SOME THOUGHTS ON PERFORMANCE-BASED PAY, EARNINGS MANAGEMENT AND CORPORATE LAW FROM AN ANTIPODEAN PERSPECTIVE

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Abstract

[Performance-based remuneration theoretically is an effective way of aligning the interests of company management with those of shareholders. However, ‘earnings management’ is a phenomenon that has been well documented by accounting researchers. Empirical studies suggest that corporate officers who are subject to performance-based remuneration may manage company accounting figures to improve their remuneration. This paper contends that such practices are inconsistent with the duties of loyalty to which these officers are subject, and concludes by identifying a corporate governance role for legal advisers in light of such conduct.]

Keywords: Performance-based pay; earnings management; legal duties

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1. Introduction

There has been an explosion in academic research on executive compensation.1 Performance-based remuneration in particular raises corporate governance issues.2 As Rehnert and Ramsay observe, accounting figures can be manipulated to suggest good company performance, which in turn may lead to increased remuneration for corporate officers. This paper contends that such practices are inconsistent with the duties of loyalty that these officers are subject to, and concludes by identifying a corporate governance role for legal advisers in light of such conduct.

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performance, thereby influencing remuneration accordingly. For example, Chalmers, Koh and Stapledon note that:

Major Australian companies, such as AMP, Commonwealth Bank and Western Mining Corporation, have recently suspended executive share option plans, at least partly in response to the perceived potential for options to provide management with perverse incentives (eg to engineer the company’s accounting procedures so as artificially to improve the company’s financial performance, and thus enhance the value of options or the likelihood of them being in-the-money at the vesting date).4

Implicit in the foregoing observation appears to be an assumption that such practices, although potentially morally questionable, are less certainly legally problematic. However, this paper queries the legality of such practices, based on an analysis of the duties owed by those preparing company financial statements. Corporate officers who utilise ‘earnings management’ to increase their performance-based remuneration are using their positions for self gain in a way that is consistent with the duties to act bona fide in the best interests of the company, and for proper purposes.

An economic analysis of the reasons for performance-based pay follows in Part II of this paper. Such an analysis has largely been absent from the legal pay for performance literature, but is crucial in understanding the theory behind earnings management, which is dealt with in Part III. Part IV discusses the practice of earnings management in an Australian context, with Part V then analysing this practice in the context of various general law and statutory duties. Finally, Part VI concludes by noting a possible corporate governance role for legal advisers in light of such conduct.

II The Role of Performance-Based Pay In Corporate Governance

A Agency Theory

Listed companies are an economic force in capitalist societies, and these companies are traditionally characterised by the separation of ownership from management. According to neo-classical economic theory, rational individuals will act to maximise their personal utility by acting in a way that is consistent with their perceived self interest. This view of the world is not without its critics, but has also been

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5 In the words of Charles Yablon and Jennifer Hill, ‘Timing Corporate Disclosures To Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?’ (2000) 35 Wake Forest Law Review 83, 89: ‘all but the most egregious examples of such conduct are either legal or, even if technically illegal, are insulated from effective legal redress as a practical matter.’


7 See, eg, the absence of similar discussion in Adenwala, above n 3; Griffiths, above n 3; Parkinson, above n 3; Booth, above n 3; Bogus, above n 3; Barris, above n 3; and Vagts, above n 3. Cf Shaun Clyne, ‘Modern Corporate Governance’ (2000) 11 Australian Journal of Corporate Law 276.


shown to generally explain human behaviour. With the separation of ownership and management that occurs in many companies, it has been recognised since Adam Smith wrote his *Inquiry Into the Wealth of Nations* in 1776 that managers who run companies will not necessarily act in the best interests of the company’s members.

Despite its critics, the ‘agency theory’ propounded above and as popularised by Jensen and Meckling repeatedly finds empirical support. It is true that managers experience utility from the satisfaction that follows a job well done, but managers’ utility also increases from generously consuming executive perquisites and from exerting less rather than more effort at a fixed salary. These last two examples may be seen as manifestations of managerial self interest that, all other things being equal, reduce the actual or potential wealth of the company. As long as managers own less than 100 percent of the company, they avoid the full cost of their ‘shirking’ but still benefit from such behaviour. However, non-manager shareholders are worse off as their share of the company’s actual or potential wealth diminishes without attendant benefit.

