Managers and Accounting Decisions

Accounting and control extends from the grassroots data collection throughout the firm, to performance reports for various managers, to public disclosures and audited financial reports. When the promoters of a firm choose a form of organization (e.g., proprietorship, partnership, cooperative, or private or publicly held firm with limited liability), they also choose the applicable legal and accounting regimes. A decision to go public in the United States, for example, implies a willingness of the firm’s agents to conform its accounting and control to the requirements of the Securities and Exchange Commission.

Within the boundaries defined by its organizational form, a firm’s managers shape the details of its accounting and control. Other agents participate in the process indirectly. Managers’ choices affect other agents, and the latter’s reactions affect the managers themselves. Therefore, managers must take into account the effect of their choices on other agents. In addition, managers actively participate in the process of changing the applicable accounting and legal regimes at local, national, and international levels.

In this chapter we examine the range of accounting decisions managers make, and review some prominent features of accounting in terms of contract theory. In addition, we look at the consequences of accounting decisions for managers, and at the part of managerial behavior that is observable to other agents in the firm. Interactions between accounting choices and regulation are discussed in Chapters 11 and 12.

Hierarchy of Accounting Decisions

At the bottom end of the hierarchy of accounting decisions are the frequent decisions on classification of specific transactions, such as expensing versus capitalization of a major repair job in the factory. At the other end are infrequent deci-
visions with long-run implications, such as decisions about managers’ roles in setting the accounting and auditing standards. Let us review the context of a range of such decisions.

**Discretionary Decisions on Expensing–Capitalization of Costs**

Managers have unique access to information about the likely causes and consequences of expenditures. Since other agents do not know, managers create “facts” when they classify transactions that do not unambiguously fall in one or another of the limited number of accounts in the firm’s books. Classification questions arose early in the history of publicly held corporations in the United States. In the mid-eighteenth century, railroad managers could exercise broad discretion on which construction costs were charged to expense and which operating costs were capitalized.

Managers also choose the accounting classification of unusual or infrequent transactions for which the firm has no defined policy. It is difficult to clearly demarcate capital improvements, repairs, overhauls, rebuilding, salvaging, and maintenance from one another. Managers have discretion over the exact timing of recognizing a transaction. Even small transaction decisions can have a large cumulative effect on financial statements.

Managers’ expensing–capitalization choices depend on the form of their contracts, their decision horizons, and their places in the managerial hierarchy. Under the clean surplus rule, all changes in owners’ equity except transactions with the shareholders must flow through the income statement, and the Law of Conservation of Undiscounted Accounting Income holds (see Chapter 5). Expensing a cost item instead of capitalizing it shifts accounting income from the current period to some future accounting period without changing the total income over the lifetime of the firm. It also lowers the accounting valuation of assets in the subfirm, and lowers the accounting rate of return on investment for the current period in exchange for a higher return in the future. Managers whose compensation is contingent on short-term income or rate of return are therefore likely to favor capitalization of costs within their range of discretion.

Three countervailing forces reign in the managerial proclivity to capitalize. First, compensation plans induce managers to smooth the measures of their performance over time, and a flat-out policy of capitalizing costs deprives them of one instrument of smoothing income. Second, compensation plans seek to lengthen the decision horizon of managers using such devices as restricted stock options near the top of the managerial hierarchy and multiperiod budgeting at the lower levels. Postponement of expense recognition becomes less important as the decision horizon becomes longer. Third, internal and external auditing limit what managers can capitalize.

**Accounting Estimates**

Managers estimate many economic magnitudes for the books of account. The allowance for bad debt, costs of warranty obligations, net realizable value of
byproducts, service life, and salvage value of equipment and plant are examples of such estimates. Once entered into the books, some estimates cannot be changed without substantial justification, which limits managerial flexibility. Other estimates allow a great deal of flexibility for the managers.

