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Recommended Citation

Guay, W. R. (2008). Discussion of Accounting Discretion, Corporate Governance, and Firm Performance. *Contemporary Accounting Research*, 25 (2), 407-4143. <http://dx.doi.org/10.1506/car.25.2.4>

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Discussion of Accounting Discretion, Corporate Governance, and Firm Performance

Abstract

Bowen, Rajgopal, and Venkatachalam (2008) explore whether managers, on average, use accounting discretion for reporting objectives that are in the interests of shareholders (e.g., signaling, tax minimization, etc.), or alternatively whether managers use discretion opportunistically in the presence of governance structures that allow greater discretion. The authors find that although accounting discretion is positively related to governance structures that allow managers greater discretion in decision-making, there is no evidence that the portion of accounting discretion related to governance structures is negatively associated with firm performance. In this discussion, I emphasize the importance of decision rights allocation within widely held corporations, and how this allocation naturally leads to cross-sectional variation in the degree of discretion afforded managers. In contrast to much of the existing governance literature, I argue that governance structures that allow managers greater discretion in making decisions do not necessarily imply weak/poor governance. For example, it is difficult to see why a firm that allocates the least possible decision-making rights to their board or executives is necessarily the firm with highest quality governance. I also discuss why the observed relation between accounting discretion and firm performance may be uninformative about whether accounting discretion is used for opportunistic purposes. If shareholders/boards thoughtfully select an appropriate amount of overall decision-making discretion to allow managers, it will be difficult to determine whether specific types of discretion are used opportunistically.

Keywords

Financial reporting, agency costs of debt

Disciplines

Accounting

Discussion of Accounting Discretion, Corporate Governance, and Firm Performance¹

(forthcoming in Contemporary Accounting Research)

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March 25, 2008

Abstract

Bowen, Rajgopal, and Venkatachalam (2008) explore whether managers, on average, use accounting discretion for reporting objectives that are in the interests of shareholders (e.g., signaling, tax minimization, etc.), or alternatively whether managers use discretion opportunistically in the presence of governance structures that allow greater discretion. The authors find that although accounting discretion is positively related to governance structures that allow managers greater discretion in decision-making, there is no evidence that the portion of accounting discretion related to governance structures is negatively associated with firm performance.

In this discussion, I emphasize the importance of decision rights allocation within widely held corporations, and how this allocation naturally leads to cross-sectional variation in the degree of discretion afforded managers. In contrast to much of the existing governance literature, I argue that governance structures that allow managers greater discretion in making decisions do not necessarily imply weak/poor governance. For example, it is difficult to see why a firm that allocates the least possible decision-making rights to their board or executives is necessarily the firm with highest quality governance. I also discuss why the observed relation between accounting discretion and firm performance may be uninformative about whether accounting discretion is used for opportunistic purposes. If shareholders/boards thoughtfully select an appropriate amount of overall decision-making discretion to allow managers, it will be difficult to determine whether specific types of discretion are used opportunistically.

JEL classification: M41; G32

Keywords: Financial reporting; agency costs of debt

¹ I thank John Core for comments and suggestions.

1. Introduction

Bowen, Rajgopal, and Venkatachalam (BRV, 2008) explore whether managers, on average, use accounting discretion for reporting objectives that are in the interest of shareholders (e.g., signaling, tax minimization, etc.), or alternatively for opportunistic purposes that benefit managers to the detriment of shareholders. They begin by noting that prior research often infers evidence of the opportunism hypothesis from findings that accounting discretion is more prevalent in firms with “poor/weak” governance quality (e.g., Klein, 2002; Menon and Williams, 2004). BRV argue, however, that if accounting discretion is primarily used for opportunistic purposes, one should observe negative effects of this discretion in firm performance. Failure to find such a relation between accounting discretion and firm performance, the authors reasonably argue, calls into question the validity of the inferences in prior research.

The authors re-examine the opportunism hypothesis by first isolating the portion of accounting discretion that is correlated with variation in governance structures. Consistent with prior results, they find that greater accounting discretion is associated with “poor/weak” governance, where “poor/weak” is generally defined as governance structures that allow management considerable discretion in their decision making (a key feature of many governance measures that I will critique below). The authors then set out to test the joint hypothesis that accounting discretion is used primarily for opportunistic purposes *and* that governance structures are “poor/weak” when they allow greater accounting discretion. They test this joint hypothesis by examining whether the portion of accounting discretion that is correlated with variation in governance structures is associated with poor future firm

performance. The authors find no evidence of such a relation and infer that “managers do not abuse accounting discretion at the expense of firms’ shareholders.”

