Chapter 8

The Efficient Contracting Approach to Decision Usefulness
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Concept of efficient contracting

Sources of demand for efficient contracting

Accounting policies for efficient contracting

Employee stock options

Contract efficiency versus opportunism

Implicit contracts, non-cooperative games

Contract rigidity
What is Efficient Contracting Theory?

• Focus is on role of financial accounting information in moderating information asymmetry between contracting parties
  – Debt contracts and managerial compensation contracts
  – Lenders’ interests and managers’ interests may conflict with interests of shareholders
  – An efficient contract generates trust between these conflicting interests at lowest cost to firm.
  – Contracts may be formal written documents or implicit
    • Implicit contracts arise from continuing business relationships
    • Implicit contracts can be modeled as non-cooperative games
8.3 Sources of Contracting Demand for Financial Accounting Information

• Lenders
  – Lenders face *payoff asymmetry*
    • They can lose heavily if firm does poorly, but do not directly share in gains if firm does well
    • As a result, they demand early warning of financial distress

• Shareholders
  – Managers assumed rational and will act in their own interest, which may conflict with shareholders’ interests
    • As a result, shareholders demand information to encourage responsible manager effort and limit opportunistic actions
8.4 Accounting Policies for Efficient Contracting

• **Reliability**
  – Lenders demand reliable information to help protect against opportunistic manager policies that hide losses and record unrealized gains

• **Conservatism**
  – Lenders demand conservative information to help predict financial distress
    • Conditional conservatism
    • Reporting unrealized losses helps predict financial distress
  – Shareholders demand conservative information for stewardship purposes
    • Conservatism makes it difficult for manager to increase reported earnings, and compensation, by recognizing unrealized gains

>> Continued
Accounting Policies for Efficient Contracting
(continued)

• Efficient contracting demand for reliable and conservative information conflicts with Conceptual Framework
  • Framework more oriented to future-oriented (i.e., relevant) information (fair value accounting)
    • Reliability downgraded to an enhancing characteristic
  • Framework more oriented to information needs of investors than to stewardship
    • Framework does state that investors need information about manager stewardship, but ignores the fundamental problem that best information for investor decision making and for stewardship evaluation need not be the same
8.5 Contract Rigidity

• Many contracts depend on accounting variables
  • Debt contracts contain accounting-based covenants
  • Manager compensation contracts depend on net income

• Both types of contract tend to be long-term
  • Accounting standards often change during contract term, affecting net income and debt covenants
    • Probability of debt covenant violation may increase
    • Manager compensation may be affected

• Since contracts are hard to change (rigid), unlikely that contracts can be renegotiated to allow for changes in GAAP

   >> Continued
Contract Rigidity (continued)

• As a result, managers are concerned about changes in accounting standards and policies, even if no effects on cash flows
  • May lobby against proposed accounting standards
  • May exploit the flexibility of GAAP to change accounting policies to offset effects of changes in accounting standards on contracts (e.g., increase net income by lengthening useful life of capital assets)
  • May change operating policies (e.g., R&D, extent of hedging)

• A new accounting standard has economic consequences if it motivates managers to change accounting and/or operating policies
8.6 Employee Stock Options

• Until 2005, no expense recorded for ESOs
  – APB 25 applied until 2004/2005
  – No expense need be recorded if intrinsic value = zero

• Are ESOs an expense? Yes
  – Dilution
  – Opportunity cost

  – >> Continued
Employee Stock Options (continued)

• Measuring ESO expense
  – Black/Scholes option pricing formula
    • Assumes option held to expiry date
    • But ESOs can be exercised early, between vesting and expiry dates
    • As a result, Black/Scholes overstates ESO expense

• Accountants’ answer
  – Use *expected* exercise date in Black/Scholes formula

>> Continued
Employee Stock Options (continued)

• June, 1993
  – FASB exposure draft to expense ESOs
    • Intense opposition from managers
    • Claimed reasons for manager opposition
      – Lower reported net income
      – Low reliability

• FASB backs down, December, 1994
  – SFAS 123
    • May report ESO expense as supplementary information or in financial statements proper
    • Most firms chose supplemental option

>> Continued
Employee Stock Options (continued)

