Accounting and corporate governance: intended and unintended consequences of IFRS

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Today

• 3 hours on IFRS/Corporate Governance
• A history of the present:
  - historical view of Swedish corporate life
  - accounting in Sweden
  - Evidence for a Swedish view of the dividend decision?
  - Builds on my PhD project (2007) and current research

Corporate Governance: one definition 1/2

• “Governance is widely regarded as being concerned with improving shareholder performance” (Colin & Mayer, 1997).
• Focus on company – shareholders.
• Focus on residual relationship and not contractual ones.
contd. 2/2

- "Governance"?
- Means that owners use to direct managers’ action in line with owners’.
- "improved shareholder performance"?
- (1) Avoid mismanagement of entrusted funds – internal control.
- (2) Improve company performance, earn a positive return on investment.

The inst.character of the Swedish capital market

- The public company as social institution
- Controll of companies in the hands of a few owners. Ranked “top” in capital versus control (La Porta et. al., 1999).
- Pyramid structures, cross holdings of ownership (cf. SNS, 2003).
- Most debated, differentiated voting rights – A (1 vote) and B shares (1/10 vote).
- No market of control or long term commitment?

The case of Ericsson (2005).

- 1 A share = 1 vote, 1 B share = 1/10 vote.
- Two dominating owners Investor and Industrivärden.
- Investor holds 5.2% of total capital but controls 19.46% of the votes (39.22% of the A shares and 2% of B shares).
- Industrivärden holds 2.34% of total capital but 13.35% of the votes (28.42% of A shares and 0.03% of B shares).
- Capital Group 2.96 % of total capital 1.71% of votes.
No market of control?

- No market of control – non-optimal corporate governance system (Harris & Raviv, 1998).
- La Porta et. al., 1999 rank Sweden low in terms of effective Corporate Governance systems.
- “It is probably only a matter of time until the two controlling parties […] are forced to abandon it [the differentiated voting rights]” (Hamberg, 2000, p.81)
- “the triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured.” (Hansmann & Kraakman, 2001, p. 468)

Strengths?

- Long term commitment – Ericsson financially troubled in 2001. Commitment of certain controlling owners dates 90 years back!
- Extralegal institutions – public scrutiny and social norms offset the drawbacks of a weak Corporate Governance system (cf. Holmén & Knopf, 2004).
- Strong regulation of the annual general meetings (Johansson, 1990; Cataús & Johed, 2007; Carrington & Johed, 2007).

Stewardship vs SWM

- Owner
- Residual value belongs firstly to company
- Equity – collected to sustain operations
- Theoretical referent - stewardship
- Financier
- Belongs to shareholder as compensation for risk
- Equity – level of equity affect possibility to pay dividends
- Financial economics
A typical view

- From 1930 and onwards:
  - retained earnings and debt (in part due to taxes)
  - control in the hands of few owners
  - close connections to banks

Accounting prior to IFRS

- Creditors/insiders vs. equity/outsiders explain national differences (Nobes & Parker, 2003).
- (Careful to textbook explanations!)
- Conservative accounting: lower reported profits than under accrual accounting regimes.

Evidence for conservative accounting 1/3

  - earnings measure under US GAAP 23% higher than under Swedish GAAP
  - book values 14% higher under US GAAP than under Swedish GAAP
  - conservative accounting less value relevant (Penman & Zhang, 2002)
The Swedish Company law regulate the dividend rules

Prior to 2006:
- calculated on the group (not parent company level)
- the rule of limited amount and the prudence principle
- In practice the dividend level was the lower of group or parent’s equity

A creditor focus – historically rooted
A stewardship view of the public company (a social institution – long term survival)
Detrimental to shareholders (common critique)

Background of the study
A study of AGMs (2004)
  - Three papers
    - SJM
      - Dual analysis
      - Ideal speech situation (Habermas)
      - Ritual/black box (Latour)
    - AAAJ
      - Accountability and ANT (Callon)
    - EAR (revise)
      - Auditors – transparency
      - The role of the SSA – a common observation
Dividends of Accounts: by Catasús & Johed 2009 1/3

- Sweden endorse IFRS
- On one hand old socioeconomic structures but one the other hand a move to a shareholder orientation
- Research question: do competing logics influence voting behaviour?