### B Performance-Based Pay As a Potential Interest Aligning Mechanism

Themselves potentially rational self-interested utility maximisers, shareholders foresee that managers may act in a self-interested way that is inconsistent with the interests of shareholders. Shareholders might therefore be expected to act to preserve their own interests. For example, Simunic and Stein argue that managers who do not implement measures that appear to align their interests with those of shareholders could...}

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15 See especially Godfrey, Hodgson and Holmes, above n Ошибка! Закладка не определена., 292, 295; Godfrey et al, above n Ошибка! Закладка не определена., 260–3; Christie, above n Ошибка! Закладка не определена., 197–9; and W Kinney Jr and D Martin, ‘Does Auditing Reduce Bias In Financial Reporting? A Review of Audit-Related...
be paid less than what they would be paid if such measures were introduced.22 Managers accordingly institute such ‘bonding mechanisms’ in order to preserve their own interests,23 and one such mechanism is performance-based pay.24

Performance-based pay in theory seeks to align the interests of managers and shareholders, by linking managerial utility to company performance.25 With


29 R Kaplan and A Atkinson, Advanced Management Accounting (2nd ed, 1989) 723; V Brudney and M Chirolelstein, Corporate Finance (2nd ed, 1979) 1153.

which managers might have little or no control over.31

A company’s performance as reported in its financial statements can be expected to be used in pay for performance arrangements because producing financial information is costly. Understanding all the data required to create the final accounting figures requires much time and effort.32 Listed companies (ie companies where the separation of ownership and management can be expected to be most pronounced)33 are legally required to produce a set of financial statements.34 These financial statements can be used to ascertain the performance of a company for pay for performance purposes,35 avoiding considerable costs in producing a separate set of figures just for this purpose.36 The Corporations Act 2001 (Cth) requires the financial statements of listed companies to be audited.37 Together with the considerable cost and effort involved in going behind these statements and ‘unravelling’ their numbers,38 this has meant that the reported figures have mostly been used unchanged for bonus plan purposes,39 even with the involvement of compensation committees.40

III Earnings Management

A The ‘Bonus Plan’ Hypothesis

The use of accounting numbers to determine company performance for the purposes of performance-based pay means that the amount of such pay may potentially be increased through ‘management’ of the accounting numbers so that the company’s financial statements suggest good company performance.41 All other things being equal, it could be expected that ‘managing’ the numbers would involve less effort than actually increasing the wealth of the company to bring about positive change to the financial statement figures.42 Considering the reality of managerial self-interest, the notion that managers could be expected to ‘manage’ the numbers to increase their income should not be surprising. In fact, Healy has documented a statistically significant relationship in general between the presence of performance-based remuneration and the use of accounting treatments that for the most part increase the reported profit of the company.43 This

31 Sloan, above n 28, 7.
32 See, eg, Rehnert, above n 5, 1151; Clyne, above n ヨシバ! Закладка не определена., 23; and Smith and Watts, above n 26, 141, 149–50.
33 Godfrey et al, above n ヨシバ! Закладка не определена., 235; and Godfrey, Hodgson and Holmes, above n ヨシバ! Закладка не определена., 260.
34 Rehnert, above n 5, 1163.
35 Under Corporations Act 2001 (Cth) ss 111AC(1), 111AE(1), 286(1) and 292.
37 See Godfrey et al, above n ヨシバ! Закладка не определена., 235; and Godfrey, Hodgson and Holmes, above n ヨシバ! Закладка не определена., 260.
‘bonus plan hypothesis’ is now said to be so well established that a further 46 studies with insignificant results are required in order to discount its extremely high explanatory power.45

B The Contingent Nature of Accounting Numbers

‘Earnings management’ through the management of accounting figures is possible and, for the most part, legal because of the fluidity of accounting numbers.46 Accounting brings about a ‘contingent’ reality, not a


Picture a vibrant esplanade. Now, equate this to the physical realities facing a business: its assets, actual transactions and commercial environment. Imagine accounting as a ‘black box’ with many coloured lenses which must be looked through in order to see the esplanade.48 Each ‘lens’ represents an accounting method or treatment that is consistent with generally accepted accounting principles.49 How one sees the esplanade depends on which lens or lenses one looks through. Similarly, how the monetary value of the assets of a business and the profitability of its activities are reported in the financial statements depends on which professionally accepted accounting methods or treatments are used to construct the statements.50 Choosing between such treatments does not necessarily entail any falsification or conduct in the nature of what might be regarded as a ‘sham’.51

48 See, eg, Trevor Johnston, Martin Jager and Reginald Hodgson and Holmes, above n 36, 204–5, 207.

49 Cf Frank Clarke, ‘Creative Accounting: Standards Compliance and Absent Spirits’ (1988) 59 Chartered Accountant In Australia 64; Healy, above n 44, 89; and Watts and Zimmerman, Positive Accounting Theory, above n 36, 204–5, 207.