In this discussion, I emphasize two main points relevant to BRV’s analysis and inferences. First, I discuss the importance of decision rights allocation within widely held corporations and how this naturally leads to cross-sectional variation in the degree of discretion afforded managers. In contrast to much of the existing governance literature, I argue that governance structures that allow managers greater discretion in making decisions do not necessarily imply “weak/poor” governance. In particular, it is difficult to see why a firm that allocates the least possible decision-making rights to their board or executives is necessarily the firm with highest quality governance. Second, a finding that greater accounting discretion is not associated with poor firm performance may imply little or nothing about whether accounting discretion is used for opportunistic purposes. If firms make optimal decisions regarding the amount of overall decision-making discretion to allow managers, it will be difficult or impossible, to determine whether specific types of discretion are used opportunistically.

2. Allocation of Decision Rights in Organizations

The allocation of decision rights within an organization is a fundamental building block of organizational structure (Jensen and Meckling, 1990). Because it is costly to transfer information in a timely manner across individuals in an organization, it is easy to see the merits of collocating decision rights with those individuals who possess the information necessary to best make decisions. At the same time, the organization needs to consider agency problems, and whether the individuals holding the decision-relevant

knowledge have appropriate incentives to take actions that are in the best interests of the owners of the organization.

These basic principles of allocating decision rights within an organization play an important role in designing the contracting relations between shareholders, the board of directors, and senior management. In widely-held corporations, it is well understood that substantial decision rights are allocated by shareholders to the board of directors, due in part to the considerable information costs and coordination costs that would be necessary for shareholders to make many key decisions themselves. In turn, and for many of the same reasons, the board of directors allocates substantial decision rights to executive management. Executive managers involved in the day-to-day activities of the firm are likely to have much better decision-relevant knowledge, and can take actions in a more timely manner than board members or shareholders. At the same time, shareholders and boards are rightfully concerned about agency conflicts with executive managers and the possibility that such managers will take opportunistic actions that benefit themselves to the detriment of shareholders.

As noted by Jensen and Meckling (1990), one can view these two organizational costs along upward sloping continuums. In an organization where decision rights are fully co-located with the managers holding the decision-relevant knowledge, the costs of making uninformed decisions are small, but agency costs are potentially large. In an organization where managers are restricted in their decision rights, which are instead retained by shareholders or boards, agency costs will be small, but the costs of making uninformed decisions are large. Total organization costs will be minimized at the level of decision-rights allocation where the sum of these two costs is lowest.

Naturally, shareholders are motivated to choose, or at least move toward, a level of decision-rights allocation that is expected to minimize total organization costs. Further, firms with different economic characteristics are expected to choose different levels of decision rights allocation. For example, in firms where decision-specific knowledge is complex and difficult to transfer, or dynamic settings where decisions must typically be made quickly, managers are likely to be given considerable discretion to make decisions. Likewise, in firms where shareholders and/or boards are confident in their monitoring ability and therefore less concerned about agency conflicts, managers are also likely to be given considerable discretion to make decisions.

3. Corporate Governance Measures of Discretion Allocated to Boards and Managers

In many ways, commonly used measures of corporate governance capture variation in the “tightness” or “looseness” of constraints placed on executives’ decision-making, or said a different way, the degree of discretion or “length of rope” that executives are allowed in making decisions. For example, consider the variety of common governance measures examined by BRV. One such measure that has gained tremendous recent popularity with researchers is the Gompers, Ishii, and Metrick (2003) governance score (“g score”) that measures the incidence of various corporate provisions related to shareholder rights. As is standard in the literature, BRV interpret this measure as providing an indication of governance quality, where firms that concentrate greater decision-making rights in the hands of shareholders, and less decision-making rights in the hands of boards or executives, are considered to have higher quality (i.e., better) governance. The arguments above, however, suggest that such a view is at best incomplete. It is difficult to see why a firm that allocates the least possible decision-making rights to their board or

executives is necessarily the firm with highest quality governance. Rather, one can imagine that shareholders optimally choose to allocate greater decision-making rights to boards and executives when it is most important for these individuals to have such authority, or when expected agency costs of doing so are not large.

