FIRM'S OWNERSHIP STRUCTURE AND ITS ACCOUNTING POLICY CHOICES – A LITERATURE REVIEW

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Choices about accounting methods which firms adopt can have economic implications when a specific reporting treatment affects a company's cash flows, and their distributions among a firm's stakeholders (e.g. shareholders, managers, bondholders etc.)[1]. Assuming that each individual aims to maximise his utility, it is sensible to expect that he will prefer a higher to a lower cash flow surplus (Grinyer, 1986). Therefore, when the adoption of a particular accounting methods can increase, or decrease, different stakeholders wealth, these parties have an apparent motive for preferring certain accounting methods (Watts and Zimmerman, 1978; and, 1986). When financial and tax accounting treatments coincide, the choice of a reporting method for financial accounting purposes has important cash-flow implications, through its impact on the level of a firm's tax burden (Wolfson, 1993; Cloyd *et al.,* 1996). A tax-reducing strategy, therefore, can have positive cash-flow implications. As a consequence, assuming investors' rationality and efficient capital markets, accounting methods that minimise taxable income should be preferred (Biddle and Lindhal, 1982; Niehaus, 1989). However, if the reduction of a firm's tax liability is usually accompanied by a corresponding decrease in the firm's reported income, the implications of a tax-reducing strategy may not always be beneficial for those who have a stake in the firm. In other words, the implications are not necessarily identical for every stakeholder; it may not even

1. Notice that it is not assumed that the firm has a utility function. As Jensen (1983) has put it: "Organisations do not have preferences, and they do not choose in the conscious and rational sense that we attribute to people." (p. 327). The firm within the neo-classical economics is conceived as "...a production function to which maximisation objective has been ascribed." (Williamson, 1981, p. 1539; see also Demsetz, 1983; and Jensen, 1983). This perception of the concept of the firm has been developed in order to facilitate neo-classical economics main objective which is: "...to understand how the price system co-ordinates the use of resources, not to understand the inner workings of real firms."(Demsetz, 1983, p. 377; see also Jensen, 1983). Despite the merits of this approach for the analysis of the functions of market mechanism, it is not a particularly helpful one in developing a theory concerning organisations' structure and internal modes of behaviour (Jensen, 1983).

be identical for the same party under all circumstances[2]. Under certain circumstances, a strategy aimed at increasing tax savings may negatively affect the wealth of various parties involved in the firm, including those that implement it[3]. The adverse consequences of a tax-reducing policy designate the non-tax costs of such a policy; in most cases these are related to a reduction in the level of reported financial figures; the non-tax costs are alternatively called the financial accounting costs of a tax-reducing policy. In any case, each firm's stakeholder is presumed to weigh the tax benefits against the costs that accompany a tax-reducing policy (Cloyd *et al.*, 1996).

The firm's ownership/control status has been identified as a factor that gives rise to significant non-tax costs, and influences the balance between tax benefits and non-tax costs[4]. This study aims to present the arguments that have been articulated regarding the impact that firm's ownership/control status may have on firm's accounting policy decisions and more specifically on the balance between the tax benefits and non-tax costs that may result from those decisions. Furthermore the findings of empirical research aiming to examine the association between firms' ownership/control status and their accounting policy choices are reviewed.

Firm's ownership structure and non-tax costs

The non-tax costs of tax planning often arise as result of the

2. See, Scholes, Wilson and Wolfson, (1990); Scholes and Wolfson, (1992); Wolfson, (1993).
3. See, Scholes and Wolfson, (1992); Wolfson, (1993); Cloyd *et al.*, (1996); Klassen, (1997).
4. Others factors that can influence the balance between tax benefits and non-tax costs are (i) management's perceptions about the impact of accounting figures on the firm's value, (ii) the perceptions of external parties regarding management's efficiency and ability, (iii) the perceived influence that reported figures can have on the ability of a firm to raise debt-capital at reasonable costs, (iv) the various regulatory and lending-related constraints that a firm may face (see, Scholes and Wolfson, (1992); Wolfson, (1993); Cloyd *et al.*, (1996); Klassen, (1997).

fact that in order to maximise tax savings, it is usually necessary to accelerate expenses or to waive revenues (Cloyd *et al.*, 1996). Such a policy, though, will usually reduce the level of reported profits. In efficiently functioning capital markets, firms' shareholders are assumed to respond adversely to lower cash flows, since the value of their stockholdings in a company is a function of the underlying cash flows (Biddle and Lindhal, 1982; Abdel-Khalik, 1985; Hunt, 1985). As a consequence, a firm's owners are expected to prefer that their firm is involved in tax planning in order to maximise the present value of any tax savings; since, according to Niehaus (1989):

> "In a well-functioning capital market, higher tax liabilities imply a lower share price, *ceteris paribus*." (p. 270)

However, the resulting reduction in the financial accounting figures can have real wealth implications for a firm's management. The extensive use of compensation and bonus schemes based on accounting-numbers, means that a manager's utility becomes a function of the level of bonus payments, which in turn are a function of the level of reported profits[5]. Since managers are assumed to maximise their utility, which is directly related to their compensation, it is logical to hypothesise that they will prefer higher to lower compensation (Watts and Zimmerman, 1978, and 1986; Zmijewski and Hagerman, 1981). Given that different reporting methods have different impacts on the level of reported profits, and as result on the level of a manager's compensation, a firm's managers will not be indifferent to differences between different accounting methods. They are more likely to prefer accounting treatments that will result in higher rather than lower reported profits. As Hagerman and Zmijewski (1979) point out:

> "If management incentive schemes are related to account-

5. See, Watts and Zimmerman, (1978), and (1986); Zmijewski and Hagerman, (1981); Dhaliwall *et al.*, (1982); Kelly, (1983); Healy, (1985); Pavlik *et al.*, (1993).

ing earnings we expect that management has an incentive to use accounting principles that increase accounting earnings if part of their income is derived from incentive plans." (p. 145)[6]

Empirical research has discovered that the use of accounting-based bonus plans does not necessarily imply that managers will prefer earnings-increasing reporting methods[7]. Yet it is quite likely that a reduction in reported profits as a result of an active tax-planning strategy will, in most cas-

6. A necessary prerequisite for bonus plans to induce certain managers' preferences with regard to reporting methods is that the compensation committee which supervises compensation schemes and bonus plans does not adjust the provisions of relevant schemes in response to changes in accounting standards (see, Healey, Kang and Palepu, 1987; Niehaus, 1989). Healey *et al.*, (1987) have not found any evidence which supports that in response to changes in accounting methods "..., reported earnings are transformed to earnings under the original accounting method for computing compensation awards." (p. 32). On the other hand, the parameters of the compensation plan are modified subsequently to a change in accounting method. However, even in these cases the adjustment seems to be partially related to wider industry and economy related developments. On the basis of these findings Healy *et al.* conclude that the hypothesis that : "...the compensation committee nullifies the effect of an accounting on bonus and salary awards by modifying the parameters of the compensation-earnings relation." (p. 33) cannot be rejected. However, this finding is inconclusive given "...the effect of the accounting change on compensation,.., is too small compared to the time-related effects to allow us to discriminate between the null and alternative hypotheses." (p. 33). Furthermore, Healy *et al.* provide evidence which suggests that changes in accounting methods which are supposed to result in a decrease of reported income, and therefore to be unfavourable for top executives remuneration, do not appear to have a substantial effect on senior managers salaries and bonus payments, especially if the effect of economy and industry wide changes on compensation over time is taken into account. More specifically, the Healy *et al.* study indicates economy and industry wide factors - which are contemporaneous but unrelated to the accounting methods change - will result in compensation increases which will more than set-off the potentially decreasing effects of changes in accounting methods such a switch from FIFO to LIFO inventory method or from straight-line to accelerated depreciation method.
7. Healy (1985) has provided evidence which suggests that when bonus plans include terms which define an upper limit on the level of bonus payment, managers may have an incentive to adopt earnings-decreasing accounting treatments.

es, reduce the level of bonus compensation and therefore a management's wealth. Thus, through the pursue of a tax-reducing policy, non-tax costs ensue for those managers whose remuneration is dependent to a significant extent on bonus compensation. These implications have been hypothesised to be more significant for the management of widely-held firms, since accounting-determined compensation schemes are primarily used by investors in these firms for monitoring and motivating the top management.