The U.S. savings and loan industry’s crisis in the mid-eighties, brought about by large bad debts combined with inadequate allowances made to cover such debts in their financial statements, is a good example. In other industries, independent auditors may be relied upon to provide effective restraints on such occurrences. Responsibility for oversight of U.S. banks is shared by the Federal Reserve Bank, the Controller of Currency, Federal Deposit Insurance Corporation, state regulators, the Securities and Exchange Commission, and independent auditors. This diffusion of responsibility was blamed for the glaring inadequacy of bad debt allowances in the banking industry. However, equally severe problems exist in the recognition of bad debt allowances in Japanese banks during the mid-nineties. The basic considerations that motivate managers in choosing accounting estimates are the same as in discretionary items.

**Accounting Principles**

Generally accepted accounting principles (GAAP) allow firms to choose from a menu of accounting methods and disclose such choices in a footnote on accounting policy. The timing of revenue recognition and methods of accounting for depreciation, inventory, and costs of pension plans are examples of such decisions. Managers can choose some accounting methods even if they are not included in the set recommended by the law or published accounting standards. However, managers must carefully weigh the gains from such deviations from the norm against the costs they impose on the firm. Even if a firm switches from one generally accepted accounting principle to another, it invites auditor qualification. Section AU 546.01 of the American Institute of Certified Public Accountants’ (AICPA) Professional Standards applies even if a change is recommended by the Financial Accounting Standards Board or the Securities and Exchange Commission.\(^\text{2}\) Other participating agents, especially the investors, view deviations from the norm and changes in accounting principles with unease or even suspicion. Publicly held firms do not, therefore, change accounting principles frequently.

**Disclosure Policy**

Managers decide what information, beyond the specific requirements of law and accounting standards, is publicly disclosed. Disclosure could appear as additional detail in the financial statements, in the footnotes and schedules, in management’s review, in the letter to the shareholders, or in press releases. Major purchase or sale contracts, capital investment plans, research, development and exploration, new product introduction, budgets, and financial forecasts are examples of such disclosures. Honest disclosure of additional information in public affords other participating agents a better assessment of managerial input and the value of their
own interest in the firm. However, managers may be tempted to disclose information selectively, withholding information that casts them in a bad light. Such manipulation reduces the credibility of disclosures. Such “soft” information is costly, even impossible, to verify. In choosing disclosure of additional information and its independent verification, managers trade off credibility and the cost of verification in order to enhance their welfare.

Disclosure can also affect the actions and strategies of creditors and shareholders. Public disclosure is equally accessible to participating and nonparticipating agents, and places them on equal footing as bargaining agents. It enhances the liquidity of the factor markets from which the firm draws its resources, and this increased liquidity benefits the participating agents as well as potential participants.

Disclosure of performance forecasts by managers has been debated since the 1930s. The Securities and Exchange Commission (SEC), created in 1934 in the wake of the stock market crash, considered such forecasts potentially misleading to investors and steadfastly opposed them. The SEC changed its attitude in the early seventies, however, and tried to persuade publicly held firms to issue such forecasts. Many firms voluntarily issue public performance forecasts, but managers oppose imposition of a legal requirement to do so. They are afraid of giving away proprietary information to competitors and of being held liable to investors for any forecast errors or misuse of information. (In Chapter 11 we discuss the problems that arose in requiring firms to disclose their oil and gas reserves.)

A firm’s competitors might benefit from the forecasts, but product market competition among publicly held firms is a two-way street: Each benefits from the other’s disclosure. Shareholders and often employees (through their pension funds) tend to be well-diversified across firms, so a disclosure requirement should not hurt them. The desire to curb the opportunistic use of information by managers is the major source of demand for additional disclosure.

Of course, the reciprocity argument will not hold if publicly held firms have to compete against privately held firms (not subject to disclosure requirements) in technologically innovative industries (where a great deal of high-value proprietary information exists). The theory suggests that, other things being equal, we should expect the resistance to mandatory disclosure requirements to be strongest in such industries.

