

POSITIVE ACCOUNTING THEORY & EXECUTIVE COMPENSATION

ME

- Sven-Olof Yrjö Collin
- Lecturer in corporate governance
- Associate Prof. i.e., Docent
- Teaching: Strategy, Method & Corporate governance
- Research: Corporate Governance
- Sven-Olof.Collin@e.hkr.se
- 044-203119
- <http://www.hkr.se/e.collin.htm>

AIM OF LECTURE

- TO SHOW THAT CHOICE OF ACCOUNTING STANDARDS ARE INFLUENCED BY SOCIAL FORCES, I.E.,
 - INDIVIDUAL INTEREST
 - POLITICS

*Sven-Olof Collin, Torbjörn Tagesson, Anette Andersson,
Joosefin Cato, Karin Hansson*

*KRISTIANSTAD UNIVERSITY
SWEDEN*

*EXPLAINING THE CHOICE
OF
ACCOUNTING STANDARDS IN
MUNICIPAL CORPORATIONS*

- Standard Setters -

Two opportunities of Standard Setters:

The Accounting Standards Board (ASB) (Bokföringsnämnden)

Target group: All limited companies

Low level of details, high degree of prudence and conservatism

The Accounting Council (AC) (Redovisningsrådet)

Target group: Listed Companies and companies that due to size are of interest to the public (IASB norms)

High level of details, low degree of prudence and conservatism

Consequence: ASB less costly for the firm, retaining earnings

ACCOUNTING FUNCTIONS

- INFORMATION FOR
ACCOUNTABILITY &
CAPITAL ALLOCATION
- ALLOCATION OF WEALTH

POSITIVE ACCOUNTING THEORY

“...the only accounting theory that will provide a set of predictions that are consistent with observed phenomena is one based on self-interest”

(Watts & Zimmerman, 1979:300).

ECONOMIC CONSEQUENCES

ACCOUNTING POLICY CHOICE,
LACKING DIRECT CASH FLOW INFLUENCE,
CAN INFLUENCE THE VALUE OF THE FIRM

BECAUSE

- INEFFICIENT CAPITAL MARKET
- INDIRECT WEALTH EFFECTS
 - FOR MANAGEMENT
 - FOR THE FIRM
 - FOR INVESTORS
 - FOR DEBT HOLDERS
 - FOR SOCIETY,
 - I.E. MOST STAKE HOLDERS

INEFFICIENT CAPITAL MARKETS

| INFORMATION INCLUDED IN PRICE | PUBLIC | PRIVATE |
|---|---------|---------|
| LEVEL OF EFFICIENCY | | |
| LOW EFFICIENCY <i>(weak form)</i> | NOT ALL | NOT ALL |
| MODERATE EFFICIENCY <i>(semi-strong form)</i> | ALL | NOT ALL |
| PERFECT EFFICIENCY <i>(strong form)</i> | ALL | ALL |

IMPLICATION OF IMPERFECT MARKETS

- ADVERSE SELECTION

Valuation of a corporation:

Using ASB, i.e., more conservative or using AC, more true view

No information? Uncertainty has a price = Risk premium.

(compare buying of a used car)

=> Accounting choice have price effects in imperfect markets

ACCOUNTING CHOICE IN EFFICIENT MARKETS

Price effect due to wealth effects
because of **Moral hazard**

Managerial efforts

Assumption:

Effort avoidance

Risk avoidance

EFFORT AVOIDANCE

A: Lift 25 kg and get 25SKr

B: Lift 35 kg and get 25Skr

CRITIQUE OF 'EFFORT AVOIDANCE'