50 See, eg, Stephen Haswell, Charles Rickett and Ross Grantham (eds), Corporate Ownership & Control / Volume 4, Issue 1, Fall 2006 (continued)

The accounting profit of a business may be ‘managed’ in various ways without changing the underlying ‘reality’ of that business. Provided that the requirements of Australian Accounting Standard AASB 108 are met, one way in which profit may be managed is to change from one acceptable accounting treatment to another.\(^52\) With inflation (and with all other things being equal), inventory which is bought later in time will be more expensive than inventory that is bought earlier in time. If stock at the end of the financial year is valued on the basis that the inventory of the business is sold in the order in which it is acquired (ie ‘first in, first out’), the (reported) cost to the business of the inventory that it has sold will be lower than if the cost of inventory sold were calculated as an average of the price paid for inventory at the beginning and at the end of the year.\(^53\) This would bring about a relative increase in the profit of the business as reported in its financial statements. A change to the method under which the fixed assets of the business are depreciated which reduces the yearly depreciation expenses of the business will also bring about a relative increase in reported profit.\(^54\)

The accounting profit of a business may also be managed through the use and classification of discretionary items and accruals.\(^55\) Reducing the provision for doubtful debts is one example of the former.\(^56\) As far as classification is concerned, accounting performance measures that are used in bonus plans have often been calculated on the basis of ‘operating profit’.\(^57\) Prior to the introduction of Australian Accounting Standard AASB 101, ‘extraordinary’ gains and losses were not taken into account in determining operating profit as such gains and losses were not regarded as arising from the ordinary operations of the business.\(^58\) Managerial discretion does play a part in the decision on whether a particular item should be classified as ‘extraordinary’, for example in the delineation of the scope of the ordinary operations of the business.\(^59\)

By exercising their discretion in accounting matters, managers may therefore influence the level of their remuneration when they are subject to performance-based pay. The use of pre-existing accounting numbers and the disincentives to ‘unravelling’ or modifying these numbers for the purposes of bonus plans have previously been discussed. Pay for performance arrangements that are based in whole or in part on movements in the company’s share price may still create an incentive for ‘management’ of the accounting numbers, as research has shown that reported accounting figures can have an impact on the price of a company’s shares.\(^60\)

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56 See especially M McNichols and G Wilson, ‘Evidence of Earnings Management From the Provision For Bad Debts’ (1988) 26 *Journal of Accounting Research* 1; and Becker et al, above n 55, 19.

57 Smith and Watts, above n 26, 141; and Healy, above n 44, 93–4.


60 See, eg, Ray Ball and Philip Brown, ‘An Empirical Evaluation of Accounting Income Numbers’ (1968) 6(2) *Journal of Accounting Research* 159; Philip

IV AUSTRALIAN EMPIRICAL EVIDENCE

A Australian Bonus Plans

A number of studies have investigated the incidence of bonus plans in Australia. Defina, Harris and Ramsay examined the relationship between pay and performance in 1990 using 89 of the 136 largest Australian companies and found no correlation between pay and performance levels.61 Izan, Sidhu and Taylor studied a sample of 99 firms from 1987 to 1992 and found no evidence of a relationship between chief executive officer pay and firm performance.62

However, Matolcsy points out that the prevalence of performance-based pay is not stable over time but is instead dependent on the economic cycle, noting that there is no observable relationship between pay and performance during periods of economic downturn but that there is a positive relationship between pay and performance during periods of economic growth.63


Zoltan Matolcsy, ‘Executive Cash Compensation and
This finding may explain the results observed by Defina, Harris and Ramsay,64 and Izan, Sidhu and Taylor,65 whose samples were taken from a period of recession and a period of 'soft landing, recession and flat recovery'.66

Recent research by Matolcsy and Wright reveals some evidence of the use of performance-based pay among companies with shares listed on the Australian Stock Exchange, at least as far as their directors and five most highly remunerated officers are concerned.67

Although the precise make up of bonus plans may vary between companies across industry sectors and from firm to firm, Deegan has noted that accounting numbers do play a part in determining company performance for the purposes of performance-based pay.68

B Bonus Plan Hypothesis Behaviour In Australia

Australian evidence is consistent with the bonus plan hypothesis developed by Healy,69 namely that managers may be expected to in general adopt accounting treatments that for the most part increase the reported profit of the company when they are subject to performance-based remuneration. Godfrey and Adi and Godfrey and Jones have documented that managerial remuneration does have an impact on the accounting choices adopted by a company, and in particular on decisions in relation to discretionary accruals.70 Walsh, Craig and Clarke point out that extraordinary items appearing in the profit and loss statements of Australian companies have been predominantly negative in nature, meaning that there has been a tendency to classify losses as extraordinary.71 Conversely, Hoffman and Zimmer reveal that companies with highly remunerated chief executive officers ('CEOs') have been more likely to classify gains as operating, rather than extraordinary.72

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64 Defina, Harris and Ramsay, above n 61, 349 themselves admit that their study does not deny 'the existence of … bonus plans that tie remuneration to … accounting earnings.' For other shortcomings of this study, see Izan, Sidhu and Taylor, above n 62, 39–40.

