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Financial accounting information and corporate governance☆

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Abstract

This paper reviews and proposes additional research concerning the role of publicly reported financial accounting information in the governance processes of corporations. We first discuss research on the use of financial accounting in managerial incentive plans and explore future research directions. We then propose that governance research be extended to explore more comprehensively the use of financial accounting information in additional corporate control mechanisms, and suggest opportunities for expanding such research. We also propose cross-country research to investigate more directly the effects of financial accounting information on economic performance through its role in governance and more generally. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

In this paper we evaluate and propose additional economics-based empirical research concerning the governance role of financial accounting information. We define the governance role of financial accounting information as the use of externally reported financial accounting data in control mechanisms that promote the efficient governance of corporations.

We adopt the classic agency perspective that the separation of corporate managers from outside investors involves an inherent conflict. Corporate control mechanisms are the means by which managers are disciplined to act in the investors' interest. Control mechanisms include both internal mechanisms, such as managerial incentive plans, director monitoring, and the internal labor market, and external mechanisms, such as outside shareholder or debtholder monitoring, the market for corporate control, competition in the product market, the external managerial labor market, and securities laws that protect outside investors against expropriation by corporate insiders.

Financial accounting information is the product of corporate accounting and external reporting systems that measure and publicly disclose audited, quantitative data concerning the financial position and performance of publicly held firms. Financial accounting systems provide direct input to corporate control mechanisms, as well as providing indirect input to corporate control mechanisms by contributing to the information contained in stock prices. A fundamental objective of governance research in accounting is to provide evidence on the extent to which information provided by financial accounting systems mitigate agency problems due to the separation of managers and outside investors, facilitating the efficient flow of scarce human and financial capital to promising investment opportunities. We believe that governance research is important for developing a complete understanding of the impact of financial accounting information on the allocation and utilization of resources in an economy.

The largest body of governance research in accounting concerns the role of financial accounting information in managerial incentive contracts. The heavy emphasis on managerial compensation derives from the widespread use of compensation contracts in publicly traded U.S. corporations, the availability of top executive compensation data in the U.S. as a result of existing disclosure requirements, and the success of principal–agent models in supplying testable predictions of the relations between available performance measures and optimal compensation contracts.

In Section 2, we review and critique the existing compensation literature in accounting, including the literature examining the role of accounting information in determining managerial turnover. Our discussion develops the theoretical framework underlying much of this work and evaluates existing empirical evidence. We also provide an historical overview to trace the economic roots of compensation research in accounting, discuss empirical

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