing good and bad news in the same disclosure) results in less litigation.

Manchiraju et al. (2021) use staggered adoption of the Universal Demand Laws (UD Laws) to examine the effect of an exogenous reduction in shareholders' ability to litigate the extent of accounting conservatism. On average, we find an increase in reporting conservatism post-UD. The increased conservatism is concentrated in firms contemplating equity issuance, with a high proportion of monitoring investors and high corporate governance quality.

4) Stakeholder: Creditors

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

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

- reduce information asymmetries with 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) Accounting and Covenants

Managers may select or change accounting methods 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.

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

Nikolaev (2008) examines the relationship between conservative financial reporting and the extent of covenant use in public debt. He finds that firms that provide more conservative reports are more likely to have (and have more) covenants in their debt agreements.

5) Stakeholder: Employees

(a) Accounting and Labor Negotiation

The respective 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

Recently, scholars started to study whether rank-and-file employees used 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.

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 and these different objectives lead to different rules.

a. useful information for decision-makers

b. politically drive: raise revenues, discourage certain activities, encourage others, and redistribute wealth. Location of earnings matters.

The use of public financial reports provides additional data to tax authorities that can be used in tax enforcement to complement the agency's private information.

Is it true?

Recent research analyzes this by analyzing 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) 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

Labor Negotiations Aobdiaa & Cheng (2018) analyze whether non-unionized firms have an incentive to disclose more information when their unionized rivals are engaged in labor renegotiations; that is, to weaken them. They find that non-unionized firms disclose more information and more good news when renegotiations are ongoing.

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. (2024): peer reporting fosters turnover and boosts careers of overperforming CEOs.

Shareholder rights and activism Ortiz et al. (2023): peer reporting fosters the acquisition of under-performing firms.

Questions ❓

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