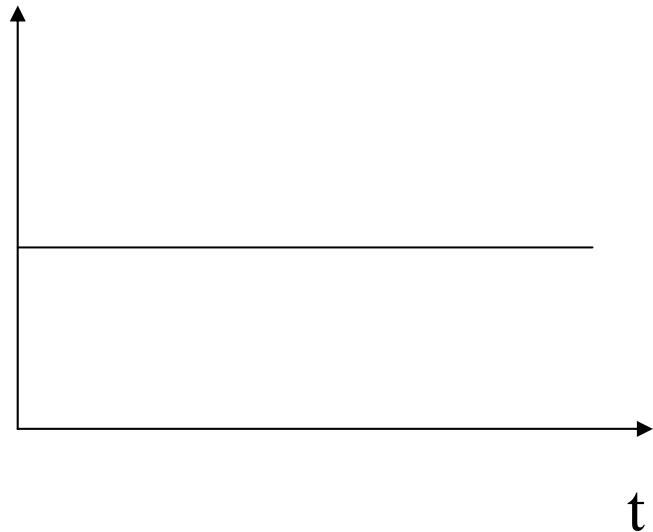
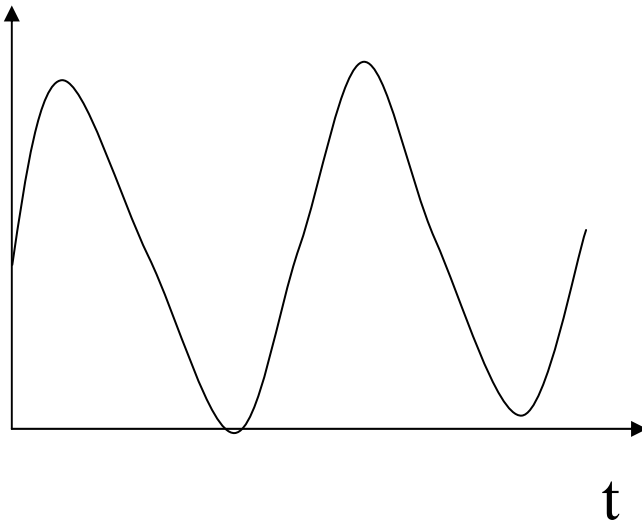
- SELECTION SYSTEM,
ORGANISATIONS SELECTING
HIGH EFFORT INDIVIDUALS
- SOCIALISATION,
INTERNALISING THE VALUE OF
HIGH EFFORT

RISK AVOIDANCE

A

B

Wage



SHIRKING MANAGERS

- EFFORT AVOIDANCE

... SO WHAT?

- MONITORING IS COSTLY

- DIVISION OF LABOUR THROUGH SEPARATION
OF OWNERSHIP AND CONTROL

COMPETENCE TO MONITOR:

INFORMATION – THEORY (EXPERIENCE)