The dispersion of a firm's share capital over a large number of shareholders characterises modern industrial concerns. Due to this development, the individual shareholder has seen his ability to oversee the conduct of companies' management to diminish[8]. As a consequence, management has become increasingly independent from shareholders and increased their effective control over a firm's affairs[9]. Under these circumstances, questions have been raised about whether a firm's management will maximise shareholders' wealth; in other words, if they will they act in the shareholders' interests[10]. It has been argued that management will pursue such personal goals, even at the expense of owners' interests. Managers' aspirations for security, in-

8. See, Monsen and Downs, (1965); Galbraith, (1967), and, (1973); Demsetz and Lehn, (1985).
9. For the purposes of the present study the definition of control provided by Smith (1976), seems sufficient: "...control refers to the power to direct the affairs of the corporation or to determine the broad policies guiding the corporation. Control, used in this sense, does not necessarily imply active decision making of the firm, but it does imply involvement in the making of more fundamental decisions such as the selection of management." (p. 709). With regard to the effective control of company's affairs by non-owners managers of corporations see, Hindley, (1970); Scherer, (1980); Demsetz, (1983); Williamson, (1984).
10. See, Berle and Means, (1968 [1932]); Monsen and Downs, (1965); Williamson, (1981). Berle and Means (1968 [1932]) who expressed their doubt, as they state: "...have we any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners? The answer to this question will be depend on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions." (pp. 113-114)

creased salaries, enhanced power and prestige, can prompt them to direct funds to operations and activities which do not necessarily contribute to the maximisation of owners' utility[11]. In general, it has been maintained that, in the case of separation between management and ownership, a firm's top management is very likely to make financial and investment decisions that do not necessarily aim to maximise shareholders' value[12]. Under these circumstances, the firm's shareholders may devise mechanisms which will motivate the firm's management to pursue policies which will further the owners' interests (Dhaliwall *et al.,* 1982; Watts and Zimmerman, 1986). Bonus-schemes and/or compensation plans constitute such a mechanism[13]. The basic rationale that underlies the usage of such incentives-schemes[14] is

11. See, Williamson, (1963); Berle and Means, (1968 [1932]); McEachern, (1978). For instance, Williamson (1963) maintains that management may have a preference for types of expenditures - i.e. staff expenditures, emolument expenditures, availability of funds for discretionary investments - that will enable it to achieve the aforementioned objectives. Those expenditures, however, "...have value additional to which derives from their productivity" (Williamson, 1963, p 1034; see also Monsen and Downs, 1965).
12. See, Monsen and Downs, (1965); Scherer, (1980); Hunt, (1986). The notion that the separation of management from ownership is widespread among the large industrial corporations is not unanimously accepted. Evidence has been provided which suggests that among the largest American firms the diversion between management and ownership has not been as widespread as it has been believed or hypothesised to be (see, e.g. Chevalier, 1969; Burch, 1972; Pederson and Tabb, 1976; Scherer, 1980; Demsetz, 1983; Hunt, 1986). In addition, the diversion between ownership and management that allegedly characterises modern corporations is a development that is peculiar to the US and the UK. In the industrial concerns of Continental Europe and Japan there appears to be a strong link between the ownership interests and management (see, Choi and Mueller, 1984; Meek and Saudagaran, 1990; Wolfson, 1993; Galbraith, 1994).
13. See, Demsetz, (1983); Healey, (1985); Raviv, (1985); Watts and Zimmerman, (1986). It is assumed that managers do not own any proportion of a firm's stock capital. In case they own a proportion of a firm's share capital, they have an incentive to abstain from value reducing actions. Assuming rational expectations, the market will anticipate any opportunistic managerial behaviour, and will discount the value of the stock outstanding. Thus, managers will bear the cost of a value-reducing action.
14. Raviv (1985) propose two additional explanations for the employment

that by connecting managers' compensation with a company's performance, the interests of shareholders and managers will be aligned[15] (Jensen and Zimmerman, 1985; Pavlik *et al.,* 1993). As Cloyd *et al.* (1996) state:

> "..., the diffuse ownership of public firms causes public shareholders to rely more heavily on formal controls, written in terms of accounting numbers to control management's activities." (p. 28)[16]

There are a number of reasons why in owner-controlled firms, the need for compensation plans is less apparent. Firstly, the owner-managers will refrain from value-reducing actions, since the cost of such actions will borne by themselves[17]. Conversely, the managers of management-

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of compensation plans. According to the first explanation compensation contracts function as mechanism which aims: "...to screen and sort among managers of various ability levels." (Raviv, 1985, p. 243). Compensation plans are aimed to attract and retain the most efficient managers, while less efficient ones are discouraged to apply or impelled to resign. Under the second exegesis regarding bonus-schemes are used as instruments for signalling to the market "good news" concerning the firm. It is supposed that a convincing way to communicate that information to the public is to connect : "...the managers' compensation to the measure of performance which they trying to signal." (Raviv, 1985, p. 243). It should be noted that both of these explanations do not assume any conflict of interest between owners and managers.

15. The findings of empirical studies suggest that markets perceive that compensation plans and bonus schemes facilitate an alignment between the interests of owners and managers (Jensen and Zimmerman, 1985; Hunt, 1986; Pavlik *et al.,* 1993). The executives' compensation appears to be positively related with stock price changes (see, Murphy, 1985; Coughlan-Schmidt, 1985), while the introduction of compensation plans - short-term and long-term alike - are related to an increase in the firm's stock prices (Larcker, 1983; Brickley *et al.,* 1985; Tehranian and Waegelein, 1985). Furthermore, it appears that firms which employ long-term incentive performance plans significantly outperform firms which do not around the announcement date of acquisition (Tehranian *et al.,* 1987 a) and disposition (Tehranian *et al.,* 1987 b) of important business sections.
16. Despite the fact that Cloyd *et al.* (1997) do not explicitly refer to management-controlled firms, they implicitly do so, since public firms characterised by diffused ownership are most likely to be management-controlled ones.
17. See, Jensen and Meckling, (1976); Salamon and Smith, (1979); Kelly,

controlled firms, due to the fact that they own only a very limited proportion of stock capital - or no proportion at all - are less likely to refrain from value reducing actions, since the effect on their welfare from any reduction in the firm's value will be minimal or non-existent (Watts and Zimmer-

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(1983); Watts and Zimmerman, (1986). It should be noted that the fact that there is no separation between management and ownership does not necessarily mean that the owner-manager will pursue value maximisation policies (McEachern, 1978; Demsetz, 1983; Demsetz and Lehn, 1985). McEachern (1978) argues that owner-managers, as the managers of management-controlled firms, may have a tendency towards building economic and industrial empires - i.e. increasing firms' size - sacrificing in many instances, however, firms' profitability. Schcumpeter (1934) referring to owner-entrepreneurs, argues that their behaviour can be driven from not entirely rational - in economic sense - motives, and thus the expansion of their firms can take proportions out of the economically justifiable ones. The motive behind economic actions can be: "...the will to conquer: the impulse to fight, to prove oneself superior to others, to succeed for the sake, not of the fruits of success, but of success itself. From this aspect, economic action becomes akin to sport - there are financial races, or rather boxing-matches. The financial result is a secondary consideration,..." (p. 93). Within a similar context Knight (1921) argues that: "...we must emphasise the impulse to create."(p.162) and "The business man has the same fundamental psychology as the artist, inventor, or statesman." (p. 163), while "...the desire for the increased income is not the dominant motive in much of this proved by the fact that men invest as desperately in an enterprise never likely to be profitable as they do in the most prosperous concern,..." (p. 162). In addition, the presence of owner-managers does not necessarily lead to an absence of shirking. Demsetz (1983) argues since the owner-manager spends a considerable number of hours in a job is quite likely that he will increase his at-job-consumption regardless of the potentially decreasing effect that will have on firm's profitability (see also Demsetz and Lehn, 1985). In fact, given that owner-managers are supposed to face relatively fewer external constrains that can enforce them to follow value-maximising policies, are more likely to undertake actions that are usually ascribed to managers of management-controlled firms (McEachern, 1978). Thus, McEarchen argues that: "The owner-managed firm may therefore operate like an extreme form of manager-controlled firm,..." (p.259). The empirical research does not seem to provide a conclusive evidence of whether management-controlled firms significantly differ from the owner-controlled ones, with respect to their performance and other related issues. A number of studies by examining and comparing various performance indicators of owner and management-controlled firms have concluded that owner-controlled firms on average appear to be the more profitable (e.g. Monsen *et al.*, 1968; Hindley, 1970; Larner, 1970; Boudreux, 1973;

man, 1986). Secondly, in the case of closely-held firms the extensive involvement of a firm's owners in the administration of the company ensures a close monitoring of managers' conduct and directly motivates their performance. In such circumstances, the need for introducing compensation/bonus plans is not pressing[18]. Empirical evidence seems to support the argument that the employment of compensation plans is associated with the ownership/control status of the firm (see, Collins *et al.,* 1981; Cloyd *et al.,* 1996). It appears that the executives of management-controlled firms, due to extensive use of accounting-based bonus plans in these firms, can face substantial non-tax costs when an active tax-