Even without mandates there are limits to managerial discretion in making disclosures, however. Failure to disclose, when disclosure is expected by others on the basis of past experience, may do more damage to the manager than revealing the bad news. Indeed, some firms win plaudits from the financial community for bluntly admitting setbacks and mistakes. Most announcements of corporate restructuring and large write-offs during the early nineties were followed by a jump in the corporation’s stock price.
Internal Controls

Managers exercise broad discretion in designing the accounting and controls. Since the passage of the Foreign Corrupt Practices Act in 1977, managers of publicly held firms are legally required to maintain an adequate internal control system. However, the law provides little specific guidance in designing the system. The Cost Accounting Standards Board wrote accounting standards to help the U.S. government enforce its contracts with its vendors. Most of these contracts implement the bilateral monopoly relationship between the government as the sole buyer and defense contractors as the sole suppliers of specific weapons systems. These standards are designed for this special case, and do not apply to most business relationships. As the firm changes or expands, managers, especially the controllers, continually redesign its accounting system.

A self-enforcing contract environment is created for each manager by simultaneously placing the manager in two agency relationships. In one relationship the manager is the principal in relation to subordinates; in the other, an agent with respect to superiors in the managerial hierarchy. Thus, the organization of managers in a firm can be represented as overlapping principal–agent relationships between various pairs of managers. Low-level managers at the bottom of the hierarchy supervise nonmanagerial employees. At the top, the chief executive officer is answerable to the board of directors.

In stewardship or principal–agent relationships, each manager has exclusive or preferential access to some information, resources, or skills. Each believes that he or she can be better off working within this relationship rather than by abandoning it. Neither knows for sure the actions of the other. The complex design of the managerial control system of the firm is an attempt to solve the problem of providing a set of self-enforcing contracts for all managers in the firm. We will discuss some features of managerial control systems and their economic rationale shortly.

Accounting Standards

U.S. accounting standards for publicly held firms are set by the SEC and the Financial Accounting Standards Board (FASB) through a participative process. Managers are second only to professional auditors in their level of participation in this process. Managers usually claim to speak on behalf of their firms, and rarely in their personal capacity. As with disclosure decisions, it is difficult to untangle the extent to which positions espoused by managers advance their own interests as opposed to the common interests of all agents who participate in the firm. Unless we observe managers espousing proposals that favor agents at large at the expense of managers’ personal interests, we are inclined to assume that managers, like others, seek personal goals.

To illustrate, in 1982 bank managers persuaded the FASB not to require recognition of loss at the time of restructuring of troubled debt. Their persuasive argu-
ment was couched in terms of potential damage to the interests of others: bank borrowers, depositors, and shareholders. This goes to the heart of the dilemma that accounting rule makers face. If forcing the banks to recognize huge loan losses precipitates bank failures and loss of public confidence in the banking system, such action would be self-defeating. Accounting does not merely seek to represent reality; it may also create reality. Appealing as the idea of representational faithfulness is to the advocates of realism in accounting, the reflexivity of accounting and economic reality also cannot be ignored by the auditors when they examine a firm whose continuity is in doubt. Is an adverse audit opinion that erases the doubt by forcing the firm into bankruptcy representationally faithful?

Yet the managers who made these arguments stood to benefit handsomely from the FASB’s acquiescence. Because so many of their skills are industry-specific, a fired bank manager suffers an economic loss. The top bank managers had economic incentives to fight the potentially damaging requirement of immediate recognition of loss associated with troubled debt restructuring. Similar incentives led managers to fight against recognizing the economic value of managerial stock options as part of a firm’s compensation expense, as will be discussed later in this chapter.

Although managers can, and often do, use participation in the standard-setting process to their own advantage, their exclusion from the process would only leave the field open to auditors to do the same thing. Serious errors in standard setting can be minimized by balanced representation of various interests in the standard-setting body, not by excluding agents who may have an ax to grind or personal stakes to protect. We return to the problem of designing institutions for setting accounting standards in Chapter 11.

