

ACC/ACF3100 Week 3 Tutorial Solutions

Accounting Theories and Research

Rankin Chapter 5

Review Questions

5.1 What is the underlying assumption of positive accounting theory, and how can it be used to understand the problems that exist between owners and managers? (LO2)

Positive accounting theory examines a range of relationships, or contracts, in place between the entity and suppliers of equity capital (owners), managerial labour (management) and debt capital (lenders or debt holders). It is based on an underlying economic assumption called the 'rational economic person' assumption, which assumes that all individuals act to maximise their own utility. The theory takes the view that maximising utility relates to maximising financial wealth, with non- financial aspects of utility effectively ignored.

When examining the problems that exist between owners and managers this assumption, proposing that all parties are effectively going to act in their own self-interest, helps us to consider the differences in utility that might exist between shareholders (owners) and managers; and between lenders and managers. From there we can look to alternative mechanisms to reduce these problems that might meet the utility needs of both parties.

5.3 Why would managers' interests differ from those of shareholders? What can shareholders do to ensure that they do not suffer financially because of this difference in interests? (LO2)

Managers' interests might differ from owners for a number of reasons, given both managers (agents) and owners (principals) are assumed to act in their own interest, and these actions might not necessarily align. Agency theory points to three main problems which highlight differences between interests of managers and owners: the horizon problem (managers and owners have differing time horizons in relation to the entity); risk aversion (managers generally prefer less risk than shareholders); and dividend retention (managers prefer to maintain a greater level of funds within the entity, and pay less of the firm's earnings to shareholders as dividends).

Shareholders, through the board of directors, can insist on a contract which financially rewards managers in ways that align with their interests. For example: linking managerial remuneration to the longer-term performance of the firm, through bonuses that don't vest until such time as financial hurdles are met. Options or performance rights can also serve to encourage a longer-term view.

5.4 Explain the three agency problems that exist in the relationship between owners and managers. (LO2)

The three main agency problems that exist in the relationship between owners and managers are: the horizon problem; risk aversion; and dividend retention.

The *horizon problem* exists because managers and owners have differing time horizons in relation to the entity. Shareholders have an interest in the long-term growth and value of the entity as the share value of the entity today reflects the present value of the expected future cash flows over the long-term. Managers, on the other hand, are interested in the cash flow potential only as long as they expect to be employed by the entity.

Risk aversion refers to the fact that managers generally prefer less risk than shareholders. Owners diversify their risk through investing across multiple entities, and are also likely to receive income from other sources. Managers have a large amount of ‘human capital’ tied up in the entity and rely on the entity as their main source of income. As such they are likely to be more risk averse than owners, and are less likely to want to invest in risky projects.

Managers prefer to maintain a greater level of funds within the entity, and pay less of the firm’s earnings to shareholders as dividends. This is referred to as *dividend retention*. Managers wish to expand the business they control, whereas shareholders wish to maximize the return on their investment in the entity through increased dividends.

5.5 Explain the four agency problems that exist in the relationship between lenders and managers. (LO2)

The four agency problems that exist in the relationship between lenders and managers are: excessive dividend payments; underinvestment; asset substitution; and claim dilution.

When lending funds, lenders price debt to take account of an assumed level of dividend payout. *Excessive dividend payments*, while good for shareholders, could lead to a reduced asset base securing the debt or leave insufficient funds in the entity to service the debt.

Underinvestment arises when managers, on behalf of owners, have incentives not to undertake positive NPV projects if the projects could lead to increased funds being available to lenders. This might particularly be the case when the entity is in financial difficulty. Given creditors rank above owners in order of payments in the event of liquidation, any funds from these projects would go towards debt rather than equity.

Managers have incentives to use debt finance to invest in alternative, higher risk assets in the likelihood that it will lead to higher returns to shareholders. This is referred to as *asset substitution*. Lenders bear the risk of this strategy as they are subject to the ‘downside’ risk of this strategy but do not share in any ‘upside’ returns.

When entities take on debt of a higher priority than that on issue it is referred to a *claim dilution*. While taking on additional debt increased funds available to the entity, it decreases security to lenders, making lending more risky.

5.9 What role does accounting play in reducing agency problems? (LO2)

Accounting plays two roles in reducing agency problems. The first is where the terms of managerial compensation or lending agreements are written in terms of accounting; and the second is where accounting is used to determine performance against the terms of the contracts.

According to Barker and McGeachin (2015), IFRS mitigates agency problems since it tends to recognise losses earlier than gains; however, “the weakness in IFRS that the paper highlights is that the Framework acknowledges neither the existence of agency problems, nor the role of financial statements in mitigating those problems” (p. 202).

5.16 How does the idea of value creation under stakeholder theory differ from that under positive accounting theory? (LO5)

Stakeholder theory considers creation of value for all stakeholders, considering how operations affect all stakeholders, not concentrating solely on shareholders and profits. Managers should consider balance across all stakeholders.

Positive accounting theory, on the other hand, considers value creation only from the perspective of owners and managers.

