Accounting Numbers and Management’s Financial Reporting Incentives: Evidence from Positive Accounting Theory

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Abstract: Accounting information plays a significant role in market-based economies because it is pivotal used by those who provide capital to help in making an informed economic decision. The public accepts the accounting information as the gospel truth without considering the politics underneath in the preparation and presentation of the financial statement. Unsuspected investors rely on the accounting numbers as presented in the published/final account of an entity via financial reporting. The positive accounting theory hypotheses postulated that in the choice of accounting policies underlying the preparation of financial statement there are certain factors like bonus plan, debt covenant and political hypotheses that are put into consideration. Investors to rely on the accounting information must critically examine and understand the reason behind the accounting figures as presented in the financial statement by the directors who are the agents of the entity to be able to make an economic decision as to whether it is proper to invest in such an entity.

Keywords: Accounting Information, Accounting Figures, Market-Based Economies, Positive Accounting Theory.

1. Introduction

Accounting in market-based economies has two important roles to play. Firstly, it affords capital providers (shareholders and creditors) the opportunity to evaluate the return potential of investment opportunities (the ex-ante or valuation role of accounting information) and secondly, accounting information allows capital providers to watch the use of their capital once committed (the ex-post or stewardship position of accounting as an information system) (Anne et al., 2010). This information is prepared and presented through financial reporting as stipulated by the legislation of the local entity and that of the international legislation so far it is not in conflict with the local legislation.

It is the duty of the directors to prepare and present at the end of each financial year financial statements of the entity to the members (shareholders) and any other members such as debenture holders, creditors, government agencies as well as members of the public who may be entitled to the copy of the said statement as stipulated by the law. It is universally believed that the primary reality/objective of financial reporting is the provision of information in in terms of finance about the reporting entity that is of benefit to both present and potentials investors and creditors to be able to make economic decisions as providers of capital. The objective refers to financial reporting which encapsulate all the information contents of published account as a whole and not just financial statement which is a sub set of financial reporting. Therefore, financial reporting concentrates solely on meeting the information needs of the groups who are highly interested in financial information. User group in terms of financial information aims at meeting the needs of those who have claims on the resources of an entity.

The users group consists of shareholders, creditors and other members of the public (the outsiders) who are interested in financial information because that information is useful in decision making as providers of capital. Usually, capital providers make a decision on how to allocate efficiently their resources between or among competing investments. In making this vital and very important decision, accounting numbers as reflected in the financial reporting serves as information used in assessing the entity being able generate positive cash flows and management as a form of stewardship accounting. Thus, the financial position changes in equity as well as cash flows statement serves as a decision-making process.
Financial reporting is the vehicle through which the management/directors render their account of stewardship to the shareholders. According to Lennard (2007) “Stewardship contributes an important dimension to financial reporting, which should be reflected by a specific acknowledgment in the purpose of financial reporting. Moreover, stewardship accounting should not depict simply accounting information as a mean to help in assessing how competent a steward is as well as integrity of ‘stewards’ that is management/directors, but as the process of providing information as a basis for constructive discourse between management and shareholders. Although to ensure validity, reliability and correctness of information contained in the financial statements, the provision of the law is there through which the financial statements so prepared by the directors is subjected to the scrutiny of the independent third party; therefore the basis for auditing.

This work is designed as a theoretical framework which can be tested empirically by interested researchers to confirm or otherwise the rationale behind accounting figures as prepared and presented by the directors.

2. Literature Review
A lot of work had been done on the positive accounting theory hypotheses by researchers like Patten (1991); Hines (1988); Healy (1985); Chambers (1993); Hagerman and Zmijewski (1979); Holthausen and Leftwich (1983); Watts (1977); Wong (1988); Soderstrom and Sun (2007); Ahmed and Duellman (2007) as well as Benston (2006). Additionally, the theories associated with financial reporting were considered.

3. Stewardship Theory
As far business entities are concerned, the need for accounting is being emanated as a result of agency theory. The agency theory is brought about as a result of the conflict between ownership and management. Agency theory has to do with how to resolve two problems that can occur in an agency relationship. The first problem arises when: (a) the interest of the principal and agent conflict, and (b) it is difficult or impossible for the principal to affirm what the agent is actually doing. The main problem is that the principal cannot affirm that the agent has behaved in an appropriate way. Secondly, the problem has to do with how risk is shared in a situation where the principal and the agent have different perceptions towards risk and therefore prefer different actions (Eisenhardt, 1989). However, in the work of Davis et al. (1997), stewardship theory insinuates that management tends to be more enthusiastic to act in the best interest of the organisation than in their own self-interest. Steward theory opines that senior executives over time tend to view the organization as an extension of them. Rather than use the firm for their own benefits, these executives are more interested in assuring the continuity and success of the organisation. Thus, stewardship theory suggests that in many occasions top management may care more about a company’s long-term success than do more short-term oriented shareholders.