contd. 2/3

• Empirically:
  - examine if old views of the corporation influence how certain investor groups interpret the dividend decision?
  - Despite new regulation do investors vote “old school”?
  - Focus on the dividend decision – decided at the AGM

contd. 3/3

• Stewardship – long term survival of the company
• SWM – residual value belongs to the shareholders as compensation for risk
• Dividends / Earnings = do the two views interpret and vote differently
Methodology

- Interviews
- Observations of training events and meetings
- Archival material, documents, memos, minutes etc. Used for coding and analysis.
- Participated in 31 AGMs during the spring of 2008 plus 37 in 2004.
- Rich empirical

Sample description

- Between 6 and 100 020 employees.
- Between 9 and 1004 shareholders present. Typically 1 % of all shareholders present. Approx. 50 % of the votes present.
- Lasted for 80 minutes (median value), the shortest took 40 minutes and the longest over 3 hours.
- At the AGMs of larger companies there were production promotions, excavators, a fighter pilot simulator etc.

The aims of the AGM

- Elect and re-elect members of the board. The issue of financial discharge for last year. (Legal).
- Decide on dividends and how to dispose the profit/loss. Approve the accounts. (Legal).
- Inform shareholders about the financial performance. Forum for discussions between shareholders and management.
The regulation of the AGM - Sweden

- Shareholders need only one single share to put proposals. (Same for all Nordic countries.) Proxy voting allowed from 2006.
- The presence of the auditor and the possibility to ask questions to the auditor – different to the U.K.
- The vote on discharge of financial liability. (Same in Finland.) Legal implications, more difficult for shareholders to raise claims against the board on behalf of the company. The term “discharge” has different meaning to U.K and the U.S corporate governance systems.

The recent debate on AGMs (1/2)

- Increased complexity of accounting reports impedes active participation from private shareholders. (Bartlett & Chandler, 1997).
- A devaluation of the AGM as an accountability session due to the listing agreement. Institutional investors favour more tailored events i.e. exercise their rights elsewhere. (Roberts et al., 2006).
- Dispense with the AGM. Issue raised by the Review Group of the UK company law. (Strätling, 2003).
- The critique is in contrast to regulation that suggests that the AGM is a “good” forum for corporate governance.

contd. (2/2)

"the AGM has become a formality, a nod to an antiquated ideal of shareholder democracy which companies dare not jettison. Perhaps it is romantic to assert that the AGMs of bygone days were livelier. In any case, when the vitality is sucked out of them, all that is left is a shell of arcane rituals of little or no relevance to all but the retired accountant who pounces on a discrepancy in the notes to the accounts." (Jones, 2003)
Reject dividends!

- Counterintuitive – a non economic decision
- Culturally contingent – “retain and reinvest”
- =>overall support for our hypothesis that certain investor groups reject dividends when dividends not backed by earnings, decreased time interest earned etc.

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An illustrative example

- From SWM AGM (2008):
  - proposed dividend 896 Million SEK
  - group equity attributable to shareholders 724 Million SEK
  - repurchase program of 3 Billion SEK
  - e.g., a redistribution of 3.1 Billion SEK above group equity but company equity 22 182 Billion SEK
  - illegal prior to 2006

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Irresponsible proposal

- The proposed dividend supersedes the group’s equity and although the rule of limited amount has been abolished you violate the company’s operations when you don’t make a comparison with the group’s balance sheet. You have not paid attention to the degree of the [group’s] consolidation and what is outrageous is that none of the companies has any liquidity. The reason to why you can suggest this huge dividend is because of a wide range of revaluations” Representative of investor A 2008/04/22
Interpretation

- History matters:
  - argument based on earlier legislation
  - interprets accounting with reference to the future
  - (hence) propensity to reject dividend level not backed by earnings
  - support for our hypothesis

A responsible proposal

- Re = 192%=20%+(20%-3.4%)*10.6 (stable for prior years)
- Rt about 20% (stable for prior years)
- Net debt in relation to EBITA 2.5
- Support our hypothesis that history matters – a shareholder orientation

Conclusion/Summary

- IFRS project builds on the idea of sameness, companies, industries etc.
- A clear financial investor focus – homogenous assumptions about rationales
- Background other actors use of accounting
Conclusion/Summary

- Standardization and peculiarities:
  - a need to study determinative effects of accounting interpretations (Hopwood, 2009)
  - need for studies that link accounting to broader social and institutional views (culture)