- Chapter 8 - The Efficient Contracting Approach to Decision Usefulness

The Efficient Contracting Approach to Decision Usefulness

- Consider management’s role in financial reporting
- Firms enter into many contracts, in particular, debt contracts with lenders and compensation contracts with managers
- Contracts are based on accounting information
- An efficient contract motivates the manager to act on investors’ best interests at lowest cost to the firm

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

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

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
  - Shareholders demand conservative information for stewardship purposes

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

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

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 <u>economic consequences</u> if it motivates managers to change accounting and/or operating policies

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

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.

In Class Discussion

- Debt contracts may contain covenants, such as maintaining a specified level of working capital, not exceeding a specified debt-equity ratio, or maintaining an agreed times interest earned ratio (debt service coverage). Explain how these covenants help to generate the lenders' trust that is necessary if the firm is to borrow at reasonable cost. Do these covenants give lenders complete trust that their interest and principal will be paid? Explain.

In Class Discussion #2

- Use contract theory to explain how conditionally conservative accounting can contribute to efficient contracting. Consider both debt and managerial compensation contracts.

- Conditionally conservative accounting = impairment testing