

# [Positive accounting theory](https://assignbuster.com/positive-accounting-theory/)

### INTRODUCTION

### Purpose

The purpose of this report is to analyse the effect of adopting AASB 2 Share-based Payments. Besides, this report will also provide discussions about the reaction of some parties related to this adoption.

### Background

In July 2004, there is a significant change in the accounting requirements for share-based payments. The previous standard that governs share-based payment was AASB 1046 Director and Executive Disclosures by Disclosing Entities, which then supersede by AASB 2 Share-based Payments. Under AASB 1046, share-based payments only required to be disclosed. However, AASB 2 requires an entity to reflect on its profit or loss and balance sheet the effects of share-based payment transactions at fair value (Accounting Handbook 2008).

### Scope

This analysis is done by applying Positive Accounting Theory (PAT). The report covers three main areas, impact of adoption on companies, on managers, and motivation of regulators in developing standards

### Limitations

Since AASB 2 is still new, research papers used in this reports may not

Positive Accounting Theory (PAT) that popularized by Watts and Zimmerman is one of positive theory accounting. PAT is concerned with explaining accounting practices. It is designed to explain and predict which firms will not use a particular method. It does not say something as to which method a firm should use. This is what differentiates positive and normative theories. Normative theories prescribe how a particular practice should be undertaken and this prescription might be a significant departure from existing practice.

PAT focuses on the relationship between the various individuals involved in providing resources to an organisation and how accounting is used to assist in functioning of these relationships. PAT is based on the central economics-based assumption that all individuals’ actions are driven by self-interest and that individuals will always act in an opportunistic manner to the extent that the actions will increase their wealth.

### From an efficiency perspective, why could the introduction of new rules on share option accounting be costly for an organization?

Share-based payments have been widely used by many organizations as an incentive tool – attracting and retaining employees, and compensate senior executives. Because there was a significant change in the accounting requirements on share-based payments, this will then affect quite numbers of organizations. The effect on organization can be explained by an efficiency perspective.

Efficiency perspective, which also known as ex-ante perspective, is one of perspective under the PAT umbrella. It considers up-front mechanisms in order to minimize future agency and contracting costs (TB p. 274). ????????

Theorists of efficiency perspective argued that companies adopt particular accounting methods which best reflect their underlying economic performance. By choosing the best methods, it is being argued that investors and other parties will need not to gather as much additional information from other sources. This will consequently lead to cost saving and reducing the risks of investors, which will then increase the value of the company (TB p. 274).

Another effect on the implementation of AASB 2 is that it will reduce the profit of the company, thus the performance of the company will seems to be not so attractive to the potential investors. Unattractive performance of the company may cause the investors to assume that the company has higher risks of default. Thus investors become reluctant to invest in the company or, the investors will require higher return. In other words, the company will be facing a hard time to gain investors confidence or the company will be facing a high cost of capital (TB p. 275).

Since PAT theorists believe that companies will choose the methods best reflect the companies’ performance, this means that there will be no need for regulations to be in place – anti regulation perspective. PAT theorists argued that regulation of financial accounting imposes unwarranted costs on reporting entities (TB p. 275). In the case of share-based payments, by superseding AASB 1046 with AASB 2, this provides restrictions to the company as to limited methods available to choose from. This will create inefficiencies – the companies may not able to choose the method that best reflect their performance.

Besides, by expensing share-based payments, this would harm start-up companies and decrease the entrepreneurial activity of growing companies (Sacho & Wingard 2004). The reason behind this is that both new and growing companies usually do not always have enough cash to be used as incentive tool – attract and retain skillful employees. Thus, in order to attract and retain talented employees, such companies use share options instead of giving cash incentives. Under the previous standard, whereby share options do not need to be recorded as an expense in the profit and loss statement, this will result in higher profitability which may be assumed as a good performance by investors. Besides, this will result in higher returns from investment (ROI). Thus, this makes the financial position statement of those companies look better (stronger) which then allow them to access greater capital than they would had if they have to expensed share option.