65 Izan, Sidhu and Taylor, above n 62.


69 Healy, above n 44.

70 Godfrey and Adi, above n 41; J Godfrey and K Jones, ‘Political Cost Influences On Income Smoothing Via Extraordinary Item Classification’ (Working Paper, University of Tasmania, 1998). The use and classification of discretionary accruals for the purposes of managing the reported accounting profit of a company has previously been discussed.


72 Tony Hoffman and Ian Zimmer, ‘Managerial Remuneration and Accounting For Recurring Extraordinary Items’ (1994) 34(2) Accounting and
The above is consistent with the behaviour predicted by the bonus plan hypothesis, bearing in mind that Smith and Watts have noted that accounting measures used in bonus plans in Australia have often been based on operating profit (rather than operating profit after extraordinaries), and that Easton, Eddey and Harris have demonstrated that, as might be expected, managers in Australia do act in ways consistent with their own self-interest. In the words of Hoffman and Zimmer:

[Remuneration schemes ... typically in place ... provide] incentives to manage earnings ... such contracts are ... in ... operating rather than total earnings ... [providing] incentives to classify losses as extraordinary rather than operating. ... [High ... remuneration is likely ... the result of ... performance based ... remuneration ... this ... is associated with accounting choices ... maximising operating rather than total earnings.]

Hoffman and Zimmer specifically control for the effect of other factors which could be expected to influence remuneration (such as company size, 'political exposure' and interest coverage), and further show that there is not a general tendency (ie absent a likely bonus plan) to classify gains as operating and losses as extraordinary:

As previously noted, the Corporations Act 2001 (Cth) requires listed companies to prepare financial statements. The power to prepare financial statements thus is, in many cases, a power conferred by statute. The directors of a company are required to take all reasonable steps to ensure that the company complies with its reporting obligations. The power to prepare financial statements is also said to fall within the general management power exercised by a company’s board of directors under the Replaceable Rules and under many company constitutions.
The Working Group on Corporate Practices and Conduct has observed that, in practice, directors largely entrust managers with ensuring that the company complies with its reporting obligations. Frequently, senior management finalise the financial statements and CEOs ultimately present these statements for inclusion in the company’s financial reports. The financial statements must give a ‘true and fair view’ of the financial position and performance of the company. However, this rider may in fact be empty as the phrase ‘true and fair view’ awaits authoritative definition and apparently means complying with generally accepted accounting principles, which is what the Australian Accounting Standards are already intended to reflect.

As previously discussed, the Standards allow considerable discretion by enabling apparently similar business facts to be portrayed in different ways for accounting purposes. This flexibility in theory exists in order to accommodate the diverse environments in which businesses operate. It has been noted that managers accordingly are required to use their ‘professional skill and specialised knowledge’ when choosing between available accounting treatments, so as to choose the treatment that most appropriately reflects the circumstances of the company.

Boards of directors therefore for the most part effectively give senior company managers like CEOs the ability to select between different accounting treatments under the Accounting Standards for the purposes of satisfying the company’s reporting obligations. As noted above, the accounting performance of the company as reported in its financial statements can be expected to be taken into account in the pay for performance arrangements under which these managers may be remunerated.

It can be argued from the research previously conducted that the board’s potential liability for possible misconduct by managers in the exercise of this delegated power is discussed in the text accompanying nn 154–164, below. In the text accompanying nn 27–41, Rowland, above n 46, 169; and LBC, Laws of Australia, vol 4 (at 16 September 2005) 4 Business Organisations, ‘4.2 Company Management’ [312].


The board’s potential liability for possible misconduct by managers in the exercise of this delegated power is discussed in the text accompanying nn 154–164, below. In the text accompanying nn 27–41, Executive directors may also be subject to performance-based pay.

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Working Group on Corporate Practices and Conduct, Corporate Practices and Conduct (3rd ed, 1995). See also Geoff Stapledon, Institutional Shareholders and Corporate Governance (1996) 7–8; Hanrahan, Ramsay and Stapledon, above n 4, 116–7, 119, 182, 202, 436; AWA Ltd v Daniels (t/a Deloitte Haskins & Sells) (1992) 7 ACSR 759, 832–3, 865–6 (Rogers CJ) (‘AWA’); and Re City Equitable [1925] 1 Ch 407, 426–7 (Romer J). This delegation is said to occur because boards focus on strategic matters rather than on recurring management issues like financial reporting. Even if boards are involved in the preparation of financial statements, it is likely that executive directors will play a greater role in this process than non-executive directors, as the former possess greater knowledge of the company’s day to day operations and this knowledge facilitates the preparation of the financial statements. Cf R Tomasic and S Bottomley, ‘Corporate Governance and the Impact of Legal Obligations On Decision Making In Corporate Australia’ (1991) 1 Australian Journal of Corporate Law 55, 67.