- Manager abuses of ESOs
  - Since no effect on net income, firms overdosed on ESO compensation
    - Managers motivated to increase reported net income in short run so as to increase ESO values
  - Pump and dump
  - Manipulate share price down prior to scheduled ESO grant dates
  - Spring loading
  - Late timing

» Continued
Employee Stock Options (continued)

- Increasing evidence of abuses led to renewed pressures to expense ESOs, despite continued strong manager resistance
  - Manager resistance overcome 2005
    - IFRS 2, SFAS 123R
Employee Stock Options (continued)

• Why such strong manager resistance to ESO expensing, particularly since:
  – No effect on cash flows
  – ESO expense already reported as supplementary information

• Possible reasons
  • May lead to reduced use of ESOs as compensation
    – Resulting reduced scope to abuse ESO value?
  • Concerns about reliability of Black/Scholes?
  • Lower reported net income?
  • Rejection of market efficiency?
8.8 Distinguishing Efficiency and Opportunism in Contracting

• A basic question in contract theory
  – Are managers’ accounting policy choices driven by
    • Opportunism: manager benefits at expense of investors
    • Efficiency: manager chooses accounting policies to maximize contract efficiency (i.e., good corporate governance)
  – Opportunistic view
    • Managers choose accounting policies to maximize their own expected utility
  – Efficient contracting view
    • Managers choose accounting policies to attain efficient contracting

>> Continued
Distinguishing Efficiency and Opportunism in Contracting (continued)

- Some research consistent with contracting efficiency
  - Mian & Smith (1990)
    - Consolidated financial statements
  - Dechow (1994)
    - Net income more highly associated than cash flows with share returns
  - Dichev & Skinner (2002)
    - Debt covenants
  - Wittenberg-Moerman (2008)
    - Conditional conservatism and information asymmetry (measured by bid-ask spread) positively associated
    - No association for unrealized gains

>> Continued
Distinguishing Efficiency and Opportunism in Contracting (continued)

– Some research consistent with opportunistic manager behaviour
  • Hope and Thomas (2008)
    – For multinational firms that did not disclose earnings by geographic segment, foreign sales increased but earnings did not. Suggests empire building
  • Dechow and Shakespeare (2009)
    – Most firms in sample adopted aggressive fair value accounting for securitizations so as to avoid reporting a loss

– Conclude: while significant evidence for efficiency version, also evidence for opportunistic accounting policy choice
8.10 Implicit Contracts (no Binding Agreement)

Table 8.1 UTILITY PAYOFFS IN A NON-COOPERATIVE GAME

<table>
<thead>
<tr>
<th>Investor</th>
<th>Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>REFUSE</td>
<td></td>
</tr>
<tr>
<td>TO BUY (R)</td>
<td>35, 20</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>BUY (B)</td>
<td></td>
</tr>
<tr>
<td>HONEST (H)</td>
<td>60, 40</td>
</tr>
<tr>
<td>Opportunistic (O)</td>
<td>20, 80</td>
</tr>
</tbody>
</table>

>> Continued
Implicit Contracts (continued)

• Nash equilibrium solution
  – RO: payoffs 35,30

• Cooperative solution
  – BH: payoffs 60, 40

• Single play of the game
  – Why is BH unlikely?

• Multiple plays: BH more likely
  – Manager reputation and ethical behaviour
  – Folk theorem (Chap. 1, Note 23)
Implicit Contracts (continued)

• Example 8.2
  – A 5-period game
  – If parties do not trust each other, game unravels to single-period
  – If parties trust each other, game continues with probabilities shown.
    • Note: trust is not complete but depends on difference between a player’s expected
      payoff from continuing and payoff from ending the game
  – How is trust maintained?
    • Ethics
    • Legal liability
    • GAAP
Conclusions

• Contract theory argues that the role of financial reporting is to generate trust between contracting parties
  – Debt and managerial compensation contracts emphasized
• Contract theory conflicts somewhat with Conceptual Framework
  – Supports increased emphasis on reliability and conditional conservatism
• Managers have accounting policy choice
  – Is this flexibility consistent with efficient contracting or with manager opportunism?
    • Empirical evidence is mixed.