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Plamer, 1973; Stano, 1976). On the other hand, an indication has been provided that does not support the assumption that the manager-controlled firms will be significantly less profitable comparing to the owner-controlled ones (Kamerschen, 1968; Radice, 1971; Elliot, 1972; Sorenson, 1974; Holl, 1975; Ware, 1975; Demsetz and Lehn, 1985). It should be noted that some of the empirical studies mentioned above have indicated that the relationship between ownership structure and a firm's performance is not a straight-forward one. For instance, Plamer's (1973) findings suggest that only in industries characterised by a high degree of monopoly power do management-controlled firms appear to be significantly less profitable comparing to their owner-controlled counterparts. The infirm constraint imposed by the market competition provide to these firms' managers with the opportunity of diverging from profit-maximising behaviour. Similarly, Holl (1975) notices that a firms' industry classification influences the explanatory power of ownership-structure with regard to the performance characteristics of the two group of firms. As far as the hypothesis that the managers' preference for expansion and certain type expenditures concerns, again the existing evidence is not altogether conclusive. It has been hypothesised, for instance, that the management-controlled firms will demonstrate a strong tendency towards profits' retention as opposed to dividend's payments, since retained earnings constitute a source of funds for financing expansion and for expenditures discretion (see, Hunt, 1986). The findings of empirical research, however, do not seem to support this hypothesis, since they testify that the dividend payout ratios for the management-controlled firms are higher than the respective ratios for owner-controlled firms (see, e.g. Kamerschen, 1970; Sorenson, 1974; Holl, 1975; Ware, 1975). Hunt (1986) concludes that: "...the evidence is quite convincing that, contrary to the predictions of the managerialists, owners who are also managers of a firm appears to have a higher preference for retained earnings than managers of other types of firms."(pp. 97-98)

18. See, Smith, (1976); Salamon and Smith, (1979); Dhaliwall *et al.,* (1982); Kelly, (1983); Penno and Simon, (1986).

reducing policy is followed. Managers of owner-controlled firms, on the other hand, are not supposed to face similar non-tax costs. Thus, they can get involved in tax-planning more aggressively[19].

The above discussion presupposes that managers of a widely-held firm own an insubstantial proportion of a firms' share capital - or no proportion at all. Yet, it has been suggested that managerial ownership of a substantial proportion of a firm's share capital can align managers' and shareholders' interests[20]. Additionally, it should be noted that compensation plans are not exclusively based on reported earnings. Managers' remuneration may be linked with a firm's stock value by correlating managers' compensation with company's share price, or by offering stock-options to managers instead of directly paying them cash bonuses (Kelly, 1983). When ownership of a firm's stock capital constitutes a substantial proportion of managers' personal wealth[21], managers have a personal interest in ensuring that value-reducing actions are avoided; otherwise managers will bear the cost of undertaking such actions. Demsetz (1983) argues that:

> "..., [managers] receive incomes that are highly correlated with stock performance. This correlation derives not only from bonuses but also, to a surprising degree, from managers' ownership of stock. Ownership and control are not so separate as is often supposed."(p. 388). Therefore: "...managers' sharehold-

19. See, Smith, (1976); Dhaliwall *et al.*, (1982); Scholes and Wolfson, (1992); Wolfson, (1993); Cloyd *et al.*, (1996); Klassen, (1997).
20. See, Demsetz, (1983); Benston, (1985); Jensen and Zimmerman, (1985); Hunt, (1986); Pavlik *et al.*, (1993).
21. It should be noted that, what is of importance is not so much what percentage of a firm's share capital is owned by managers, but what proportion of their personal wealth this percentage constitutes (see, Kelly, 1983; Demsetz, 1983; Benston, 1985). As Benston (1985) states : "... a very small percentage of a large publicly-traded company is a lot of money....". "For executives (as for other people) the determining variable is the amount of the executives total wealth invested in the companies they manage."(p.72). Lewellen (1969) indicates that for top executives the stock-based compensation exceeds four times their after-tax compensations. Demsetz (1983) provides evidence which suggests that a considerable proportion of firms' share capital is owned by top executives in all but most largest firms (see, also Murphy, 1985).

ings create a substantial linkage between the financial interests of managers and those of outside shareholders." (p. 389)[22]

Thus, when stockholdings constitute a substantial proportion of executives wealth, tax-reducing policies may be pursued, since they constitute a value-increasing choice. Niehaus (1989) argues that high managerial ownership tends to reduce the conflict of interest between owners and managers with respect to the trade-off between tax benefits and non-tax costs. In any case, managers will face the trade-off between increasing reported profits, and as a result increasing their remuneration, or increasing tax benefits and thus increasing their wealth, due to a rise in the value of any stock or stock options which they hold. The outcome of this trade-off will ultimately be dependent on what proportion of a managers' wealth each of the above elements constitute. In other words, the more correlated managers' personal wealth is with stock values, the more likely it is that they will pursue a tax-reducing policy, since that policy will *ceteris paribus* result in the increase of their overall wealth.

It has been argued that managers have an incentive to refrain from value-reducing actions, irrespective of the size of their equity stake in the firm. The competition in labour market for managerial skills can induce managers to abstain from value-reducing actions[23]. This competition can be both external and internal. Assuming that the labour market is efficient, it has been argued that managers will restrain from value reducing actions in order to avoid unfavourable adjustments to their compensation. It has been suggested that when outside directors are appointed to the board of directors, the monitoring and disciplinary func-

22. Findings of empirical research seem to support this argument. More specifically, Lewellen *et al.* (1985) and Tehranian *et al.*(1987, a and b) provides that stock-market returns are positively correlated with the proportion of managers' shareholdings. Walking and Long (1984, as cited in Jensen and Zimmerman, 1985) provide evidence that extensive management shareholdings lessens the friction between the interests of managers and owners in the case of take-over (see, also Pavlik *et al.*, 1993).
23. See, Zimmerman, (1979); Fama, (1980); Fama and Jensen, (1983); Watts and Zimmerman, (1986).

tions assumed by the board can constitute an effective control of management's decisions and conduct[24]. Because the value of outside directors' human capital in labour marker for corporate directors will be evaluated on the basis of their performance, they have an incentive to perform their tasks responsibly and efficiently (Fama, 1980; Fama and Jensen, 1983; Beasley, 1996). Similarly, the fear of professional disgrace that may result from not strictly fulfilling their duties can prompt outside directors to apply strict controls on managers' actions (Ricardo-Campell, 1983). It seems, therefore, that outside directors have important incentives for restraining managers from any opportunistic action which may hurt owners' interests (Ricardo-Campell, 1983). As Ricardo-Campel stated:

> "The stockholders or risk takers, through the directors, whom they elect, do have some monitoring and decision controls. Ownership and management are not completely separate." (p. 393)[25]

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24. See, Fama, (1980); Fama and Jensen, (1983); Ricardo-Campell, (1983); Williamson, (1984). However, when the board of directors is dominated by inside-directors its ability to adequately perform its controlling and monitoring duties can be seriously impeded. Top officials after succeeding securing a membership in the board of directors may "...decide that collusion and expropriation of security holder wealth are better than competition among themselves" (Fama, 1980, p.293; see also Hindley, 1970; and Beasley, 1996). Yet, Williamson (1984) argues that the fact that an extensive participation of top managers in the board of directors is likely to undermine a board's ability to perform its controlling duties does not necessarily means that managers should completely excluded from it. He identifies three benefits that can ensue from managers' membership in the board of directors. Firstly, it enables outside directors to gain a first hand experience of management's conduct and competence, and as result facilitates boards' function as a supervising and governing body. Secondly, the board's decision making function is facilitated by the fact that managers' participation improves the board's ability to collect necessary information. Thirdly, it can help in preserving the occupational relationship between management and the firm. Williamson stresses, however, that a boards' main responsibility is to protect shareholders' interests, and therefore managers' participation should be restricted within the limits that enables it to adequately perform its duties.
25. Results of empirical studies seem to support the argument that inclusion of outside directors significantly enhances the controlling and monitor-

Thus, outside directors are supposed to detect any value-reducing behaviour of the top managers, and arrange managers' compensation accordingly. Furthermore, if a firm's management is involved in value-reducing actions, this information will eventually become known and their professional reputations will be impaired. Thus, even if a manager's salary is not affected at present, it will most likely be affected in the future. Consequently, a manager who is not going to retire in the near future has an incentive to refrain from being involved in actions that harm shareholders' interests (Fama, 1980). As Demsetz (1983) argued:

> "Managerial personnel are also quite concerned about the value of their services to other firms that may seek to employ them. The many years of investment in human capital and reputation are not lightly put at risk in the pursuit of advantages offered by shirking.[an example of value-reducing action]" (p. 387)

Additionally, competition within the firm may impose restrictions on managers' behaviour. Senior managers have an incentive to examine and control the efficiency of subordinate managers, since the former' executives compensation and promotion can be determined, among others, on the basis of their ability to adequately perform such a duty. Similarly, the subordinate managers are induced to monitor their superiors, since their promotion prospects are enhanced by doing so (Fama, 1980). Furthermore, the welfare of subordinate manager is affected by their superiors' value-reducing behaviour, since the value of their human capital in the labour market is negatively affected as a result of that

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ing efficiency of that body. Lee *et al.* (1992, as cited Beasley, 1996) indicate that in case of management buyouts, that shareholders' wealth increases when the majority of the members of the board of directors is consisted by outside directors, while the appointment of outside directors appears to be connected with positive share price reactions (Rosenstein and Wyatt, 1990). The inclusion in the board of directors of outside ones seem to result in a decrease in the level of expenditures related with salaries' payments (Brickley and James, 1987, as cited in Beasley, 1996). Moreover, the proportion of participation in the board of directors of outside directors appears to be negatively correlated with the likelihood of financial statement fraud (Beasley, 1996).