Cf Royal Commission into the Tricontinental Group of Companies, Final Report of the Royal Commission Into the Tricontinental Group of Companies (1992) para 19.56; and Entwells Pty Ltd v National & General Insurance Co Ltd (1991) 5 ACSR 424, 427 (Ipp J). The financial report contains the company’s financial statements but also contains other material, such as the directors’ declaration about the financial statements and the notes to the financial statements.


discussed that the preparers of financial statements who are subject to pay for performance arrangements that draw on the accounting performance of the company as reported in its financial statements can often be said to have prepared these financial statements in ways that might generally be expected to maximise the remuneration of the preparers under these arrangements, in large part by choosing accounting treatments that would increase the reported profit of the company over treatments which would have the opposite effect. This conduct will now be discussed in the context of the duty to act bona fide in the best interests of the company, the duty to act for proper purposes and the prohibition against making an improper use of position.

B Acting Bona Fide In the Best Interests of the Company

It is well established that the directors of a company must act bona fide in the best interests of the company. While this does not mean that a court will closely scrutinise the merits of board decisions, it does mean that directors generally may not benefit themselves at the expense of the company. This prohibition might be said to extend not just to directors, but to all fiduciaries of the company who exercise discretionary powers in this capacity.

Senior company managers like CEOs would stand in a fiduciary relationship vis-à-vis their company, as a result of their top level ‘decision-making discretion and responsibility’ over management matters. One such discretion is the power to select

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96 Although this paper focuses on senior managers as they are often the ones responsible for preparation of the financial statements, the principles discussed are equally applicable to executive directors who are subject to performance-based pay and who engage in ‘earnings management’.

97 A detailed discussion of the conflict of interest issues that may arise in relation to managers and their performance-based pay can already be found in Hill and Yablon, above n 25.


102 Senior company managers like CEOs would stand in a fiduciary relationship vis-à-vis their company, as a result of their top level ‘decision-making discretion and responsibility’ over management matters. One such discretion is the power to select
between alternative accounting treatments, which they have as a result of the responsibility often delegated to them by the board for the preparation of the company’s financial statements. Senior managers like CEOs also arguably are ‘officers’ of the company, bound by s 181 of the Corporations Act 2001 (Cth), as the financial statements that they (effectively) prepare can significantly affect the financial standing of the company.

When managers choose accounting treatments that would increase the reported profit of the company over treatments which would have the opposite effect and do so in order to increase their remuneration under pay for performance arrangements, the question arises as to whether such choices are being made bona fide in the best interests of the company.

It would firstly appear that such choices would probably not be ‘genuine’ (and therefore not bona fide) choices, if one borrows from notions of `fiduciary accountability’, above n 101, 141, 172.

Discussed in the text accompanying nn 84–85, above.


On the relationship between genuineness and bona fides see, eg, Hindle v John Cotton Ltd (1919) 56 SCots LR 625; 630–1 (Viscount Finlay) (‘Hindle’); Darvall v North Sydney Brick & Tile Co (No 2) (1989) 7 ACLC 659; 680 (Kirby P) (‘Darvall’); Marson Pty Ltd v Pressbank Pty Ltd (1987) 12 ACSR 465, 471 (McPherson J); Corporate Affairs Commission v Papoulas (1990) 2 ACSR 655, 657 (Allen J); Flavel v Roget (1990) 1 ACSR 595, 607, 609 (O’Loughlin J); Morgan v Flavel (1983) 1 ACSR 831, 837–8 (White J) (‘Morgan’); and Fitzsimmons v The Queen (1997) 23 ACSR 355, 364–5 (Parker J, with whom Owen and Murray JJ agreed). The relationship is also discussed in Sealy, ‘“Bona Fides” and “Proper Purposes”’, above n 100, 269; Parsons, above n 103, 395–6, 417; Malcolm, above n 100, 69–72; Baxt et al, above n 106, ‘relevant’ and ‘irrelevant’ considerations from public law. As discussed above, the flexibility that the choice of different accounting treatments provides exists in order to accommodate the diverse environments in which businesses operate. When managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration and thereby gain a personal financial benefit, there is an issue as to whether they are ignoring relevant considerations and instead having regard to improper considerations.

Secondly, it can also be said that conduct of this kind is not in the best interests of the company. Increasing reported profits through accounting choices with the aim of maximising performance-based remuneration has negative implications for shareholder wealth. When managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration, they may end up receiving by way of remuneration more than what they would otherwise have received had they not made such choices. The company’s enhanced performance (albeit potentially consistent with the Accounting Standards) exists only on paper, whereas real wealth flows out of the company to managers in the form of managerial compensation. This would appear to be

32–4; and Worthington, ‘Directors’ Duties’.