Debt covenants, which also known as banking or financial covenants, are agreements between a company and its lenders that the company should operate within certain limits (Pietersz 2009). The limits set by the lenders are usually expressed in accounting numbers (i. e. level of gearing ratios). Besides set the limits, lenders will also impose obligations if the company breaches the agreement. Thus, if the company has to expense-off the share-based payments transactions, this will affect the bottom line of its financial statement which then will affect some accounting ratios. This will create difficulties for the company to operate within the limit written in the debt covenant. Company will need to re-examine the debt covenants and need to consider how to communicate this adverse impact on reported profits and key performance ratios to the market. In a worse case, company may wants to renegotiate the terms and conditions of the agreements (Chalmers & Godfrey 2005). Both re-examine and renegotiate are not easy tasks, it takes a lot of efforts, considerable amount of time, and it is costly.

Since AASB 2 requires companies to record share-based payments transactions as an expense, which then leads to lower profit, this will discourage companies to use share options as a compensation tool. This may cause managers to lose their motivation to improve the performance of the company, because share option is a method that widely used and most benefiting to the managers. Sacho and Wingard (2004) argued that expensing share-based payments would hurt companies like Apple, Intel and Microsoft (information technology companies) due to earnings pressures caused by share-based payments.

Expensing share options will also distort earning per share (EPS). Distortion may occur due to inclusion of expense for employee stock options in the profit and loss statement will result in an inaccurate ‘ double’ charge in the financial statement (BIO 2004). When the employees exercise their options, it will be recorded as an expense and increase in the number of share issued. Thus, EPS will be diluted.

In compliance to AASB 2, companies have to determine the fair value of the stock options. However, it is complicated to determine the fair value of stock options at grant date, due to difficulties in predicting future movement of share prices. Thus, mathematical models, such as lattice model are often used to predict the future movement in the share price and therefore to derive the value of the stock options. However, to apply this model, expertise is required. Thus, companies have to hire external experts. Besides, additional internal compliance costs, costs of external audit will also increases (BIO 2004).

### Why could the introduction of new rules on share option accounting be costly for manager??

A new set of regulation regime in the share option accounting will lead to a different treatment of accounting method to adopt in the company. The complex changes in the new treatments will increase administration and reporting requirements. According to Miles, manager will need to employ accounting industry specialist to assist them in order to comply with the latest regulatory changes. The additional administration requirement will burden the managers with extra costs. This is because managers will have to put in a lot of effort, allocate more time and money in order to familiarize and adopt the new set of the regulation which is generally called as bonding cost (Deegan). These extra allocations will go into training the existing staffs to get used to the new regulations. In addition to that, in certain cases, managers will have to employ new staff; specialists will cost even more money, to deal with the new accounting method which will ultimately result in an increase in the operational cost of the company.

Besides time consuming and increase in operational cost, the new set of share option accounting rules will limit the manager’s option in applying different accounting methods. The new set of rule forces managers to be more transparent in preparing the financial report. Managers will lose the opportunity to construct a financial report that best indicate the company’s performance. This is because, AASB 2 requires manager to recognize expenses that are related to services or goods received or acquired in the share based payment transaction. As a result, by expensing the items mentioned will significantly reduce the profit in the income statement. In the case of companies relying on profit based performance, managers are directly affected by the diminished profit. Low profit indicates low bonuses for the managers. On the other hand, for companies relying on share-price based performance, manager has to bear indirect impact of the huge deduction in the profit. This is because investors are the ones who are influential in regards to the movement of share prices. Investors are acting based on the information provided in the financial statement. Unexpected decline in the profit will lead to a negative sentiment; as a consequence, the investors are not convinced in either purchasing or retaining the company’s share (Deegan pg. 262). Instead of increase in the share price, it will drop the share price. Ultimately the value of share options will drop in line with the drop in share prices.