behaviour. Consequently, subordinate managers have an obvious incentive to prevent their superiors from taking value-reducing actions (Fama, 1980; Zimmerman, 1979; and Fama Jensen, 1983). Zimmerman (1979) states: "As the superior's decisions start to impinge on the subordinate's welfare, the subordinates either try to convince their superior to eliminate the wealth-reducing expenditures or they go directly to their superior's principal." (p.510). It appears, therefore, that competition in the labour market can give rise to mechanisms that will limit managers' ability to undertake value-reducing actions that may be harmful to owners' interest. As Fama (1980) states:

> "The viability of the large corporation with diffuse security ownership is better explained in terms of a model where the primary disciplining of managers comes through managerial labour markets, both within and outside of the firm,..." (Fama, 1980, p.295)

Additionally, the competition in the market for corporate control has been advanced as mechanism that can refrain top management from assuming value-reducing activities[26]. For example, Manne (1965) argues that:

> "Only the take-over scheme provides some assurance of competitive efficiency among corporate managers and thereby affords strong protection to the interests of vast numbers of small, non-controlling shareholders." (p. 113)

According to Scherer (1980), the market for corporate control can restrict management's opportunistic actions, and indeed prompt them to pursue policies that will be in shareholders' interest, since failure to maximise value:

> "...will depress company stock prices below their potential value; this will induce some outside entrepreneur to bid for a controlling interest, remove the old management, and re-

26. See, Manne, (1965); Hindley, (1970); McEachern, (1978); Marris and Mueller, (1980); Scherer, (1980); Demsetz, (1983); Fama and Jensen, (1983); Hunt, (1986).

direct the company's energies toward increasing profits and hence stock values." (p.37)

Thus, the labour market and the market for corporate control are assumed to exercise pressures on managers which can restrain them from undertaking value-reducing actions. As a consequence, managers are supposed to adopt accounting policies that maximise a firm's value. Within this context it is reasonable to expect that considerations regarding non-tax costs will not affect their decision making. As a result, tax-minimising strategies which result in an increase in the after-tax value of the firm will be pursued. If the above mentioned arguments are valid, then there should be no significant difference between the accounting choices of the management and owner-controlled firms[27]. However, the ability of these mechanisms mentioned to check management discretion is called into question.

Doubts have been expressed about whether the board of directors, can effectively execute its monitoring role even when outside directors are present. Mace (1971, as cited in Scherer, 1980) argues that in management-controlled firms, outside members are usually selected by inside top managers. Furthermore, because top management work full-time and have detailed knowledge about the operations of the firms, they can control the information released to the board of directors. As a consequence, outside directors may be kept inadequately informed about the corporation's operations, and play a rather passive role within the board. Thus,

27. An alternative approach to the issue of a potential conflict of interest between managers and shareholders with respect to tax benefits vs. financial reporting costs can be provided by the arguments developed by Grinyer (1986). While Grinyer is not explicitly concerned with the issue of tax and non-tax considerations relating to an accounting-policy choice, his arguments can be relevant. He argues that managers prefer higher to lower cash-flows anyway, since high cash flows provide them with opportunities to directly increase their wealth and well-being - e.g. increased salaries, perquisites etc. - and their job security by reducing the possibility that the firm will not meet various financial constraints. Within this context it can be argued that managers will get involved in tax planning since by doing so they increase the available cash-flows. It should be noted that Grinyer does not make any inference regarding the

the board of directors becomes an instrument which perpetuates managers' control without being able to effectively monitor and control their conduct (Williamson, 1984). Scherer (1980) concludes that:

> "„there is reason to believe that, at least in management-controlled corporations, the board of directors does not impose much restraint on management's operating discretion." (p.33)

Likewise, the efficiency of the market for corporate control as a controlling mechanism has been questioned. If the market for corporate control is to constitute an effective control over top management's decisions and actions, it must be efficient and the value of controlling interests must exceed transaction costs (see, Hindley, 1970). However, Hindley (1970) has provided evidence which suggests that market control is not wholly effective. Furthermore, it appears that the transaction cost of displacing top management may be high. Thus, the threat of take-over may not be that effective a mechanism for compelling management to pursue value-maximising policies[28]. In addition, it has been argued that top management, due to its controlling interest in the company, can influence the information disclosed to shareholders in a way that presents the firm's performance and management's efficiency, in a favourable light (Monsen and Downs, 1965; Williamson 1967, in Phillips and Williamson (ed.), 1967). As Monsen and Downs (1965) argue:

> "*Carefully screening all information which is forwarded to stockholders or the public at large* so that it reflects an outstanding management performance" and "..., it is quite easy for managers to conceal great deal of inefficiency from such

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distribution of the increased cash flows between various firms parties. The distribution will be dependent on factors "...such as the relative power of different groups of participants, institutional controls, managers' perceptions and preferences, and the level of completeness and breadth of distribution of economic information about the firm." (p. 320)

28. See, Manne, (1965); Williamson (1969), in Manne ed. (1969); Scherer, (1980); Demsetz and Lehn, (1985).

> [professional reporting agencies] "outsiders",.." (p. 232) [their italics]

Thus, a firm's management, by issuing imperfect or incomplete information to shareholders, aims to impede them from detecting value-reducing actions which might be pursued by managers. At the same time, the favourable picture that emerges from publicly-disclosed information concerning a firm's performance prevents current shareholders from supporting take-over attempts (Williamson, 1967, in Phillips and Williamson (ed.) 1967; Salamon and Smith, 1979). In that way management defends its actions and secures its position. Similarly, Schiff (1966) argues that, given the information asymmetry between managers and owners, the latter are not in a position to determine whether the former's actions aim to maximise profits. Moreover, management's' ability to choose reporting methods further impedes owners' ability to judge and evaluate managers conduct. He maintains that:

> "If there is a conflict between the managers' and owners' interests in corporations with diffuse ownership, the opportunity to choose the accounting method gives an important advantage to the manager." (Schiff, 1966, p.62)

It appears, therefore, that executives of manager-controlled firms, in order to protect their position from pressures from the board of directors and/or from competition in the market for corporate control, may exercise control over the information it releases. Unquestionably, accounting information is one of the main sources of information that might be controlled (Salamon and Smith, 1979; Dhaliwall *et al.*, 1982). Managers are supposed to: "...exercise their control over the information released regarding firm performance in an attempt to present the results of firm operation in a most favourable or defensible way." (Salamon and Smith, 1979, p. 319). Thus, it is reasonable to expect that they will prefer higher to lower reported profits, and thus they are more likely to choose accounting methods that will improve the level of earnings (Dhaliwal *et al.*, 1982). Empirical re-

search seems to support the contention that the manager-controlled will attempt to influence accounting information in a mode which may disguise a firm's performance (Salamon and Smith, 1979)[29].

Within this context, an active tax-reducing policy can generate significant non-tax costs for managers of management-controlled firms, since it usually results in a lower reported income. Conversely, in the case of the owner-controlled firms, where owners themselves direct the firm or they oversee its administration closely, there is very little - if any - scope for the managers to control accounting information. Consequently, the non-tax costs relating to tax planning can be trivial for the owner-controlled firms. Therefore, it seems that certain types of ownership-structures can raise substantial non-tax costs, while other types of ownership-structure may be associated with lower financial reporting costs[30].

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29. Dhaliwall *et al.* (1982) maintains that the fact that managers attempt to manipulate accounting information in order to influence users of accounts perceptions does not imply capital markets do not function efficiently, since "...these arguments do not assume that management can influence stock returns by choosing one set of accounting methods over others. The arguments only assume that the accounting methods chosen by management can convince *some* of the firm's shareholders that management is doing creditable job and thus make these shareholders unwilling to support a takeover." (p. 43). [their italics].
30. It has been argued that managers of management-controlled firms will be concerned not only with the level of the reported profits but with the variability of profits across time, as well. In fact, the managers by choosing a particular accounting method will aim : "...to reduce earnings fluctuations rather than to maximise or minimise reported earnings,..." (Moses 1987, p.358). In other words they will be involved in what is called "income smoothing", which has been defined as : "...a means used by management to diminish the variability of a stream of reported income numbers relative to some perceived target stream by the manipulation of artificial (accounting) or real (transactional) variables." (Koch, 1981, p. 574). Managers of management-controlled firms have been hypothesised as being more inclined towards smoothing income figures. The appraisal of managers efficiency and abilities can motivate them to arrange reported earnings. As Monsen and Downs (1965, see also Smith, 1976; Scherer 1980; Moses, 1987) state: "...although a very poor management performance may result in a rebellion, a very good one does not usually cause a powerful movement among stockholders to reward their