See especially Sealy, ‘“Bona Fides” and “Proper Purposes”’, above n 100, 268, 277; and Worthington, ‘Directors’ Duties’, above n 80, 122–3. On how to distinguish between relevant and irrelevant considerations see, eg, Minister for Aboriginal Affairs v Peko-Wallsend (1986) 162 CLR 24; R v Australian Broadcasting Tribunal; Ex parte 2HD Pty Ltd (1979) 144 CLR 45; and R v Toohey (Aboriginal Land Commissioner); Ex parte Northern Land Council (1981) 151 CLR 170.


Cf Gevurtz, above n 51, 1276–7.

Performance under pay for performance arrangements may also be measured in terms of upward movement in the company’s share price, but research has shown that a company’s reported accounting profit can have an impact on the price of the company’s shares. See n 60 above, and accompanying text.

See generally P Dechow, R Sloan and A Sweeney, ‘Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject To Enforcement Actions By the SEC’ (1993) 13(1) Contemporary Accounting Research 1; and Robert Holthausen, ‘Accounting
contrary to the rationale underlying performance-based remuneration, namely that such remuneration is premised on an increase in the wealth of the company.\(^{113}\)

All other things being equal, it would therefore be hard to see how an intelligent, honest CEO could genuinely consider the accounting choice in question to be in the best interests of the company.\(^{114}\) It is at least arguable that no fiduciary acting reasonably could consider this to be the case,\(^{115}\) as fiduciary relationships exist to align the interests of fiduciaries with those of the beneficiaries of the fiduciary relationship.\(^{116}\) In particular and as discussed above, pay for performance arrangements are aimed at aligning the interests of company management with those of the company (practically, the company’s members).\(^{117}\) As previously noted,\(^{118}\) when managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but in order to maximise the reported profit of the company so as to maximise their performance-based remuneration, they are furthering their own interests at the expense of the company.\(^{119}\)

It would not appear to be relevant that the pay for performance arrangements themselves might not expressly prohibit choosing between available accounting treatments not so as to most appropriately reflect the circumstances of the company but so as to maximise the performance-based remuneration in question.\(^{120}\) Chief Justice Cardozo has observed that a laissez-faire, free-market philosophy only has a limited role to play in fiduciary relationships,\(^{121}\) as the obligations imposed under such relationships in general exist in order to curb the potential for self-interested exploitation of contractual opportunities by the fiduciary.\(^{122}\) In particular, Duggan suggests that fiduciary obligations represent ‘default contracts’, in that if equity did not impose such obligations, the parties to the relationship would expressly agree to them in any event.\(^{123}\)

It might be said that this argument gains support from the view that fiduciary obligations safeguard the integrity of socially beneficial relationships in cases where there may be a divergence in the interests of the parties to the relationship.\(^{124}\) As noted above, listed

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\(^{113}\) Rehnert, above n 5, 1157, 1168.


\(^{115}\) On this requirement of reasonableness see, eg, Shuttleworth v Cox Bros & Co (Maidenhead) Ltd [1927] 2 KB 9, 23–4 (Scrutton LJ) (‘Shuttleworth’); Hutton v West York Railway Co (1883) 23 Ch D 654, 671 (Bowen LJ); and Wayde v New South Wales Rugby League Ltd (1985) 61 ALR 225, 232 (Brennan J). An example of the application of this reasonableness requirement in a recent, high profile case is Re HIH Insurance Ltd; Australian Securities and Investments Commission v Adler (2002) 168 FLR 253.


\(^{117}\) As A Barnea et al, Agency Problems and Financial Contracting (1985) 61–79; and Healy, above n 44, 85 recognise.

\(^{118}\) In the text accompanying nn 110–113, above.


\(^{123}\) See generally J Coffee, ‘No Exit? Opting Out, the Contractual Theory of the Corporation and the Special
companies are an economic force in capitalist societies and such companies are traditionally characterised by the separation of ownership and management.

C Proper Purposes

It is well established that corporate powers must be exercised for proper purposes. This principle has predominantly been considered in the context of hostile takeovers but is one of general application. Further, while the principle has mostly been applied to directors, they are not the only ones who are bound by this rule. As Corkery and Worthington point out, the principle is applicable to all donees who exercise limited powers.

As previously noted, the power of a company’s board to prepare financial statements can be said to arise from statutory disclosure provisions, the board’s general management power over the company and the duties of care, skill and diligence imposed on directors. The common delegation of this power to senior management in practice has also been discussed.

Disputes in relation to proper and improper purposes have predominantly arisen in the context of the issuing of shares, and the purposes for which the power to prepare financial statements may or may not be exercised do not appear to have been judicially considered. It has been said that the nature and sources of a power will determine the purposes for which the power may or may not be used. As has been observed, the considerable discretion that is available in the exercise of the power to prepare financial statements is present in order to accommodate the diverse environments in which businesses operate, which requires managers to use their ‘professional skill and specialised knowledge’ when choosing between available accounting treatments so as to most appropriately reflect the circumstances of the company.