Certain Features of Control Systems

Electronic computers make it cheaper to include additional details in accounting records. However, the costs of identifying the additional details, classifying them into appropriate categories, and converting them into machine-readable form must be incurred first. For example, a magazine publisher may decide that computerizing subscriber accounts should be accompanied by collecting demographic and renewal data to support marketing and advertising. The firm would have to redesign its accounting system, identify additional pieces of data needed, specify procedures for collecting it, enter it into the system, and process it after entry. To justify such efforts, the expected benefits from improved marketing would have to exceed the costs of redesign and implementation.

Auditors’ demands for verification of accounting systems often require the use of otherwise redundant, even inefficient, accounting procedures. Optimizations of accounting systems reckon not only the direct costs of accounting, but also the cost of auditing and the indirect costs that follow from errors and failure of internal controls.
Transfer Pricing

According to Coase, a firm replaces market transactions with administrative organization when the cost of the latter is less than the cost of the former. When two stages of production are organized within a firm and managed by a single person, the need for a transfer price vanishes. However, if each stage is managed by a separate manager, a transfer price can be used to split the transaction cost savings between the two managers. Ideally, this price should align their individual incentives with the interests of the firm as a whole.

The standard textbook solution to this problem (use of the market price as the transfer price) is a nonsolution. When a well-defined market price exists for the transferred good, there is no economic rationale for the two divisions to be part of a single firm. This is a common problem with computing transfer prices by assuming that a central planner knows all the facts. But information asymmetry in favor of subordinates is an essential driver for decentralization. Decentralization brings its own costs in the form of decisions that may serve the interests of the subordinate, but not the interests of the larger firm. One of the toughest problems of organization design is to make this trade-off between the benefits (decisions optimized for superior local information) and costs (global suboptimality of local decisions). Ignoring this fundamental trade-off does not yield useful organization designs or transfer pricing schemes. Organizations tend to address the problem by defining a process rather than a specific solution. Accounting and organizational practices for determination of transfer prices (e.g., cost plus, negotiated, and full cost, etc.) are best seen in this light. Such practices often appear to be suboptimal in narrowly constructed scenarios that leave out the essential trade-off that lies at the heart of organizational design.

Cost Allocations

It is often cheaper for a firm to have two or more managers share a plant or facility that was created by incurring a fixed cost. After a plant has been acquired, it seems irrational to allocate the sunk cost of the facility among the managers who utilize it. Charging the managers may only result in suboptimal utilization of a plant whose costs have already been paid for by the firm.

Plant use after its purchase is only a part of the problem. The other part of the problem, frequently ignored in the cost allocation literature, concerns the critical decision to acquire the plant and incur the cost in the first place. A decentralized firm needs an accurate and efficient method of finding out how much of the capacity of the shared facility each division needs. This information is in the hands of the division managers. If they know that the use of the facility, once it is installed, is free, they will demand more capacity than they can productively use. This will result in economic waste for the firm. On the other hand, charging managers a high price for using the facility will induce them to underestimate their demand, again hurting the firm. Allocation of costs creates a pseudo-marginal price
for the services of the plant and helps improve the quality of the firm’s decision to buy the capacity.

After capacity is installed, it is inefficient to charge the users of the capacity if the opportunity cost of such capacity is zero. On the other hand, if no price were charged, managers would learn to anticipate this policy and provide inflated estimates of demand that would result in too large a capacity being installed by the firm. If they had to pay on the basis of their estimated demand for the use of the proposed facility, managers will tend to understate their projected use. Inefficiency after installation is the unavoidable price that a decentralized firm must pay in order to gain other benefits of decentralization. Cost allocation schemes balance the efficiency of plant acquisition against the efficiency of plant utilization.