An alternative approach to examining the balance between tax benefits and non-tax costs, argues that the distinct "informational environment" in which management operate can generate important non-tax costs for owner-controlled firms. Due to the close relationship between managers and owners in closely-held firms, executives can directly communicate to shareholders, information regarding firm's value and managers' abilities, without being dependent on published financial statements (Wolfson, 1993; and Klassen, 1997). On the other hand, for managers of widely-held/ management-controlled firms, financial statements are one of the main devices available for signalling information to shareholders regarding firms' value and management's ability. Management's failure to signal to shareholders - through reported earnings - increases in firm's value and efficiency gains, can result in managers' being undervalued by shareholders (Klassen, 1997). Therefore, managers of widely-held firms may prefer higher to lower reported earnings. In order to increase the level of reported income, managers: "... can borrow income from the next period in an attempt to increase the market's assessment of their firm's value." (Klassen, 1997, p. 458). However, the acceleration of reported income will almost certainly increase taxable income. Despite the increase in tax payments, managers have to balance the tax cost with costs which may ensue if they do not adopt income-accelerating policies. Those costs include take-over threats, reductions in managers' remuneration and so on (Stein, 1989; Klassen, 1997). The larger these costs, the more

managers with lavish bonuses. Hence *the punishment of grievous error is greater than the reward for outstanding success.* This asymmetry between failure and success tends to make the managers of a diffused-ownership firm behave differently from the managers of the type of owner-managed firm envisioned by traditional theory." (p. 226) [emphasis in the original]. It should be noted that the pursue of a income smoothing policy does not aim to a reduction on reported profits but to : "...a gradually rising performance measure..." (Smith, 1976, p. 708). Therefore, even if the firm is engaged in an income smoothing policy, non-tax costs will most likely arise if an aggressive tax reducing policy is adopted. For the findings of empirical research regarding the relationship between a firm's ownership structure and the adoption of income smoothing policies see subsequent paragraph.

likely management are to sacrifice tax benefits in order to achieve higher reported profits. Thus, the different informational environments in which firms with different ownership/control status operate, seem to influence the level of non-tax costs that firms face.

A subsequent section discusses findings of empirical research, which generally support the argument that there is an association between ownership structure and reporting-policy decisions. Furthermore, empirical results suggest that the financial reporting costs (i.e. non-tax costs) which are associated with tax planning influence firms' accounting choices for financial-reporting and tax-reporting purposes. Firms' ownership-structures also appear to influence the trade-off between tax and non-tax costs.

Review of findings of empirical research

The findings of empirical research are generally consistent with the hypothesis that a firm's accounting-method choices are not made in a random fashion; they suggest that an association may exist between firm's ownership structure and reporting-methods selected.

The investigation of income smoothing behaviour, has been an area in which the association between a firm's ownership/control status and its accounting choices has been examined. The studies of Gordon (1964, as cited in Hunt, 1986) and Schiff (1966) constitute early attempts to study the association between accounting choices and firms' ownership structures. Schiff (1966) examined the case of a publicly held company listed on the New York Stock Exchange, which had selected accounting policies in order to report earnings per share "...in a constant or rising pattern to give the effect of "pseudo" profit maximazation" (p. 66). Because of the information asymmetry between managers and shareholders, executives were in an advantageous position relative to investors. Schiff argued that management, by controlling and influencing accounting information, could impede shareholders' ability to monitor and evaluate managers' conduct.

Smith (1976), again within the context of examination of income smoothing behaviour, explicitly addresses the issue of the different accounting-policy choices of owner-controlled and management-controlled firms[31]. He empirically tests the hypothesis that the management-controlled firms will be more likely, in comparison to the owner-controlled, to smooth the level of reported profits, by making the appropriate selection of accounting methods. Smith argues that due to the diffusion of ownership, and the information asymmetry that prevails in management-controlled firms, the managers of those firms are very likely to smooth accounting figures in order to provide "...a gradually rising performance measure..." (Smith, 1976, p. 708). By doing so they keep the uninformed shareholders "satisfied", and thus reduce the likelihood of shareholders' rebellion and/or take-over threat. On the other hand, in the case of owner-controlled firms there is little need and/or scope for smoothing income. The owners are expected to have a direct and comprehensive knowledge of their firm's affairs in general, and of accounting choices in particular. Thus, the latitude for artificial manipulation of financial figures is very limited. Owner-controlled firms may not be so concerned with reducing the fluctuations in the level of reported earnings, as with reducing the level of a firm's tax burden and /or with reducing reported profits in order to influence labour's demands during wage negotiations. In order to test this hypothesis, Smith selected a sample of 110 firms - 57 manager-controlled and 53 owner-controlled ones - listed on the New York Stock Exchange in 1954, and examined their accounting-policy decisions for the period 1954-1962. A firm was classified as a management-controlled one if no party controlled more than 5 per cent of the stock, while it was identified as an owner-controlled if one party con-

31. Despite the fact that this study is not primarily concerned with the investigation of the issue of income smoothing, the study of Smith will be discussed in some details. The reason for doing so is that the study of Smith has been the first one which has explicitly and formally tested operational hypotheses regarding the association between accounting decision policies and firm's ownership structure.

trolled more than 10 per cent of the voting stock. For the firms in the latter group, representation of major owners in the board of directors and/or involvement in the firm's management was considered as evidence of active control. He identified the earnings per share as a possible object of an income smoothing policy, and he set five targets regarding their level. Subsequently, he examined for each target of earnings per share, and the reporting methods choices - the latter being perceived as instruments for achieving each target. The result of the tests supported the hypothesis, that:

> "The policy decisions made by manager firms smoothed income significantly more often than the policy decisions made by owner firms." (Smith, 1976, p.721)

Similarly, Koch's (1981) and Amihud *et al.* (1983)[32] findings are consistent with the hypothesis that manager-controlled firms will smooth income to a greater extent than owner-controlled ones, while Moses (1987) found no evidence to support this hypothesis. Yet, empirical research suggests that the relationship between income smoothing behaviour and firm's ownership structure, is not a straightforward one. For instance, Kamin and Ronen (1978 a and b, as cited in Hunt, 1986) provide evidence which indicates that the barriers to entry prevailing in an industry can strongly affect the association between the two variables. More specifically, when high barriers to entry exist, manager-controlled firms appear to become more extensively involved in income smoothing, in comparison with the owner-controlled ones. However, when the barriers to entry are low that rela-

32. It should be noted that Amihud *et al.* (1983) based their analysis with regard to the smoothing behaviour of management-controlled firms as opposed to the owner-controlled firms, on the premise that the managers of the former category of firms face greater risk in comparison with the managers of the latter. They argue that the hired managers "...having the value of their human capital dependent on the performance of the firm they manage, and being unable to diversify away this risk, are expected to attempt to reduce their employment risk internally by project selection or by income smoothing, intended to stabilize the firm's income stream." (p. 189)

tionship is reverted. According to Kamin and Ronen this result suggests, that the barriers to entry may have an impact on the ability of managers of management-controlled firms to smooth income. Alternatively, the owner-managers may have a strong incentive to smooth income when the barriers to entry are low.

Salamon and Smith (1979) tested the hypothesis that the managers of the management-controlled firms will influence accounting information, in order to provide the firm's stockholders with a favourable presentation of its performance. As a result, owners will be satisfied, and will be less inclined to support any takeover attempt. They called this hypothesis the "managerial misrepresentation" hypothesis. The owner-managers, on the other hand, do not have an incentive to misrepresent their firm's performance. In addition, the hired managers of owner-controlled firms have very little discretion on variables which could be employed to misrepresent performance, due to the close inspection of their conduct by the major shareholders and owners' easy assess to internal information. In order to test this hypothesis, Salamon and Smith formulated two operational hypotheses. According to the first hypothesis: "If the information misrepresentation hypothesis is correct, the association between security returns and accounting earnings will be significantly weaker for MC [management-controlled] firms than for OC [owner-controlled] firms in accounting policy decision years." (p. 320). The justification for this test is that, if capital markets are efficient, security returns will reflect firm's economic position as it is reflected in reporting figures[33]. The second hypothesis refers to the time in which the change in accounting methods takes place. Salamon and Smith argue that it is more likely that the management of

33. With regard to the fact that the analysis is restricted only to years in which accounting methods change, they maintain that : "it must be realized that the managers of MC firms may not need nor be able to misrepresent firm performance in every year", while the years in which accounting methods change "...are the years in which it is most likely that managers may have attempted to misrepresent firm performance." (Salamon and Smith, 1979, p. 321).

management-controlled firms will attempt to influence the level of reported profits during years with below-average stock returns, than during years with above average stock returns. They collected relevant data for a sample of 32 manager-controlled and 32 owner-controlled firms, for the period 1954-1962. A firm was identified as manager-controlled when no party owned more than 5 per cent of equity capital, while a firm was classified as owner-controlled, (i) when one party controlled 10 per cent or more of the voting stock and exercised active control, or (ii) if one party controlled 20 per cent or more of the voting stock. The results indicated that, in comparison with the owner-controlled firms, the association between earnings and stock returns was weaker for manager-controlled firms, while it appeared that there was a significant association between the security-return performance and the timing of the reporting policy choice for the manager-controlled firms. The association is not significant for the owner-controlled firms. Therefore, both hypotheses were supported by the empirical findings and Salamon and Smith (1979) conclude that: "...managers of MC firms attempt to control the information in annual accounting reports in a manner which causes firm performance to be misrepresented." (p.327)