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125 See eg, *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, 671 (Lindley MR); *Mills* (1938) 60 CLR 150, 169 (Rich J) and 185–6 (Dixon J); *Ure* (1923) 33 CLR 199, 217 (Isaacs J); *Ngurli* (1953) 90 CLR 425, 438–40 (Williams ACJ, Fullagar and Kitto JJ); *Richard Brady* (1937) 58 CLR 112, 142 (Dixon J); *International Leasing* (1969) 1 NSWLR 424, 436 (Helsham J); *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, 303 (Browne-Wilkinson LJ); *Harlowe’s* (1968) 121 CLR 483, 493 (Barwick CJ, McTiernan and Kitto JJ); *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285, 293 (Mason, Deane and Dawson JJ); *Vatcher* [1915] AC 372, 384 (Lord Parker); *TecK Corporation Ltd v Millar* (1972) 33 DLR (3d) 288, 312 (Berger J); *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109, 137 (Ipp J, with whom Malcolm CJ and Seaman J agreed) (‘Wheeler’); and *Corporations Act 2001 (Cth)* s 181.


127 See eg, *Mills* (1938) 60 CLR 150, 185 (Dixon J); *Ngurli* (1953) 90 CLR 425, 439–40 (Williams ACJ, Fullagar and Kitto JJ); *Richard Brady* (1937) 58 CLR 112, 142 (Dixon J); *Wheeler* (1994) 14 ACSR 109, 137 (Ipp J, with whom Malcolm CJ and Seaman J agreed); and *Corporations Act 2001 (Cth)* s 181.

128 As Sealy, ‘“Bona Fides” and “Proper Purposes”’, above n 100, 271 points out.

129 See, eg, *Topham* (1864) 11 HLC 32, 54 (Westbury LC); *Vatcher* [1915] AC 372, 378 (Lord Parker); *Mills* (1938) 60 CLR 150, 185 (Dixon J); *Ngurli* (1953) 90 CLR 425, 438 (Williams ACJ, Fullagar and Kitto JJ); *Wheeler* (1994) 14 ACSR 109, 137 (Ipp J, with whom Malcolm CJ and Seaman J agreed); and *Corporations Act 2001 (Cth)* s 181.


131 In the text accompanying nn 79–83.

132 In the text accompanying nn 84–85, above.


135 See, eg, *Howard Smith* [1974] AC 821, 835 (Lord Wilberforce); *Kokotovich Constructions Pty Ltd v Wallington* (1995) 17 ACSR 478, 490 (Kirby ACJ, with whom Priestly and Handle JJA agreed); and *Re Burton’s Settlements* [1955] Ch 82, 100 (Lord Upjohn).


137 LBC, above n 91, [307], [312]. See also Rowland, above n 46, 169.
It is therefore arguable that choosing accounting treatments with the aim of maximising performance-based remuneration represents an exercise of the power to select between different accounting treatments for an improper purpose. As Lord Wilberforce has observed, self-interest is ‘the commonest instance of improper motive’. It is arguable that dishonesty potentially is present when managers choose between available accounting treatments in order to maximise the reported profit of the company so as to maximise their performance-based remuneration, accounting choices ostensibly are not being made so as to best reflect the performance of the company. The fiduciary position occupied by senior managers who in practice are largely charged with the preparation of the financial statements has been noted above, and arguably reinforces the view that the power to select between different accounting treatments must be exercised for the benefit of the company and not for managerial self gain.

D Improper Use of Position

Section 182 of the Corporations Act 2001 (Cth) proscribes the making of improper use of a corporate position. When managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration, it can be argued that they are in contravention of the prohibition in s 182. As previously discussed, such conduct arguably involves a breach of the equitable duties to act bona fide in the best interests of the company and for proper purposes. The cases suggest that such wrongs would constitute impropriety for the purposes of s 182, and the terms of the section apply the prohibition against improper use of position to everyone from the directors of the corporation to its employees.

Under s 184(2) of the Corporations Act 2001 (Cth), an officer or employee of a corporation commits a criminal offence if he or she uses his or her position dishonestly with the intention of:

• directly or indirectly gaining an advantage for himself or herself; or
• causing a detriment to the corporation.