**Participative Budgeting**

Traditionally, participative schemes have been explained by the satisfaction agents receive from the act of participation or power sharing. However, it is also possible to understand the value of participation in terms of the fundamentally dispersed nature of information in any economy or organization. Nobody, not even the boss, knows everything. It is impossible to get others to share the information they have without giving them a say in decision making. They decide what information they will share and how precisely and how truthfully they share it. This influence of others on decisions made is the price paid for information. All participation in decisions, in budgeting and elsewhere, involves a trade-off between (1) the value of information gathered from the participants through better informed decisions, and (2) shading of the decisions in favor of the participants through the information they choose to share.

This trade-off is eternal. However, in management consulting circles, the participative style of decision making is a fad that waxes and wanes in cycles. There are two reasons for this instability. First, participation is often sold by management gurus as a good thing in itself, and not in terms of the economic trade-off just described. When the manager does not make sure that the gains outstrip the losses in the implementation of participation, the experiment fails, consultants are fired, and the boss returns to the office to brood.

A second cause of failure lies in the expectations of those invited to participate in the process. Human beings are not blank slates. They carry a history of their experiences in the form of expectations. Under conditions of uncertainty, we all act relative to these subjective expectations. When invited to participate in budgeting or other forms of decision making, people act in light of their past experiences. If they have played out a failed round of a participation game in the past, the chances of success diminish with each subsequent experience. If people do not trust the boss to do right with them when they share information, they will not share information.
Standards and Variance Analysis

The use of budgets or standards in managerial contracts suggests the existence of a discontinuity in the managerial reward function. In other words, managerial rewards change in some qualitative manner if the performance falls above or below some specified standard. Variance analysis implies a search for additional information by the principal when performance of the agent falls in some prespecified range. Whatever policy the manager uses to set budgets, standards, or investigations, it is reasonable to assume that, sooner or later, subordinates will learn about this policy and adjust their behavior in light of this knowledge. Most standards and variance analysis systems have complicated nonlinear dynamics, making it difficult to predict the end point of this action–reaction sequence between the manager and subordinates.

Managerial Consequences of Accounting Decisions

Accounting and managerial welfare are intertwined. Let us discuss a few examples of the consequences of accounting decisions.

The LIFO Puzzle

When the unit costs of inventory rise and the unit volume is stable or increasing, the use of the last-in-first-out (LIFO) cost-flow assumption to calculate the cost of goods sold lowers the income of the firm. This method is acceptable for income tax purposes in the United States. It offers nongovernment participants of firms that satisfy the unit cost and volume conditions an opportunity to enlarge their share of the corporate pie at the expense of the government. Most U.S. firms satisfy these conditions. Yet, a majority of publicly held corporations do not use LIFO. Why this reluctance to save taxes?

Managers are more likely to choose income-enhancing accounting methods if their compensation is tied to income. Managers’ bonuses are often linked to accounting income. They assume that adopting LIFO, unless accompanied by an adjustment in the bonus calculation, will reduce their compensation. Although such adjustments are not routinely made, empirical studies reveal that adopting LIFO does not decrease executive compensation. The tax savings are so much larger than the compensation costs that only large barriers or costs to renegotiation of managerial contracts could support the absence of adjustment in compensation.

Because LIFO results in lower earnings, adopting LIFO may lower stock prices and, therefore, the short-run wealth of shareholders and managerial compensation. When some managers believe that investors value the shares of stock on the basis of accounting income instead of cash flow, even an efficient stock market is not, by itself, sufficient to discipline such managers and correct their beliefs.
Other explanations of firms’ reluctance to use LIFO are possible. For example, the complexity of the managerial structure of a firm, the slow speed of innovation in organizations, the differential enforcement policy by tax authorities towards LIFO users, the cost of implementing LIFO accounting, the volatility of earnings under LIFO, and expectations of future rates of price change may influence decisions not to adopt LIFO. In addition, managers may use LIFO as a costly device to send credible signals about future prospects of the firm to the shareholders.