Dhaliwal, Salamon and Smith (1982) have directly examined the association between a firm's ownership/control status and their choice of accounting methods by comparing the depreciation-policy choices - straight line vs. accelerated - of management and owner-controlled firms. They argue that the managers of management-controlled firms, in order to keep the shareholders satisfied and/or increase their remuneration - when accounting- numbers-based compensation schemes are used - will prefer accounting methods which will "...result in high and/or early reported income." (p. 44). Conversely, in owner-controlled firms there is very little - if any - need to employ bonus schemes, and in any case the close inspection of a firm's affairs by owners precludes - or at least renders very difficult - a manipulation of accounting figures by hired managers. Therefore, owner-controlled firms are not hypothesised as being concerned with increasing reported profits, as their manage-

ment-controlled counterparts. Instead, they are expected to be mainly concerned with reducing the level of tax burden - and possibly with reducing the level of reported profits in order to influence labour unions' negotiation positions. Within this context, Dhaliwal *et al.* (1982) argue that management-controlled firms will choose depreciation methods which increase reported income. Thus:

> "MC firms are more likely than OC firms to use straight-line depreciation method for financial reporting purposes." (Dhaliwall *et al.*, 1982, p. 47)

To determine the influence of the control status on the firm's accounting decisions, other factors which have been hypothesised to affect the choice has been studied. More specifically, the effect of a firm's size and its leverage characteristics have been examined[34]. The depreciation-method choices in the period of 1959-1962 for a sample of 57 management-controlled firms and 53 owner-controlled firms, were examined[35]. The outcome of the statistical analysis of the data, supported the hypotheses that have been devel-

34. Firms' leverage characteristics have been assumed to be a proxy of firms' proximity to violating debt covenants. A firm that is close to violating these covenants is likely to adopt income increasing accounting methods so that these constraints to be relaxed (see, latter for details regarding findings of empirical research concerning this issue). As far as the firms' size concerns, this variable has been assumed to be a surrogate for firms political costs. It has been hypothesised that larger firms are more likely to attract politicians attention as a possible "target" for wealth transfer. Thus, the larger firms, in order to became less "politically" visible, are supposed to adopt income decreasing methods which will reduce the level of reported profits. This argument has been based on the economic theories regarding political process. The basic assumptions that underlies this argument are that political process is a competition for wealth transfer; and everybody participating in this competition aims to maximise his utility. Therefore, politicians will strive to secure for themselves the larger proportion of the transferred wealth. As has been already mentioned, due to their size the larger firms are a more probable target for wealth transfer (Watts and Zimmerman, 1978, 1979, and 1986; Zimmerman, 1983).
35. The criteria which have been employed for identifying a firm as either management-controlled or owner-controlled, were those adopted by Salamon and Smith (1979).

oped regarding the association between the variables of interest. This result conflicts with Fama's (1980) prediction that there should be no difference between the behaviour of owner-controlled and management-controlled firms, since competition in the labour market will discipline the latter. Dhaliwall *et al.* (1982), conclude:

> "Fama theorizes that the market for managerial talent is such that there will be no difference in behaviour between the managers of MC and OC firms. Our result indicate that there exists a difference in the depreciation methods adopted by MC and OC firms in the direction hypothesized by the theory and, thus, the results are inconsistent with the prediction of Fama's theory." (p. 52)

Similarly, Ayres (1986) examined whether a firm's ownership structure can explain its choice with regard to the adoption date of the SFAS 52 of FASB - dealing with the foreign currency translation. It has been hypothesised that, where different adoption dates can have a different impact on the level of reported income, the management-controlled firms are more likely to prefer the dates which will increase income. The results were consistent with the hypothesis.

Penno and Simon (1986) investigated the accounting choices of private firms. In order to do so they compared the accounting-policy decisions of private and public firms. It should be noted that Penno and Simon did not explicitly compare the accounting policies of management and owner-controlled firms. However, by recognising that "...public firms are more likely to be manager-controlled than are private firms." (p.562), they introduced - at least indirectly - this element into their analysis. Yet, for the purposes of this project the distinction between public and private firms - irrespective of the former' ownership structure - is important. As the previous paragraph mentioned, whether or not a firm is listed can influence the trade off between tax benefits and non-tax costs. Penno and Simon tested the hypothesis that the publicly-traded firms, are more likely to select accounting methods which will have an increasing influence on the level of reported figures. Privately-owned companies,

on the other hand, will be more concerned with reducing a firm's tax burden. They argue that, due to the perceptions of the public-firms' managers regarding the impact of reported income on security prices, income-increasing accounting methods are more likely to be adopted. Furthermore, the dependence public-firms' managerial remuneration on compensation schemes, will reinforce this tendency; public companies are supposed to be mostly manager-controlled, and thus to employ bonus schemes. Privately held firms are not supposed to have the same incentives to choose accounting policies, and thus:

> "..., with less perceived need for high reported accounting income, managers of private firms might have less incentive to use accounting policies which have real economic costs such as the use of FIFO inventory accounting when LIFO would reduce tax liabilities." (Penno and Simon, 1986, p. 562)

In order to test the hypothesis, Penno and Simon examined the differences between accounting-policy choices for a sample of matched-pairs of publicly-traded and private-held firms. Size and industry classification was controlled for in the analysis. The accounting -method decisions which have been examined, are: (i) straight-line vs. accelerated depreciation; (ii) LIFO vs. other inventory method and (iii) deferral versus flow-through methods for the investment tax credit. They assumed that "...accelerated depreciation, the LIFO inventory method, and deferral method of accounting for the investment tax credit to be income-decreasing alternative for each accounting choice." (p. 562). Data was collected by conducting a questionnaire survey, while in certain cases for the publicly-held firms financial statement information was used. In the case of the treatment of the investment tax credit the results supported the hypothesis, although the relationship was not a significant one. In the case of depreciation choices and inventory methods, on the other hand, the result supported the hypotheses, and the relationship was statistically significant. Penno and Simon (1986) concluded that:

> "These results are consistent with the view that participation in external equity markets is associated with firm's choices among accounting alternatives." (p. 566)

As mentioned in the previous section, the use of accounting-based compensation schemes may prompt managers to adopt income-increasing accounting methods. The employment of bonus-plans is expected to be more common among the manager-controlled firms, since the need for motivating managers is supposed to be more pressing in this type of firm. The findings of the empirical research which examined the association between the employment of accounting-based bonus plans, and firm's accounting-policy decisions are not conclusive. Watts and Zimmerman (1978) who examined the factors which might have influenced firms' management attitudes, towards the FASB proposal regarding the treatment of General Price Level Adjusted (GPLA) statements, concluded that the use of compensation schemes was not significantly associated with managements' disposition towards the specific proposal. Hagerman and Zmijewski (1979) investigated whether the usage of incentive plans, along with other factors - i.e. firm's size, risk, capital intensity and competition - can influence a firm's accounting-policy decisions. The results indicated that the use of bonus plans is associated with certain accounting-treatments (i.e. the choice of depreciation method, the duration of the amortisation period of past service costs); however, in other cases (inventory method and investment tax credit method) no significant association appears to exist[36]. It appeared that the firms using incentive schemes were more likely to choose options that result in increased profits, i.e. straight-line depreciation method and longer amortisation periods. Zmijewski and Hagerman (1981) examined whether the employment of (i) bonus scheme - among other factors, such as firm's size, industry concentration, risk, capital intensity and the debt to asset ratio - is associated with the

36. The association between the use of incentive schemes and the choice of depreciation method is a weak one, since it is significant only at a level of 10 per cent.

firm's over all income strategy. In contrast to the Hagerman and Zmijewski (1979) study, they assume that accounting-policy decisions are not taken independently, but they constitute a part of an strategy, which aims to achieve a given objective concerning the over-time income. As in the 1979 study, they examined accounting policies concerning inventory and depreciation methods, the amortisation period for past service pensions costs and the investment tax credit procedures. The results of the statistical analysis indicated that the use of incentive schemes - along with the firm's size, the competition and the debt to assets ratio - influence the firm's overall accounting strategy. More specifically, the empirical findings suggest that: "...managers are more likely to choose accounting strategies that increase net income if such plans [management compensation plans] are available to them." (Zmijewski and Hagerman, 1981, p. 143). El-Gazzar, Lilien and Postena (1986) provide evidence which is consistent with the hypothesis that the employment of compensation schemes may encourage the adoption of income-increasing accounting methods. In particular, they provide evidence which indicates that the usage of bonus-plans is associated with the accounting treatment of leases, which lead to an increase of reported income (see also Francis and Reiter, 1987). On the other hand, when Bowen, Noren and Lacey (1981) examined the factors that are associated with a firm's decision regarding the treatment of capital-investment interests costs, they did not find any evidence to support the hypothesis that the employment of bonus schemes is likely to encourage the selection of income-increasing accounting methods.