4. Agency Theory
As suggested in the work of Berle and Means (1936) as quoted by Alayemi et al. (2014) is that top managers are employees who may very likely to be more self-interested in their welfare against that of the shareholders (principals). The agency problem arises when (a) the interest or objectives of the owners and the agent's conflict or (b) it is very difficult or expensive for the owners to verify the actual action of the agent. Therefore, to better align the interest of the agent with those of the owners and to increase the organization’s overall performance, agency theory suggests that top management degree of ownership in the firm should be significant or have a strong financial stake in its long-term performance. In support of this argument, research indicates a direct relationship between organization’s performance and a number of directors shareholding.

5. Stakeholder Theory
Stakeholders are defined as individuals or groups with legitimate interests in procedural and substantive aspects of the activity of the organisation. This shows that the stakeholder theory objective viewpoints are to satisfy the interests of each group (the principal and the agent) and not as a mean to achieve other goals. Hence, stakeholder theory is used to interpret the function of organizations in the identification of moral or philosophical guidelines governing the management of organisation (Hichem and Hedi, 2013). Freeman (2004) stated “The principle of stakeholder recourse”. Stakeholders may bring an action against the directors for failure to perform the required duty of care.
6. Veil Behind Information in Financial Reporting

The way elements from which the financial statement is recognized, measured and constructed are greatly influenced not only by the accounting standards but by the directors to show what they want the information to look like. This is the proposition of the proponents of positive accounting theory hypotheses.

Three major hypotheses as propounded by Watts and Zimmerman (1986) are as follows:

1. The bonus plan hypothesis states, ceteris paribus managers of firms with bonus plans are more likely as a matter of choice choose accounting procedures that shift reported earnings from future periods to the current period. By doing so, they can increase their bonuses for the current year.

2. The debt covenant hypothesis states .ceteris paribus, the closer a firm is to violate accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period. Increasing current earnings, the company is less likelihood to violate debt covenants, and management has reduced to the barest minimum its constraints in running the company.

3. The political cost hypothesis states that ceteris paribus, the greater the political costs faced by the firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods. This is because high profitability can lead to increased political “heat”, and can lead to new taxes or regulations.

Then, the pertinent question is what is the reason for the making of accounting choices as they do by the management. According to intentionalism, as propounded by Fay (1996) the explanation revealed that the disposition of the agent determines what accounting choices will be made in other to concealed certain things from the principal (the shareholders). Thus, choice of accounting policies is determined by and large by what the agent has in mind. The validity of explanation does not depend on the regularity of the particular accounting choice behavior in the same situations by the agent himself or herself and others (Lessnoff, 1974). This is because the human beings cannot be predicted because they do not always behave or respond to the same action in the same situation. Two persons can take two different actions in the same situation and the same action in different situations.

Benston (2006) provided evidence on the use of accounting choice in a different situation on the extensive use of fair value by Enron and argued that misuse of fair value by management contributed to its demise. Byrne et al. (2008) have reported substantial variations in assumptions – discount rate, wage growth, expected return on equity, discount rate spread, and equity return spread – used in fair value accounting for pensions in the UK. They have further suggested that the variations in assumptions are related not to economic fundamentals but to management’s motives to inflate income from pension scheme assets. The PAT literature documents that management manages reported earnings to serve its purpose (Watts and Zimmerman, 1986).

7. Conclusion

As a result of the industrial revolution in the 1900s the management of an entity was divorced from the owners (the shareholders). The management/directors statutorily must render an account of their stewardship at the end of the accounting period. There is a conflict of interest by this type of arrangement. How reliable is the accounting figures in the financial information? What factors are put into consideration in the choice of accounting policies which is the cornerstone of the information contents of financial reporting? Whose interest are the directors protecting? Hence, the providers of funds and any other stakeholders, as a matter of fact, must try as much as possible to unravel the veil behind the accounting figures in the financial statement as presented by the directors through financial reporting. Hence to unravel the reason for any figure whatsoever in the financial reporting of an entity and whether to invest one resource in an entity, there is a need to analyse critically the information provided in the financial statement. Accounting figure is a puzzle, the more you look the less you see.

Reference