Similarly, many of the other governance proxies examined by BRV also appear to capture aspects of the allocation of decision-making rights to executives. Whether the CEO is the chair of the board, the proportion of insiders on the board, and the number of board meetings can all be viewed as measures of how much autonomy or decision-making authority is granted to the CEO and top executives. For example, a board that is optimized to assist management with project selection and investment decisions may justifiably appoint insiders with firm- and industry-specific knowledge that are not necessarily independent of the CEO. Fama and Jensen (1983) make this point by noting that since the board is to be comprised of experts, it is natural that the most influential members are internal managers with valuable firm-specific information about the organization. Some of BRV's other governance variables, such as the extent of stock and option holdings by the CEO, can be viewed as proxies for monitoring mechanisms that can mitigate potential agency costs associated with the optimal allocation of decision rights to executives.² That is, when greater decision rights are allocated to executives, equity incentives can serve to ensure that executives use these decision rights to take actions in the best interests of shareholders.

² A puzzling aspect of the authors' discussion of equity holdings, is that greater stock holdings are viewed as a mechanism to mitigate agency conflicts, whereas greater stock option holdings are viewed as increasing agency conflicts. From an economic perspective, it is difficult to understand this stark difference in perspective. Since the values of both stock and option holdings derive from the stock price, and both types of securities are subject to executives' decisions on liquidation, it is difficult to see how the agency costs stemming from these two types of securities give rise to opposite predictions. While a body of literature claims that greater stock options leads to more fraud, more recent studies suggest these earlier results may be spurious (e.g., Armstrong, Jagonlinzer, and Larcker, 2007; Hribar and Nichols, 2007).

The role of decision-right allocation in corporate governance structures is likely to have important implications for the relation between corporate governance and discretion in financial accounting choices. It is not hard to imagine that executives who are granted greater decision-making discretion, in general, will also have greater discretion with respect to making accounting choices. For example, when the CEO is granted substantial autonomy by allowing him/her to be board chair and by including insiders on the board, it would not be surprising to observe greater discretion being used by management across a variety of dimensions, including project selection, financing activities, mergers and acquisitions, executive compensation, and accounting policy. In other words, when shareholders deem it appropriate to allow executives greater decision rights, it seems likely that one would observe greater executive discretion across all of the various dimensions of decision-making, including accounting choices. If this is correct, one expects to observe a positive relation between corporate governance choices that allow discretion, and accounting choices that reflect such discretion. Importantly, however, neither corporate governance discretion nor accounting discretion is expected necessarily to indicate “good” or “bad” corporate governance *or* accounting policy.

4. Interpretation of the Authors’ Results

The authors’ primary objective in the paper is to investigate whether management’s use of accounting discretion is best viewed as being detrimental to shareholders, or alternatively as being used for purposes that benefit shareholders. A large volume of papers articulate reasons why accounting discretion can either benefit or harm shareholders. One side of the debate argues that accounting discretion has been purposefully allowed within GAAP to allow managers to tailor their financial statements to provide the most accurate

and informative representation of their firm's financial position. Further, accounting discretion can be used to avoid debt covenant violation, reduce political costs or taxes, or meet certain forecasting benchmarks, all of which can be beneficial to the firm's shareholders (although sometimes potentially detrimental to creditors and other parties). The other side of the debate argues that managers use accounting discretion mainly for opportunistic purposes, such as to manipulate bonuses or facilitate personal stock sales at inflated prices, thereby benefiting themselves to the detriment of shareholders.

It is not clear that the authors' tests discriminate between these opposing viewpoints on the role of accounting discretion. The authors' primary empirical research design first extracts the component of accounting discretion that is correlated with variation in corporate governance structures. Accounting discretion is measured using three common empirical constructs: abnormal accruals, earnings smoothing via accruals, and incidence of small positive earnings surprises. The authors then correlate the governance-explained-component of accounting discretion with firms' future financial performance, measured using stock returns, operating cash flows and earnings performance. As acknowledged by the authors, future stock returns may be the most problematic of the three performance measures due to the fact that investors are likely to understand variation in how firms use accounting discretion, and can incorporate any relevant effects into current period stock prices.