5.17 Stakeholder theory proposes that it is important to harmonise or balance stakeholders' needs and expectations. Choose two stakeholder groups and evaluate how a company can balance the views of these shareholders in its dealing with them. (LO5)

Any two of the following organizational stakeholders can be identified and discussed:

- Investors/owners – Investors and particularly institutional investors have power through the provision of equity funds, and their role in appointing the board of directors. A company will need to balance the needs of larger or institutional shareholders with minority shareholders to ensure they are both considered in decisions.
- Political groups – these groups can incorporate community groups, lobby groups and shareholder associations amongst others. Different groups have varying ability to influence the operations of the organization with respect to their area of influence. For instance, environmental lobby groups can influence public opinion about an entity's environmental performance, so the entity needs to ensure they manage this relationship. The company will need to carefully balance the needs and expectations of all these groups in decision making.
- Customers – these are major providers of cash funds to the entity. In many industries meeting consumer needs is the driving force behind the organization, and it will find it difficult to operate successfully without the source of customers. Meeting the needs of customers is important, and it is necessary for companies to balance this against the needs of shareholders and employees in particular.
- Communities – some companies have a major impact on local communities. A specific example is the mining sector where towns and the communities which live there are significantly impacted by the organization, and the entity is reliant on local communities for support including labour, services and other resources. In these circumstances community groups can be seen as powerful parties, as it is important for entities to ensure a close working relationship. It is particularly important to balance the needs of community groups against the demands of shareholders.
- Employees – as the suppliers of one major resource to companies – labour – employees are important to the smooth operation of the entity. Issues with employee conditions can significantly affect this supply of labour and therefore the continuous operation of the entity. This needs to be balanced against the needs and demands of other suppliers – of capital, raw materials etc.
- Governments – government at all levels have a significant amount of influence over the operations of entities through legislation that impacts on operations. This can relate to corporations legislation, legislation that dictates taxes, fees, tariffs and allowances the entity receives, and that dealing with how entities need to treat employees, the surrounding environment and consumers, as just some examples. These all have the potential to incur financial costs on the entity in terms of compliance, and need to be carefully considered against other demands from employees, suppliers and shareholders in particular.

- Suppliers – raw materials are also a major cost to the entity, so any demands from suppliers for information, performance expectations etc. are likely to significantly impact on the entity. Decisions not to supply to an entity can also be costly as it requires the entity to seek out alternative sources.

5.24 A clothing manufacturer has decided to close its factory in a regional Australian town and move its operations offshore to another country where they are going to be able to employ workers at a substantially reduced cost. Closing the factory will result in the loss of 400 jobs in the town. Outline the issues the company might face with regards to its implied social contract. You should identify what groups or people are likely to be concerned or affected by the decision and whether the decision is likely to be seen as advantageous or disadvantageous to these groups. You should also discuss actions the company could take to reduce any potential negative reaction to the decision.

(LO4 and LO5)

In a regional town a clothing factory that employs 400 workers is likely to be responsible for employing a major proportion of the community; in fact it may be the major employer in the region. This means closure will have a significant effect through increased unemployment. This will have a flow-on effect to other businesses in the area which are supported by the clothing factory employees (e.g. retail stores, housing, medical services, child care services etc.).

Because of this close association with the community it has an implied social contract with the local community to communicate with employees and the broader community with regards to its intentions. Many employees may have moved themselves and their families to the area to seek employment. The company is likely to face opposition and lobbying by employees themselves, other businesses in the area, local government and employer associations. The decision is likely to be disadvantageous to all these groups.

Shareholders of the company are also likely to be affected by the decision, and are likely to be supportive, given reduced costs are likely to lead to increase profits.

Customers of the company are also going to be affected, and may make a decision to boycott the company's products if they are not supportive of the company's move offshore. This is likely to lead to adverse publicity, which may also be seen by shareholders as negative.

The company can take a number of actions to reduce the potential negative reaction to the decision. They should communicate with all interest groups, both in the local community and externally, to explain fully their decision. They need to highlight the advantages to the Australian economy, and to interest groups. They should also seek ways to reduce the impact on employees and the local community by seeking alternative employment opportunities for employees etc.

Case study 5.3

Supply chain – using child labour or paying unfair rates can destroy a brand

Questions

- 1. The above article discusses investors' call for more transparency in regard to human rights and employment issues through companies' supply chains. Many companies discuss this information in their sustainability report. What is sustainability? Provide three examples of activities that are considered to have an impact on the sustainability performance of a company.**

- 2. Corporate decisions to voluntarily disclose information about policies and practices relating to human rights and employment can be explained using a number of theories addressed in this chapter. Discuss one of these theories, and explain, from a theoretical viewpoint, why firms would choose to provide this information when they are not formally required to do so.**
- 3. How does a company's supply chain relate to determining sustainability of an organisation's operations? Explain your answer, supporting your view with examples from the article.**
(LO7)

1. Sustainability refers to the ability to meet the needs of the present generation without compromising the ability of future generations to meet their own needs. There are a range of activities that could affect a company's sustainability performance. These might include its impact on the environment, relationship with employees and the community, human rights issues and other aspects of social performance.

2. One popular theory that could be used to explain voluntary disclosure of human rights and employment issues might be legitimacy theory. In this case organisations might be providing this additional information to ensure they align with an implied social contract. It could also be a way to maintain or regain corporate legitimacy.

3. A company's supply chain is an important aspect of its operations, and investors and consumers are increasingly concerned about the source of goods and services, and the human rights and therefore sustainability issues surrounding the source of these goods. There are a number of points made in the article to support this perspective including: investors are concerned about the conditions faced by textile and footwear manufacturing in Asia; the Rana Plaza fire in Bangladesh has put this at the forefront of investor's minds.