### What would motivate the regulators to develop the new rules?

Big organizations represent large visible blocks of wealth and the government possesses the ultimate authority; through legislation and through court decisions. Politicians, bureaucrats, and special interest groups are interested in expanding their welfare, supporting rules that would work to their own benefit (Jensen, 1976). Generally, the regulators are controlled; if not, influenced by the government in power. Regulators might be motivated in developing new rules; in the scope of self-interest, that would benefit the government. For example, the majority of the public demands the government to solve discrimination and poverty or to be stricter with issues in regards to the environment. In order for the government to stay as the popular choice of the public, the regulators can develop rules that will have these big organizations to serve as a vehicle for social reform (social responsibility); by mitigation of discrimination and poverty, and the establishment of training and pollution prevention programs (Jensen, 1976). This will work in favor of the government’s self-interest by addressing the public’s interest. Likewise, the regulators can also develop rules that would benefit big organizations; ultimately the government in ways of getting sponsorship

The inefficiency of the ESOs would be a reason for regulators to develop the new rules; because inefficiency of ESOs can lead to abuses and frauds. Frauds that are related to ESOs may crop up from the managerial power doctrine, negotiation and execution of ESO agreements, award and implementation of ESO plans, re-pricing, and disclosure of ESOs; as exampled in the recent corporate crimes at Enron, Tyco and Arthur Anderson (Nwogugu, 2006 pg 9). What happened with the big three companies showed that there was over-reliance on company’s internal governance mechanisms for prevention of corporate crime. In order to prevent abuses on ESOs, it is paramount for the regulators to develop new rules; i. e. to enhance transparency and corporate governance, criminalize the misconduct which was formerly regulated by corporate governance mechanisms.

Often ESOs in large organizations can result in over-compensation which is substantial to opportunity costs. The costs to cover over-compensation will directly impinge on other areas of a business (opportunity costs) such as capital expenditures and limiting expansion. Establishing proper compensation is difficult; according to Nwogugu (2006 pg 11) the business judgement rule cannot eliminate over-compensation because of the difficulty in determining and applying the reasonableness standard. This is when the regulators come in. There is a potential for regulators to develop an optimal compensation structure to avoid companies from practicing over-compensation, thus encouraging regulators to lay down new rules.

Other inefficiencies and abuses of the ESOs that might encourage the regulators to develop new rules include the potential usage of ESOs as a device for taxation avoidance and as device to prevent a takeover (Lenne, Mitchell, and Ramsay, 2004 pg 10). Taxation concessions related to ESO schemes are introduced with the objective of promoting the practice of ESO. But there are concerns of abuse of the concessions given in the form of tax relief for private equity ownership (Lenne, Mitchell, and Ramsay, 2004 pg 19). This will result in people who are not qualified, able to take advantage of the tax incentives.

In the scope of takeover prevention, companies might extend their ESO. By doing so, the company is able to redistribute control among its own management which makes a takeover seem unappealing. There is also an issue of companies making trade-offs with their employee by offering ESOs in exchange with wages. It is suggested that ESOs should be a supplement to the employee’s income rather than being a substitute for wages instead (Lenne, Mitchell, and Ramsay, 2004 pg 10). New regulations are needed in order to monitor and prevent these issues from taking place in the future.

Another factor that should prompt the regulators into developing new rules in regards to ESOs is to achieve consistency and comparability. According to a research by Lenne, Mitchell, and Ramsay (2004 pg 14), 513 annual reports of ASX-listed public companies for the financial year ending 2001 was conducted in regards to ESO disclosures. In the research, they’ve identified that the disclosure practices varied significantly between companies. Some annual reports disclosed noteworthy detail on the company’s various ESO schemes while some, basic information such as the scope of the scheme of their ESOs are not even provided (Lenne, Mitchell, and Ramsay, 2004 pg 14), making comparability impossible because of the inconsistency of the disclosures.

Last and most important factor that will motivate regulators to develop new rules is related to ESOs being expensed. ESO plans did not require any expense recognition in terms of the prevailing accounting standards (Sacho and Wingard, 2004 pg 155). This resulted in investors forecasting the value of companies with misleading information as exampled in the 2001 share market bubble burst. Investors get a false impression in regards to the reality of the value of the related transactions which ended up in billions of dollars lost due to the fall of share prices. Markets can only allocate resources efficiently when prices accurately reflect underlying values; which can only be achieved by expensing ESOs (Sacho and Wingard, 2004 pg 155). By expensing ESOs, investors are able to obtain the true input costs of generating corporate revenues, enabling them to efficiently allocate capital and undertake the best possible investment decisions. In addition to that, expensing ESOs will lead to improvements in corporate performance and reduction in abuses of the ESOs (Sacho and Wingard, 2004 pg 158).

### CONCLUSION

### REFERENCE LIST

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