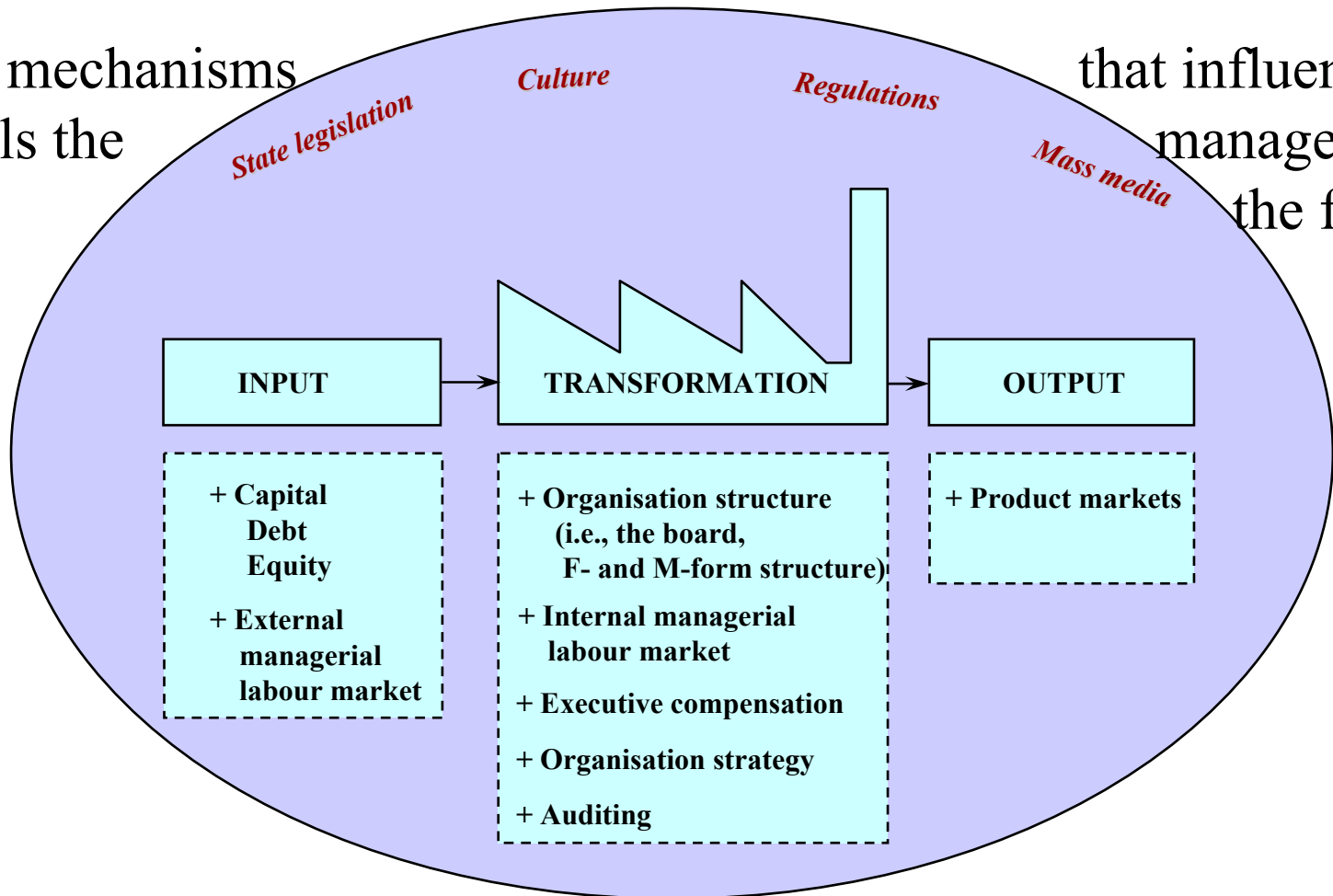
=> TO MANAGE THE MANAGER

TO MANAGE THE MANAGER

CORPORATE GOVERNANCE

Those mechanisms
controls the

that influence/
manager of
the firm



TO ANALYSE ACCOUNTING POLICY CHOICE

- POSITIVE ACCOUNTING THEORY
USE
 - GAME THEORY
 - AGENCY THEORY

GAME THEORY

- TWO RATIONAL INDIVIDUALS
- FULLY INFORMED ABOUT PAY-OFFS
- NO INFORMATION ABOUT THE OTHER INDIVIDUALS STRATEGY

PROS OF GAME THEORY

SHOWS THE IMPORTANCE OF

- COOPERATION
- OF REPUTATION
- OF INCENTIVES/SANCTIONS

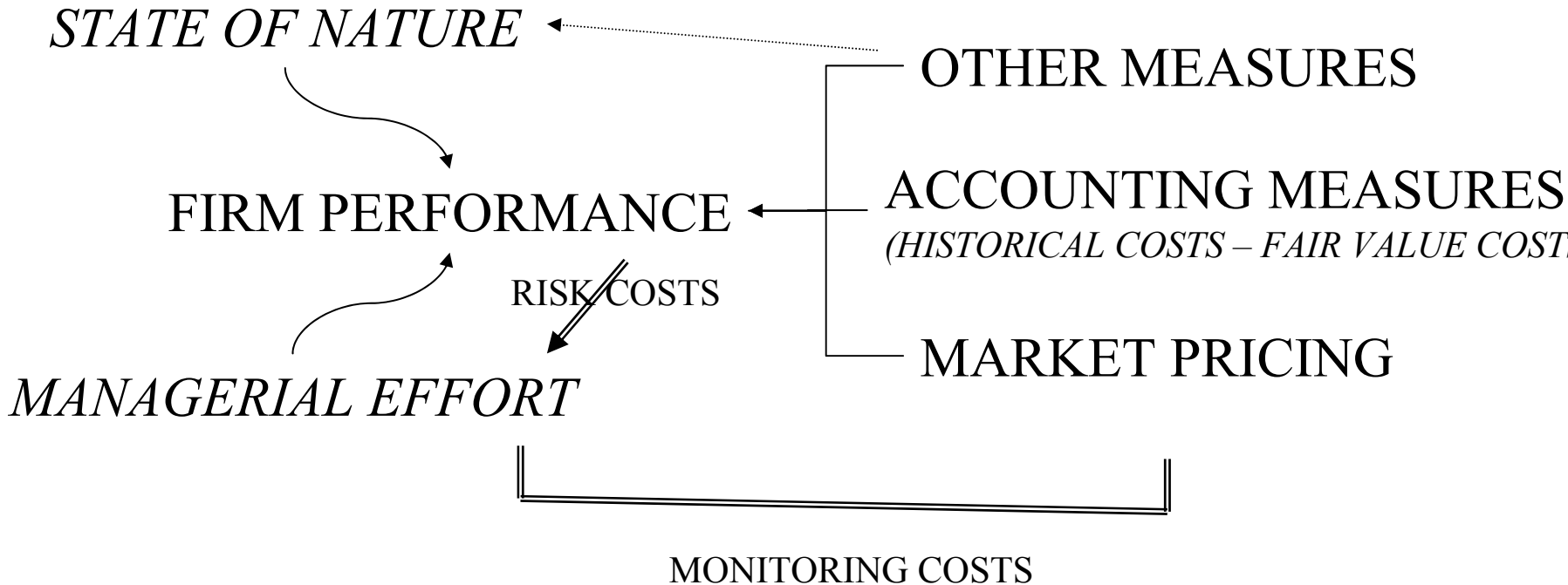
CONS OF GAME THEORY

- ORGANISATIONAL BEHAVIOUR ANALYSED AS INDIVIDUAL BEHAVIOUR
- NO HONOUR...I.E., NO SOCIALITY

AGENCY THEORY

- COOPERATION THROUGH CONTRACT
- PRINCIPAL DELEGATE TO THE AGENT
- MINIMISING THE COSTS OF CONTRACTS

BALANCING MONITORING AND RISK COSTS



EXAMPLE: RESEARCH INTENSIVE FIRM

HIGH COSTS – LOW REVENUES: LOW PROFIT

ACCOUNTING MEASURES?

SALARY

- EVALUATION OF CASH BURNING RATE
