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Free cash flow, debt-monitoring and managers' LIFO/FIFO policy choice

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Abstract

This paper explores the explanatory power of Jensen's free cash flow hypothesis in managers' choice of LIFO versus FIFO. The association between FCF, and choice of inventory methods is based on the assumption that there is a potential conflict of interest between managers and shareholders when LIFO is the tax minimization method and that non-value-maximizing managers of firms with the FCF problem have incentives to choose FIFO, an income increasing method, in order to increase their compensation. However, since debt can act as a monitoring device and mitigate the agency problems of FCF, managers of firms with high FCF and high debt are less likely to choose FIFO than managers of firms with high FCF and low debt. The evidence is consistent with this expectation. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

An important strand of corporate finance and accounting research examines agency/contracting explanations for managers' choice of corporate policies such as debt, dividend, compensation and accounting policies (Smith and Watts, 1992; Skinner, 1993). In particular, choice of accounting policies has been the focus of

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some research interest. This paper focuses on managers' choice of inventory methods LIFO versus FIFO. Although prior studies provide some insight on why firms select LIFO, the understanding as to why firms remain on FIFO is still unclear and subject to some controversy (Biddle, 1989; Niehaus, 1989; Cushing and LeClere, 1992; Christie and Zimmerman, 1994).[1] This paper attempts to provide an explanation for managers' choice of LIFO/FIFO by drawing on Jensen's (1986) Free Cash Flow (FCF) theory. FCF is defined as the excess cash available after mangers have invested in net present value (NPV) projects (Rubin, 1990, p. 81). According to Jensen (1986, 1989), low growth/high FCF firms face an agency problem in the sense that managers indulge in 'value-destroying activities' such as increasing their perquisites, investing in negative NPV projects and generally acting against shareholders' interests. Jensen (1993, p. 849) also asserts that lucrative compensation and benefits are other ways in which the agency costs of FCF can manifest themselves. This suggests that managers of low growth/high FCF firms are more likely to choose FIFO, an income increasing method, rather than LIFO in order to receive higher compensation. Other reasons why non-value-maximizing managers may choose FIFO include job security (Weisbach, 1988; Christie and Zimmerman, 1994) and the need to mask non-value-maximizing expenditure from outsiders (Christie and Zimmerman, 1994).

Jensen (1986, 1989) also argues that debt can mitigate the agency problems between shareholders and managers of firms with the FCF problem and motivate management to act in the interests of the shareholders. Debt not only reduces the FCF but also provides discipline to management through the debt market. This debt monitoring hypothesis is formalized by Harris and Raviv (1990) and Stulz (1990) and empirically demonstrated by Maloney et al. (1993) and Gul and Tsui (1998). Following the debt monitoring hypothesis, managers of firms with the FCF problem and high debt are less likely to choose FIFO (and act against the interest of the shareholders), than managers of firms with the FCF problem and low levels of debt, ceteris paribus.[2]

The above reasoning regarding the role of FCF and debt monitoring was also examined by Gul and Tsui (1998) in a recent audit pricing study. They tested the hypothesis that there will be a positive association between FCF and audit fees and that the positive association is weaker for firms with higher levels of debt. They

[1] Four hypotheses have been advanced for inventory accounting choices. These are the efficiency contracting hypothesis (Skinner, 1993), the tax hypothesis (Cushing and LeClere, 1992), the political costs hypothesis (Dopuch and Pincus, 1988; Lee and Hsieh, 1985) and the agency or opportunistic hypothesis (Abdel-khalik, 1985; Skinner, 1993).

[2] This prediction runs counter to the debt covenant hypothesis which suggests that managers will choose income-increasing methods in order to loosen debt covenants. An extension of this prediction in the context of the debt hypothesis suggests that models used in prior studies may have an omitted variables problem by not explicitly considering the FCF problem (see, for example, Skinner, 1993 who did not find any significant results for the debt/inventory method relationship).

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