The authors explore two key hypotheses regarding their empirical analysis. First, they hypothesize that if corporate governance is structured optimally, one should observe no relation between corporate governance and accounting discretion after controlling for the economic determinants of accounting discretion (e.g., size, leverage, growth,

performance, etc.). Second, they predict that if accounting discretion mainly reflects opportunistic managerial behavior, one should observe a negative relation between accounting discretion attributable to governance structures and future firm performance.

The authors' first prediction is problematic because, as noted above, one might naturally expect a positive correlation between discretion allowed within governance structures and discretion observed in accounting choices. Further, because identical economic determinants may underlie the choice of discretion in both corporate governance and accounting choices, it might be virtually impossible to identify an important component of accounting discretion that is associated with governance structures, but is unrelated to the economic determinants of shareholders decisions regarding how much decision-making discretion to allow managers. In other words, an empirical finding that accounting discretion is correlated with governance structures neither implies that corporate governance is sub-optimal, nor that the component of accounting discretion that is explained by corporate governance structures reflects opportunistic behavior on the part of boards or executives.

The authors' second prediction on the relation between accounting discretion and future performance is certainly useful to consider, but is also potentially problematic. As noted above, accounting discretion can be used by executives either to improve corporate disclosure (i.e., for "good" purposes), or for opportunistic purposes (i.e., for "bad" purposes). Also noted above is that allowing executives greater decision rights in general comes with both benefits (e.g., better and quicker project selection choices) and costs (e.g., agency conflicts). If accounting discretion is on average used for "good" purposes, and firms have optimally selected the degree of discretion granted to executives, one does not

expect to find a relation (either positive or negative) between firm performance and accounting discretion (or the component of accounting discretion correlated with governance, and firm performance). If, on the other hand, accounting discretion is on average used for “bad” purposes, and if firms have sub-optimally selected the degree of discretion granted to executives, then it may well be that measures of discretion are negatively correlated with future performance.

At the same time, however, it should be recognized that if accounting discretion is on average used for “bad” purposes, *but firms understand this and optimally select the degree of discretion granted to executives*, one does not necessarily expect to find a relation (either positive or negative) between accounting discretion and firm performance. Although this latter statement may seem odd, it stems from the fact that it is not clear whether accounting policy choice is a first-order consideration when shareholders are deciding how much discretion to allow boards and executives. It is not hard to imagine that shareholders’ first-order concern in allocating decision-making authority to executives revolves around key business activities such as project selection, mergers and acquisitions, hiring and firing decisions, etc. Shareholders may well recognize that granting boards and executives discretion along these dimensions will have certain unavoidable “side effects”, such as difficult-to-mitigate agency costs that take the form of accounting discretion, excess perquisite consumption, or other forms of excess compensation. The cross-sectional variation in discretion allowed to managers likely reflects the aggregate consideration of all of these benefits and costs. In summary, the failure to find a negative relation between accounting discretion and firm performance may imply either that accounting discretion is on average used for “good” purposes, or that accounting discretion is on average used for

“bad” purposes but that firms understand this and factor it into their decisions regarding the degree of overall decision-making discretion to allow management.

5. Conclusion

The allocation of decision rights within an organization is a fundamental building block of organizational structure. In widely-held corporations, a key aspect of the governance structure lies in deciding how much autonomy and decision-making discretion to allow senior executives. Importantly, in this context, it is not useful to view greater discretion as either better or worse than less discretion since the economic costs and benefits of allocating decision rights to managers are expected to differ across organizations.

Bowen, Rajgopal, and Venkatachalam (2008) examine discretion in accounting choices as one important aspect of managers’ decision-making discretion. They provide evidence that the use of accounting discretion is positively associated with overall discretion in corporate governance structures, and that accounting discretion is not negatively associated with firm performance. Although it is difficult to conclusively interpret this result as implying that accounting discretion is not used opportunistically by managers, it is a useful step forward in initiating discussion of the role of discretion afforded to executives.

Given the key role that decision-rights allocation and discretion in decision-making play in organization structure, it would seem that further investigation of these issues is a fruitful avenue for future research. Most research to date on these issues focuses on *how* the use of discretion varies across corporations. It would be interesting, however, to better

understand *why* the use of discretion varies across corporations and what economic factors determine firms decisions about how much discretion to allow their managers.

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