- DIRECT CASH FLOW EFFECT

MARKET MEASURES?

OPTIONS

- EVALUATION OF THE POTENTIAL
- NO CASH FLOW EFFECT

EXAMPLE: MANUFACTURE FIRM ON MATURE MARKETS

MODERATE COSTS – HIGH REVENUES: GOOD PROFIT

ACCOUNTING MEASURES?

SALARY

- EVALUATION OF PAST PERFORMANCE
- DIRECT CASH FLOW EFFECT

(HISTORICAL COSTS: HARD MEASUREMENT)

MARKET MEASURES?

OPTIONS

- EVALUATION OF THE POTENTIAL
- NO CASH FLOW EFFECT

ONE PAT PREDICTION

MANAGERS WITH BONUS WILL CHOOSE ACCOUNTING PROCEDURES THAT SHIFT REPORTED EARNINGS FROM FUTURE TO CURRENT PERIOD

ANOTHER PAT PREDICTION

MANAGERS WITH OPTIONS WILL CHOOSE ACCOUNTING PROCEDURES THAT STIMULATE THE PRESENT TASTE OF THE STOCK MARKET

PAT PREDICTIONS FOR MUNICIPAL CORPORATIONS

- No interest in profit but in providing services.
- Subject of legislation of transparency
- No link between top managers' wealth and the profit of the firm

Congruence of interest between shareholders and managers

- Retain earnings.
- Use the less costly alternative.