**Accounting for Leases**

When the FASB issued *Statement No. 13* specifying criteria for capitalization of leases, its action elicited a managerial response that it did not anticipate. Managers redesigned long-term lease contracts to avoid capitalization and the board was kept busy for several years issuing six modifications and seven interpretations of the original statement in an attempt to plug the “loopholes.” What do managers gain by avoiding capitalization of leases? Explanations tend to follow those given for LIFO.

**The Restructuring of Troubled Loans**

When the FASB proposed that banks recognize the loss in economic value of loans when they agree to restructure troubled loans in favor of the creditors, banks took a unified stand against the proposal. Banks succeeded in diluting the requirements of loss recognition. Under *Statement No. 15*, loss is recognized only to the extent that the undiscounted value of all payments to be received under the restructured debt falls below the original face amount. That is, no loss is recognized unless the effective interest becomes negative.

Why did the bank managers, presumably sophisticated in financial analysis and the workings of capital markets, join hands to oppose the recognition of economic reality in financial statements? They argued that recognizing a loss at the time of loan restructuring would result in (1) a loss of deposits for the banks, (2) a loss of investor confidence in the banks, and (3) borrowers being forced into bankruptcy instead of agreeing to restructure their debts. The bankers succeeded in blocking a proposed accounting standard that would have produced a more “realistic” reporting of the financial condition of banks. Whether the banks’ stand arose from the interests of banking firms as a whole or from the personal stakes of the bank managers in the issue was not debated.

**Cost of Exploration, Research, and Development**

FASB *Statement No. 19* required firms to expense the cost of unsuccessful oil and gas exploration. It was subsequently withdrawn under stiff opposition from segments of the oil and gas industry and the Securities and Exchange Commission. Managers of the mostly smaller exploration firms, who capitalized such costs in
their books of account, argued that this rule would raise their cost of capital and force them to scale back their exploration efforts.

Since 1974, the FASB's Statement No. 2 has required immediate expensing of the costs of research and development. It was argued at the time that such a rule would tend to reduce the research and development outlays of publicly held corporations. Horwitz and Kolodny found evidence in support of such an effect, while Dukes, Dyckman, and Elliot looked for, but could not find, such support.

### Recognizing Option Value as Compensation Expense

In 1993, the FASB proposed that the economic value of stock options granted to employees, mostly managers, be recognized as part of the firm's compensation expense. The proposal faced determined opposition from corporate managers, especially from the high-technology start-up firms. A relatively large proportion of compensation in such firms is paid in the form of stock options. Speaking on behalf of their firms, these managers argued that the accounting proposal would cripple their ability to attract managerial talent and to raise capital. They also argued that estimating economic value of complex options would be difficult and arbitrary in the absence of a liquid market. In 1995, the FASB gave up and issued Statement No. 123 that suggests, but does not require, that firms recognize this expense.

### Rationality of Apparently Irrational Decisions

Many other examples, in addition to those given here, suggest that managers oppose changes in accounting methods that tend to reduce currently reported income. How do we explain such reluctance, especially if the change produces a substantial increase in the size of the economic pie, as is the case with LIFO?

If everyone knew everything, such reluctance to increase the size of the economic pie would be irrational, and there would be little need for accounting. In the world of business, people cannot know everything. They can't even know all there is to know about. People gather what information they can, and try to infer the rest from what they see of others. An action by a participant in the firm is a substantive economic choice as well as a signal to other agents who can see the action or its consequences. Each agent evaluates the direct consequences of his or her action, as well as how the action will be perceived by others. Others' perceptions determine the agent's reaction, and the effect of such reaction on the agent's own welfare. Common knowledge (see Chapter 1) of this action-reaction sequence is impractical.