Healy (1985) criticised previous research which examined the association between the use of bonus schemes and accounting-policy choices, for ignoring details of the compensation plans. He argues that in many cases, provisions in compensation-plans define earnings in such a way that accounting-method decisions do not affect the level of a bonus. Furthermore, he argues that previous studies assumed that the employment of compensation plans would always prompt managers to prefer income-increasing accounting methods. Healy maintains that when bonus plan

include binding upper and/or lower bounds, managers may be motivated towards income-reducing accounting methods. Compensation schemes:

> "...typically permit funds to be set aside for compensation awards when earnings exceed a specified target. If earnings are so low that no matter which accounting procedures are selected target earnings will not be met, managers have incentives to further reduce current earnings by deferring revenues or accelerating write-offs, a strategy known as "taking a bath". This strategy does not affect the current bonus awards and increases the probability of meeting future earnings' targets." (Healy, 1985, p. 86)

By taking these parameters into account, Healy attempted to investigate the relationship between compensation schemes and accounting-policy decisions. He examined the association between a compensation plan's terms, and managers' decisions regarding accruals and accounting procedures. The results indicated that a significant relationship exists between accrual decisions and managers' incentive regarding income, as these emerge from the terms of the compensation plan. More specifically, it appears that when incentive plans include binding upper or lower bounds, managers are likely to choose income-decreasing accruals, while when bounds are not binding, income increasing accruals are more likely to be preferred. As far as accounting-procedure choices are concerned, results confirm that in the period following the adoption or modification of a compensation plan, a high frequency of changes in accounting procedures occur. It should be pointed out, though, that the presence of binding bounds - upper or low ones - did not seem to prompt managers to adopt income-decreasing accounting procedures.

Many studies which investigated the choices of an inventory method, have not explicitly introduce the trade-off between tax benefits and non-tax costs as an element in their analysis, however by examining their findings some useful insights can be obtained. For instance, Abdel-Khalik (1985) when investigating whether the inventory-method decision

is related to the effect that such decisions have on managerial compensation indirectly introduced the element of non-tax costs that managers face when pursue a tax reducing policy. Abdel-Khalik argued that managerial ownership is a factor that can influence managers' inventory-method decisions. The FIFO vs. LIFO decision a effects a firm's tax liability and as a result can influence that firm's share price. When managers' wealth is primarily dependent on the value of their stock holdings, they prefer the LIFO method. On the other hand, if managers' compensation is strongly correlated with accounting-based bonus payments, it is expected that the FIFO method will be preferred. Abdel-Khalik hypothesises that an owner-manager's wealth is primarily dependent on the value of the share-holdings, while the remuneration of a manager of management-controlled firms is more dependent on accounting-based bonus schemes. Therefore, a firm's ownership structure can influence the choice inventory-method. As Abdel-Khalik argues: "The ownership variable could influence this choice to the extent that executives in owner-controlled firms derive more personal wealth from increases in the value of their stock holdings than would come about from the switch to *LIFO*." (p. 430). Within the context of a tax benefits vs. non-tax costs analysis, the implication would have been that for management-controlled firms, the tax benefits which result from a LIFO-adoption will be foregone in the face of the increased accounting profits related to a FIFO-adoption. Consequently, the FIFO will be preferred. The reverse reasoning applies for the owner-controlled firms. Owner-controlled firms are likely to adopt the LIFO, due to the tax benefits that ensue from such a choice. However, the results did not indicate that for firms that switched from FIFO to LIFO, there was any difference between the management and owner-controlled firms, with regard to the structure of payment to executives. Furthermore, results testified that on average the executives' compensation for the firms that switch to LIFO was not adversely affected. That result indicates, according to Abdel-Khalik, that bonus plans had been adapted in response to the change in the accounting method. On the other hand, the results indicated that the management-con-

trolled firms which retained the FIFO method had a higher accounting-based schemes, compared with the other firms.

Hunt (1985) also identified ownership-structure as an explanatory variable regarding firms inventory-method choice. Similarly to Abdel-Khalik, Hunt hypothesised that owner-managers' wealth is more correlated with share value. In management-controlled firms, accounting income can have an important impact on bonus payments, and as a consequence on managers' wealth. Thus, management-controlled firms are more likely to retain the FIFO method, while owner-controlled ones are more likely to switch to the LIFO. Hunt has also hypothesised that firms that have employed LIFO are less likely to use accounting-determined bonus schemes. In addition to the ownership-structure, the firms' ability to avoid breaching debt-covenants has been identified as a factor influencing firms' inventory-method choice. More specifically, it has been hypothesised that the closer a firm was to violating debt-covenants, the less likely it was to adopt the LIFO method. Again a tax benefits vs. non-tax costs framework can be applied. The non-tax costs that are related to the adoption of the LIFO method may prompt a firm to prefer the FIFO method, despite the tax costs that accompany that choice. The results of univariate and multivariate tests were consistent with the hypothesis that the closer a firm is to violating the lending-related constraints, the less likely it is to adopt the LIFO method. Concerning the link between ownership structure and inventory-method choice, the results were not consistent with the hypothesis. In particular, not only no relationship emerged between the inventory-method choice and the usage of income-based bonus schemes, but it appears that firms which adopted the LIFO method had a significantly lower levels of managerial ownership.

Within the context of tax benefits vs. non-tax costs analysis, Hunt's findings regarding the inventory-method choices of firms closing to violating debt-covenants are consistent with the findings of Matsounaga *et al.* (1992) and Maydew (1997) reported earlier. It should be noted, however, that Sweeney (1992, as cited in Smith, 1993) provides evidence which suggests that when an accounting-method choice

have significant tax costs - as in the case of choice between LIFO vs. FIFO - the firm is likely prefer the method which ensures greater tax benefits, despite the increase in the likelihood of violating debt covenants.

Concerning the link between ownership-structure and tax-related considerations, the two aforementioned studies suggest that it may not be that strong. Niehaus (1989), on the other hand, provides evidence which supports the hypothesis that there is an association between a firm's ownership structure, and its accounting-method decisions. His findings suggest that the tax benefits and non-tax costs related with each method can influence the firm's decision. Niehaus argues that in firms with concentrated outside ownership, the owners' wealth is mainly a function of the value of their stock holdings. Additionally, shareholders can effectively monitor and control mangers' actions. Thus, the concentrated-ownership firms are expected to adopt accounting methods, which result in an increase of tax savings.

A conflict of interest between owners and managers may arise, however, since the latter, for the reasons which have been previously discussed, will prefer high reported profits. The extent of managers' ownership of the firm's stock capital can influence their attitude towards a tax-reducing choice. In particular, in case that managers own a substantial proportion of shares, their interests are likely to be aligned with those of the owners. On the other hand, an increased managers' ownership, can reduce the ability of owners to control managers. As a result, the managers' discretion regarding accounting-method choices, is enhanced. Under these circumstances, it is likely that the relationship between managerial ownership and the firm's accounting choices will be a non-monotonic one.

In order to investigate these issues, Niehaus examined the inventory-method choice of a sample of industrial firms which differed with regard to the extent of managerial ownership. Furthermore, Niehaus investigated the relationship between the ownership-structure and other accounting methods choices, such as depreciation methods and investment tax credit methods. He argues, that since the ac-

counting treatment of those items might be different for tax and financial reporting purposes respectively, it is less likely that a conflict of interest will arise between managers and shareholders[37]. The results were consistent with all hypotheses. No significant relationship existed between firm's ownership structure, and the choice of depreciation method and investment tax credit method[38]. Regarding the inventory-method choice, the hypothesis that high outside-ownership will increase the likelihood of adopting a tax reducing method, i.e. LIFO, has been confirmed. Regarding the hypothesis about the association between the managerial ownership and the inventory-method choice, the results are consistent with the hypothesis that their relationship can be a non-monotonic one. As Niehaus (1989) states:

> "...the probability of choosing LIFO initially decreases as managerial ownership increases. Beyond a point, however, the probability of choosing LIFO increases with managerial ownership." (p. 283)

These findings suggest, that for a firm's executives, the related with a tax reducing policy non-tax costs, vary - in a non-monotonic way - on the basis of the proportion of their stock capital ownership. The fact that below a certain level of managerial ownership managers choose the income-increasing method, may indicate that the accounting-based bonus payments constitute a larger proportion of their personal wealth, compared to the wealth attributed to stock ownership. Above a certain level of stock ownership, however, this relationship is reversed and the tax reducing meth-

37. He recognises, however, that even in the case of these accounting choices a conflict of interest can arise. As he states: "A conflict can still exist if shareholders do not factor in the incentives of managers to choose income increasing accounting methods when compensation contracts are designed. In addition, a conflict exists with these accounting choices in the sense that shareholders prefer to pay managers lower compensation, *ceteris paribus*." (p. 281).
38. With respect to the choice of depreciation method decision, this result contrasts with the findings of Dhaliwal *et al.* (1982), who have argued that the choice of depreciation method and the firm's ownership structure are not independent of each other.

od will be preferred. It appears that concentrated outside ownership reduces the possibility of value-reducing actions from managers. Thus even when managers have a motive to prefer income-increasing methods, their tight monitoring by the shareholders, secures that a tax reducing methods will be adopted. Therefore, when an accounting choice has implications regarding the level of a firms' tax burden, that firm's ownership/control status can influence the choice[39].

