Responsibility Accounting

- The Agency Conflict in General

- Agent works for Principal but
  - Agent is a self-interested party
  - Agent’s goals may differ from principal’s

- Agency problem exists for two reasons:
  - Goal Incongruence
  - Agents’ actions/information are not perfectly observable
Examples of Agency Conflicts

- Theft and fraud
- Shirking
- Consumption of perquisites
- Empire-building
- Risk Reduction
- Horizon Problem
The Firm’s Organizational Problem

Benefits of Specialization \(\iff\) Agency Costs

Methods to Reduce the Conflict
1. Systems to measure performance
2. Systems to reward and punish performance
3. Systems to partition decisions rights

Accounting’s Role in this Problem
1. Responsibility Accounting
   - Transfer pricing between divisions
   - Performance Evaluation using Variance Analysis
2. Compensation Contracting
Controllability Principle

Measure performance of sub-units based on the variables over which they have control

Cost Centers (ala Seligram ETO)
  Decision rights over costs, but not responsible for revenues
  Evaluated on ability to:
    Maximize output with given resources
    Minimize costs while meeting output targets

Profit Centers
  Decision rights over costs and prices
    Fixed amount of capital resources
    Evaluated on profitability

Investment Centers
  “Firm within a firm”
    Decision rights over capital expenditures
    Evaluated on ROI (profit/investment base)
Transfer Prices

*Internal price attached to units transferred from one cost or profit center to another (recall ETO use of costs)*

Two main goals of transfer prices:
- International Taxation: allocate company profit between two or more tax jurisdictions
- Incentives and performance measurement of profit centers

Potential problems arise when:
- Transfer prices encourage each profit center to maximize sub-unit profit, but
- The resulting actions decrease total enterprise profit.
Transfer Prices
General rules to avoid these problems

1. Transfer at outside market price if
   a. Such a price exists, i.e., $ an external market
   b. Producing division is operating at capacity

2. Cost-based transfer price (< market price) if producing division has excess capacity
Compensation Contracts

- **Goal:** Align incentives of managers with those of owners
- **Make managers better off when they take actions that make owners better off**

- **Examples:**
  - Earnings-based bonus plans
  - Bonus for meeting specific objectives, such as sports team making the playoffs

- **Key Issue:** Risk-sharing and agency costs
  - Reduce agency cost associated with effort
  - Increase agency cost associated with risk-sharing
Compensation Contracts: Pros and Cons

- Accounting-based contracts
  - Variables within manager’s control
  - May create incentives to manipulate income
  - Horizon problems

- Stock-based compensation
  - Many variables affecting value aren’t controllable
  - Risk-related agency problems
  - Effects on income statement / balance sheet
Alternative Performance Measures

- What’s wrong with the “old” ones?
  - Accounting profits don’t properly measure income and costs.

- Residual Income - subtracts from profits a charge for capital

- Economic Value Added =
  - adjusted accounting income - (capital*WACC)
Economic Value Added

• What is value? Why shareholder value?
  • Shareholders are residual claimants

• Several competing measures have been introduced to measure value and value creation by firms
  • EVA is an accounting concept
  • EVA is easiest to understand
  • EVA and related concepts are mentioned a lot in the press (in different shapes or forms)
Economic Value Added: Concept

- **Starting point:** Market Value Added (MVA)
  \[ \text{MVA} = \text{Market Value (MV)} - \text{Invested Capital (IC)} \]

- **What is the problem with MVA as a performance measure?**
  - Share price
  - 'Stock' measure

- **EVA is a 'Flow' measure**
  - Definition: NOPAT - Capital Charges
    \[ \text{NOPAT} = \text{net operating profit after taxes} \]
  (NO relation with stock prices)
Balanced Scorecard

Four sets of measures
  Fast but comprehensive view of how a business is doing

Customer perspective
Internal Business Perspective
Innovation and Learning Perspective
Financial Perspective
Balanced Scorecard

• Customer perspective
  • Specific measures to reflect the factors that customers value
  • How do you determine the appropriate goal?
  • How do you assess performance toward goals?

• Internal Business Perspective
  • Focus on critical internal operations required to satisfy customer needs
  • Timeliness of data may be key
  • Measures should reflect employees’ actions
Balanced Scorecard

- Innovation and Learning Perspective
  - Targets for success change over time
  - Emphasis on continuous improvement

- Financial Perspective
  - Factors above should produce improved profits
  - What if they don’t?
What was our course objective?

- To become intelligent users of accounting information
  
  - Learn the language and techniques
  
  - Go beyond bookkeeping and computation
    - Use a common framework to conceptualize issues
    - Emphasize the simultaneity and feedback effects of accounting and economic decisions