H1: Swedish municipal corporations will tend to use ASB regulations

- Exception 1

Multiple municipal owners

The interest of the different owners cannot be assumed to coincide

He1: SMCs owned by several municipalities will have higher probability of selecting AC than SMCs that are owned by one single municipality.

EXECUTIVE COMPENSATION

FAMA: INCENTIVE CONTRACTS
ARE NOT NECESSARY IN A
PERFECT MARKET WORLD

- REPUTATION EFFECT
- BACK-STABBING

EXECUTIVE COMPENSATION IN A LESS THAN PERFECT WORLD

| | FIXED SALARY | SHORT- TERM | LONG- TERM |
|--------------------|-------------------------|------------------------|-----------------------|
| CURRENCY | MONEY, CAR, ETC | BONUS | OPTIONS |
| PERFORMANCE | COMPETENCE ETC | ACCOUNTING NUMBERS | MARKET VALUE |
| EVALUATION | SUBJECTIVE | SUBJ/OBJ | OBJECTIVE |
| LIMITED AMOUNTS | YES | YES | OFTEN |

ESSENCE OF EXECUTIVE COMPENSATION

- RISK SHARING
- INCENTIVE FOR GOAL
ATTAINMENT AND CONGRUENCE
- ...fairness, intrinsic rewards,
employment
- And politically correct for politically
sensitive corporations

CRITIQUE OF PAT

- RATIONALITY
- MARKET EFFICIENCY
- MARKET AVAILABILITY (NON-LISTED?)
- SET OF CORPORATE GOVERNANCE MECHANISMS
- OTHER GROUPS

- Exception 2 Institutional coercive influence through Size and Big City -

The definition of general interest due to size is unclear

He2a: SMC's probability of selecting AC standards will increase with corporate size.

Large municipalities tend to have more comprehensive and detailed financial reporting than smaller municipalities. Policy of The parent municipality influence the subsidiary corporations.

He2b: SMCs owned by the three big cities have higher probability of selecting AC than corporations owned by other municipalities.

- Exception 3 Institutional mimetic influence through Industry -

- Legitimacy
- Competitive similarity
- Create possibilities of comparisons
- Good code of accounting practice

He3: SMCs belonging to the same industry tend to choose the same accounting standards.

- Exception 4 Institutional normative influence through auditing firm -

- Auditors influence their conditions through their professional bodies and by being part of the regulatory regime.
- Culture and client portfolio may influence the audit habits of the different auditing firms and their auditors.

He4: The auditing firm influence the SMC's choice of accounting standards.

