Financial accounting and corporate governance: a discussion

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Abstract

Bushman and Smith (2001, this issue) provide a useful review of research on the role of accounting in management compensation contracts and an appealing future research agenda that builds on recent research using a cross-country approach. This paper rounds out their discussion by highlighting some limitations of their research agenda, providing a critical review of the contributions of accounting scholars to governance research and highlighting research opportunities on the role of financial accounting in governance mechanisms other than managerial incentive contracts. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The study of corporate governance is concerned with understanding the mechanisms that have evolved to mitigate incentive problems created by the separation of the management and financing of business entities. Financial
accounting provides financiers with the primary source of independently verified information about the performance of managers. Thus, it is clear that corporate governance and financial accounting are inexorably linked. Indeed, many of the central features of financial accounting, such as the use of historical costs, the reliability criterion, the realization principle and the conservatism principle are difficult to understand unless one adopts a corporate governance perspective. Without governance problems, the role of financial accounting would be reduced to providing investors with the risk and return information required to facilitate the optimal portfolio allocation decision. The review by Bushman and Smith (2001, B&S hereafter) therefore addresses an area of fundamental importance in financial accounting.

B&S’s review focuses on two main areas of governance research. First, they provide a comprehensive summary and evaluation of research on the role of financial accounting information in managerial incentive contracts. Second, they propose an agenda for future research that builds on previous research exploiting cross-country differences in financial reporting and governance regimes. While B&S provide a useful and thorough analysis in each of these two areas, my task is to identify potential limitations of their review. I identify three broad limitations. First, their proposed research agenda only analyzes the role of accounting information at a very macro-level. Second, they provide little in the way of a critical assessment of the contributions of accounting scholars to governance research. Finally, they provide only a superficial discussion of the role of accounting in governance mechanisms other than managerial incentive contracts. Below, I discuss these limitations in more detail and suggest additional research opportunities in this area.

2. Limitations of cross-country research agenda

B&S’s most specific and detailed suggestions for future research involve the use of cross-country research designs to investigate the effects of financial accounting on economic performance. While appealing and well worthy of serious consideration, this research agenda is nevertheless subject to some limitations. First, it is not clear that accounting researchers have a comparative advantage in conducting such research. The determinants of national economic performance are many and varied, with the financial accounting system representing only one small and interrelated piece. Moreover, such research only analyzes the role of accounting information at a macro-level, using crude measures of the quality of the accounting system, such as the CIFAR Index described by B&S. Financial economists have conducted the seminal research in this area, and are best equipped to conduct this research moving forward. Financial accountants most useful role in this research agenda is in helping to develop improved measures of the quality of alternative financial accounting
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