This imperfection of information may hold a clue to explaining the LIFO puzzle. Suppose that all agents privately know that a switch to LIFO decreases tax payments without affecting other cash flows. This is not enough to ensure that LIFO will be chosen. In order for LIFO to be a rational decision, not only must the managers who make such a choice believe it to be rational, they must be con-
vinced that others, especially investors, believe it also. If managers doubt that investors can see through the accounting veil, it might not be rational for managers to choose accounting methods that would be preferable if no such doubts exist. It is not irrational for managers to believe that investors do not have the information that they might, in fact, have. Some managerial accounting practices may appear paradoxical simply because we may assume that information is common knowledge when, in fact, it is not.

When a manager’s welfare depends on income and a change in accounting method reduces reported income, the manager must ask other participating agents to revise his or her contract just to stay even. Such requests are not necessarily accepted by other agents at their face value. Not everybody is convinced that the change in a manager’s contract is simply an effort to retain the status quo. Some agents may see it as a transfer of wealth to the manager. Managers’ control of information inside the firm makes it even more difficult to convince others. The reaction of other agents to a perceived transfer of wealth to a manager alters their behavior in a way that is expected to reduce the welfare of the manager. Mistaken as such perceptions might be, the manager might have no effective means of combating them, except to refrain from making the accounting change. Thus, the imperfect communication among agents might prevent them from making Pareto improvements (some are better off but none are worse off) in the firm’s contracts.

Observable Behavior of Managers

Managers tend to favor the status quo in accounting methods and resist changes in accounting standards. They use accounting devices to attempt to smooth out sharp changes in income, though not always successfully. Some of their accounting choices can be predicted from characteristics of the firms.

Preference for Status Quo

Accounting changes beget a qualified audit opinion and unfavorable publicity. Even if the change is induced by a new standard from an authority, it means more work, staff training, new software, extra audit fees, an explanation to skeptical directors and investors, and, sometimes, lower compensation for the manager. New standards usually limit the flexibility of the firm in selecting accounting methods. Accounting changes affect the welfare of all agents, yet the accounting system is under the direct control of the managers alone. It is hardly surprising that changes in accounting methods are received with some suspicion by nonmanagerial agents. All agents must incur the costs of adjusting their behavior to the contractual arrangements. If managers have no preference between the status quo and the equilibrium state under the proposed change, these adjustment costs alone are enough to make them prefer the former.
Income Management

Managers use the flexibility in accounting systems and the timing of actual transactions, such as purchases and deliveries, to make their performance look better. Advertising, research, development, exploration, and the write-down of obsolete inventory and equipment have often been cited as areas of substantial discretion to managers. Non-accounting decisions such as capital budgeting, the sale of equipment, and early debt retirement also afford the manager similar opportunities. Changes in accounting principles with respect to inventory valuation, depreciation, recognition of revenue, and so on, can also be used toward the same end. We return to this topic in the next chapter.

Prediction of Accounting Methods by Firm Characteristics

In Chapter 2 we discussed the approximate relationship between three organizational forms and the three forms of accounting. This process could be refined. Accounting methods chosen or preferred by firms can be linked to their characteristics. For example, the preferences of oil and gas exploration firms for methods of accounting depend on their leverage. The preferences of firms toward proposals for general price-level accounting seem to be related to their size, the existence of a management compensation plan, and their involvement with regulatory agencies of the government.

Summary

Managers' interaction with accounting and control is complex. Being at the procedural hub of the firm, they operate its accounting and control system. Because their contributions cannot be measured directly, a substantial part of their compensation is based on accounting measures of output. The accounting system produces evidence on which their reputation or human capital is built. They also play a premier role in designing the accounting system, modifying it in response to changes in the environment, having its output verified by independent auditors, and even manipulating it to their private advantage. In this system, income is perhaps the single most important number. Not surprisingly, much management as well as investor attention is focused on this aspect of accounting. In the next chapter, we analyze the importance of income and its management.

Notes

5. Bertrand N. Horwitz and Richard Kolodny, "The Economic Effects of Involuntary Uniformity in the Financial
CHAPTER 4 Managers and Accounting Decisions


Additional Reading