Wolfson (1993) reports evidence which is consistent with Niehaus' findings. That is, the non-tax costs of a tax reducing strategy are expected to be less significant for firms where ownership is concentrated to a restricted number of shareholders. Thus, these firms are more likely compared to diffused-ownership firms, to get involved in aggressive tax planning. In addition, Wolfson maintains that when accounting for financial reporting purposes is distinct from the accounting for tax purposes, firms are more likely to pursue an active tax reducing policy, since the ensuing reduction in tax liability will not be accompanied with a reduced reported income. For instance, in most of the Continental European countries and in Japan, a great degree of conformity between tax and financial reporting regulation prevails. Furthermore, the ownership structure of most corporations in these countries is characterised by a high level of concentration. According to Wolfson, the fact that the earnings-to-price ratio of European and Japanese companies, is significantly lower than the corresponding ratio for the US and the UK companies - Elliot, Morse, and Souza, 1990 (as cited in Wolfson, 1993) - provide "...striking evidence of the systematic effect of tax-book (non)conformity rules on the economic and statistical properties of reported earnings." (p.321). Wolfson concludes that firms from Continental Europe and Japan "...suffer the financial reporting consequences of lower reported income so as to achieve tax savings." (p. 321). French and Poterba (1991) maintain that:

39. In addition, Niehaus results testify that managerial ownership of firm's capital is not enough for aligning shareholders and managers' interest. It is necessary that stock owned by managers constitute a substantial proportion of their wealth.

"Virtually all [Japanese] firms choose accelerated depreciation, which minimizes current taxes, rather than straight-line depreciation, which maximizes current reported earnings." (p. 349).

Furthermore, evidence from the US seems to support the argument that owner-controlled firms are more likely to get involved in tax-planning. Similarly to Matsunaga *et al.* (1992), Wolfson provides evidence which is consistent with the hypothesis that the financial reporting consequences of the disqualification of stock options are an important consideration for a firm's management, despite the considerable tax-costs that can ensue. However, Wolfson's findings indicate that firms which disqualified incentive options were characterised by highly concentrated ownership, a fact which testifies that "...concentrated ownership promotes more aggressive tax planning behaviour in the face of conflicting financial reporting considerations." (p. 324). In addition, he provides evidence which suggests, that when a tax-reducing policy does not affect the financial figures, such a policy will be pursued more aggressively. For instance, the fact that the adoption of accelerated depreciation methods and the preference of debt instead of equity, contributes to the reduction of a firm's tax burden, without, however, affecting reported income, may explain the popularity of these two options among US corporations (see, French and Poterba, 1991; Scholes and Wolfson, 1992). More specifically, French and Poterba (1991) argue that the fact that US firms can employ one depreciation method for tax purposes and another for financial reporting ones, leads most of them to employ accelerated depreciation for tax reporting purposes, while for financial reporting ones they generally employ the straight-line method. In contrast, Japanese corporations, despite the fact that they have the option of choosing accelerated or straight-line depreciation method are required to use the same method for tax and financial purposes alike. As mentioned just above, the vast majority of Japanese companies adopt the tax-reducing option. Given the differences in the ownership structure between the US and Japanese companies, these findings may indicate, that for firms with highly concentrated ownership (Japanese

firms), tax reduction will be the main consideration. On the other hand, when firms are characterised by a diffused ownership (US firms), managers' concerns centre around the effect that the level of reported income can have on their remuneration.

Klassen (1997) argued that the level of ownership concentration influences the informational environment in which a firm operates. In firms with a highly concentrated ownership, the firm's management can directly access shareholders information concerning managers' and firms' performance, without being dependent on published accounts. On the other hand, in diffused-ownership firms, management is more dependent on financial statements for communicating information to capital markets. These considerations have been hypothesised as influencing the balance between the tax and non-tax. Managers of widely-held firms are more likely to aim at an increased reported income, despite the increase in the level of a firm's tax liability. In order to test this hypothesis, Klassen examines the association between the levels of concentration a firm's ownership, and the divestiture decision, since such a decision is related with substantial tax and non-tax costs. The firms with concentrated ownership are more likely to carry out divestitures of assets which incorporate unrealised losses, since by doing so they reduce taxable income. On the other hand, the management of widely-held firms is more likely to divest assets incorporating unrealised gains, since such a decision enhances reported income[40]. The results overall were consistent with the hypothesis that a firm's ownership structure is associated with its accounting policy choice and influences the trade-off between tax benefits and non-tax costs.

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40. However, such a decision has a reducing effect on a firm's value, not only because it increases tax payment, but because the firm is deprived of assets which can generate a value greater than their liquidation price. Yet, managers will undertake such action in order to increase reported profits. Stain (1989) argues that despite the fact that markets will anticipate that fact, managers will behave "myopically" believing that the high current reported profits will influence the markets evaluation of a firm's and a manager's performance

Whether a firm is public or private may influence the trade-off between tax benefits and non-tax costs. Despite the fact that a management-controlled firm is very unlikely to be a private one, possibility cannot be ruled out that a closely-held firm is listed. Therefore, whether a firm is listed is a characteristic that can generate non-tax costs. Penno and Simon (1986) have provided evidence which is consistent with the hypothesis that managers of public firms, due to their perceptions regarding the impact that accounting information can have on stock market participants, are more likely, compared to the managers of private firms, to prefer income-increasing accounting methods. Executives of private firms will be less concerned by the level of reported income, and more interested in reducing tax liability. It appears that private firms are more likely to adopt the LIFO against the FIFO method: a choice with tax-reducing effects. Cloyd, Pratt and Stock (1996) investigated whether the fact that a firm is a public or a private one influences the balance between the tax benefits and non-tax costs. They examined the extent to which a firm uses financial accounting in order to support aggressive tax positions. They argue that a firm's management "... may choose a financial accounting method that conforms to the tax choice (i.e., conformity) in an effort to increase the probability that the Internal Revenue Service (*IRS*) will allow the tax treatment." (p. 23). Despite the fact that the tax conformity leads to increased tax savings, it can also lead to an increase in non-tax costs. Under these circumstances, it is important that "..., the value of the expected tax savings must be balanced against the non-tax costs associated with conformity." (Cloyd *et al.*, 1996, pp. 24 - 25). They argue that, assuming unchanging non-tax costs, the possibility of conformity will increase as the level of the tax benefit increases. However, as the non-tax costs increase the likelihood of tax compliance decreases. The non-tax costs are hypothesised to be related to whether or not the firm is listed; management of publicly-held firms is expected to face greater non-tax costs, compared to management of those privately-held. The dependence of the former's remuneration on reported income, and their perceptions regarding the influence that accounting figures can have on the

markets' evaluation of firms' and managers' performance, may induce them to not exploit significant tax benefits. In order to test this hypothesis they conducted a mail survey. It was hypothesised that the extent to which tax conformity will be chosen, was influenced by the extent to which it will increase the possibility of defending an aggressive tax position. The research instrument was mailed to the financial executives of a sample of publicly-held and private US manufacturing firms. Participants were asked to choose, within the context of a fictional case, between accounting treatments which had tax related consequences. In every case the possibility of successfully defending the resulting tax position have been provided. A firm's proximity in violating debt covenants was identified as a control variable. In addition, the extent to which respondents believe that the firm's share price is influenced by reported income as opposed to real cash flows, and whether a firm employs a bonus schemes, were examined. The results indicated that on average, the managers of public-firms believed that accounting profits have greater influence on firms' share price than cash flows; for the managers of the private firms the reverse seems to hold. Consequently the managers of public firms, are likely to face greater non-tax costs. Regarding the employment of bonus schemes, the results indicated that the use of bonus schemes is widespread in public-firms, while among the private firms is very limited; again the managers of public firms are more likely to face greater non-tax costs[41]. Concerning the relationship between accounting-method decisions and whether the firm is public or private, the results supported the hypothesis that : "...public-firm managers are less likely to choose conformity, perhaps because they face higher levels of non-tax costs from reporting lower income." (Cloyd *et al.*, 1996, p. 41)[42].

41. It should be noted that Cloyd *et al.* did not investigate whether the incentive scheme is a direct cash-payment based on accounting numbers or whether it takes the form of stock-options. In the case of the second option the managers would prefer higher reported profits, since it has been mentioned they believe that accounting profits significantly influences stock value.
42. Of course, the findings of Klassen (1997) suggest that listed firms which

Conclusions

The evidence provided by the studies reported above clearly suggests that tax considerations influence the accounting choices of a firm. Yet, it seems that non-tax costs are related to a tax-minimising strategy may impede a firm from fully realising tax benefits; non-tax considerations may dominate tax-related ones, and firms tax-reducing policy may be adjusted accordingly. Scholes *et al.* (1990) explain: "...efficient tax planning may be very different from simple tax minimization." (p. 627).

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have concentrated ownership, face less significant non-tax costs, compared to the diffused-ownership listed firms. This does not mean, however, that they never face non-tax costs or that when they do face then, that their reporting behaviour will not be affected.

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