- Test 1. -

H1: Swedish municipal corporations will tend to use ASB regulations

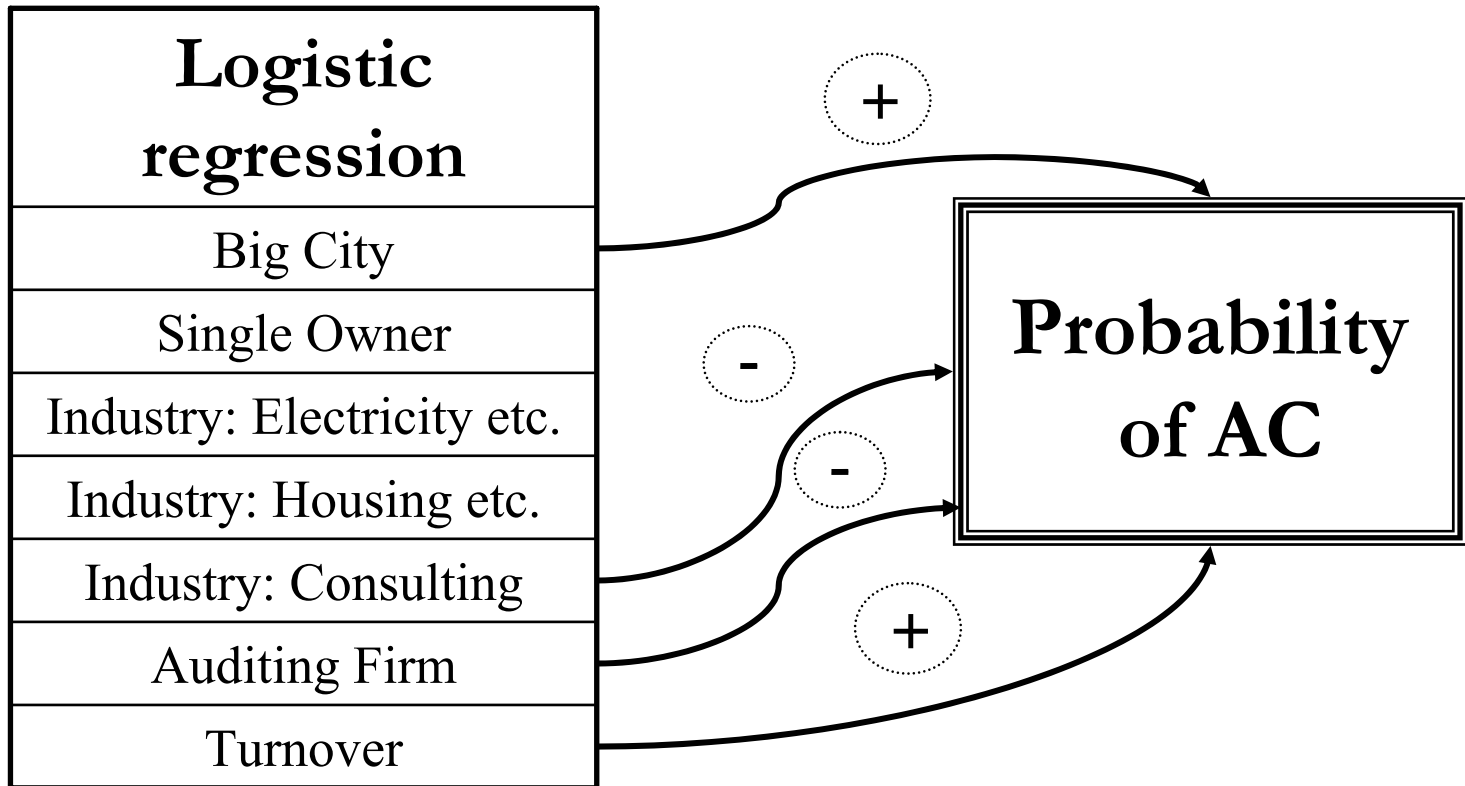
| | ASB | AC | Total |
|-------|------------|-----------|--------------|
| Numbe | 385 | 160 | 545 |
| Per | 71% ← | 29% | 100% |

cent

Accept H1!



- Test 2. -



- Results -

Positive Accounting Theory strong predictive capacity, but...
...maybe due to goal congruence, not conflict

Institutional factors do influence choice of accounting standards,
especially normative pressure through

- the experience of auditing firms and
- the group of financial accountants in the big cities

Notice the institutional embeddedness, i.e., transparency
principle, political organisation

SUMMARY

- CHOICES EXISTS
- WE CAN EXPLAIN THEM, I.E.,
WE CAN CONSIDER THEM
- THEREFORE ..
 - WE CAN USE THEM BUT HAVE TO
CONSIDER THE INCENTIVE
EFFECTS THEY HAVE

ROLE OF AUDITING IN A PAT WORLD

- AUDITING RULES COULD BE FLEXIBLE BUT OF LIMITED NUMBER
- AUDITORS NEEDED TO CREATE CREDIBILITY (FRAUD, ADHERENCE TO RULES, INDEPENDENT)