It is arguable that dishonesty potentially is present when the preparers of financial statements knowingly make accounting choices in the preparation of these statements with the intention of maximising their performance-based remuneration. As noted above, when managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration, they may end up receiving by way of remuneration more than what they would otherwise have received had they not made such choices. The company’s enhanced

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137 See Howard Smith [1974] AC 821, 835. See also Birds, above n 100, 583.
138 Cf Dechow, Sloan and Sweeney, above n 112; Holthausen, ‘Accounting Method Choice’, above n 112; Rowland, above n 46, 169; and Dechow and Sloan, above n 119.
139 In the text accompanying nn 102–104.
140 Cf Re International Vending Machines Pty Ltd (1963) 80 WN (NSW) 465, 473 (Jacobs J); Chan v Zacharia (1984) 154 CLR 178, 195, 198 (Deane J); and Re Coomber; Coomber v Coomber [1911] 1 Ch 723, 728–9 (Moulton LJ).
142 On the penalties for contravention of s 182, see Pt 9.4B of the Corporations Act 2001 (Cth), discussed in Baxt et al, above n 106, 53–5; and Hanrahan, Ramsay and Stapledon, above n 4, 209–10.
143 For discussion of the ambit of s 182 see, eg, Baxt et al, above n 106, 37–8, 55–6; and Hanrahan, Ramsay and Stapledon, above n 4, 209–10.
144 For academic discussion of this section see, eg, Austin, Ford and Ramsay, above n 98, 392.
145 Cf the notion of dishonesty as discussed in Re Southern Resources Ltd; Residues Treatment & Trading Company Ltd v Southern Resources Ltd (No 2) (1989) 7 ACLC 1130, 1152 (Perry J); and Marchesi v Barnes [1970] VR 434, 437–8 (Gowans J). The meaning of the term ‘dishonestly’ for the purposes of s 184(2) does not appear to have been judicially considered.
146 Performance under pay for performance arrangements
performance (albeit potentially consistent with the Accounting Standards) exists only on paper, whereas real wealth flows out of the company to managers in the form of managerial compensation.\textsuperscript{149} Deliberately making accounting choices with the intention of bringing this scenario about arguably would suggest that there has been a breach of s 184(1).\textsuperscript{150}

Under s 184(1) of the Corporations Act 2001 (Cth), an officer of a corporation also commits a criminal offence if he or she is intentionally dishonest and fails to exercise his or her powers, or to discharge his or her duties:

- in good faith in the best interests of the corporation; or
- for a proper purpose.\textsuperscript{151}

As previously discussed, when managers choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration, it can be argued that they are potentially in breach of their duties to act bona fide in the best interests of the company and for proper purposes.\textsuperscript{152} When managers deliberately increase the paper wealth of the company with the intention of increasing the real wealth that flows out of the company to them in the form of managerial compensation, such conduct may potentially be regarded as dishonest and therefore arguably also a breach of s 184(1).\textsuperscript{153}

\textsuperscript{149} See, eg, Dechow, Sloan and Sweeney, above n 112; Holthausen, ‘Accounting Method Choice’, above n 112; and Dechow and Sloan, above n 119. Cf Gevurtz, above n 51, 1277.

\textsuperscript{150} For detailed discussion of s 184, see Baxt et al, above n 106, 55–6; and Hanrahan, Ramsay and Stapledon, above n 4, 212, 280–1.

\textsuperscript{151} For academic discussion of this section see, eg, Austin, Ford and Ramsay, above n 98, 266.

\textsuperscript{152} See text accompanying nn 98–140, above.


\textsuperscript{154} In the text accompanying nn 84–85, above.

\textsuperscript{155} Read together with s 198D. For a discussion of these sections, see Baxt et al, above n 106, 29–30; and Hanrahan, Ramsay and Stapledon, above n 4, 202–3.


\textsuperscript{157} A similar question also arises where the board of directors delegates this responsibility to some of the directors on the board and conduct of the same kind is engaged in by the directors in question. A detailed discussion of the conflict of interest issues that may arise in relation to managers and directors and their performance-based pay can already be found in Hill and Yablon, above n 25.

\textsuperscript{158} See, eg, Healy, above n 44; Christie, above n 45;
reasonable grounds to believe that managers who are charged with preparing the company’s financial statements will make the accounting choices that are available in the preparation of these statements bona fide in the best interests of the company and for proper purposes,159 where these managers are subject to pay for performance arrangements under which their remuneration might be determined at least in part by the performance of the company as reported in its financial statements.

The above could therefore be one example of a situation where boards might have to monitor management with a great degree of care and diligence.160 However, the same potential lack of detailed familiarity by the board with the day to day operations of the business which can make the delegation of the financial statement preparation function to management efficient161 could also mean that boards and non-executive directors might find it difficult to effectively question senior management or executive directors on the dominant reasons for the choice of certain accounting treatments over others.162 It could be the case that exercising due care and diligence under these circumstances might require the board to refrain from delegating to management the responsibility for preparation of the company’s financial statements.163 However, as Rehnert points out, a board dominated by executive directors who are subject to performance-based pay under which remuneration is determined at least in part by the performance of the company as reported in its financial statements could still end up making accounting choices that ultimately are primarily aimed at increasing the remuneration of these directors.164

F Problems Practical and Legal

It would appear that the very nature of the breaches of the legal and equitable duties potentially arising from the practice of ‘earnings management’ as discussed above (eg an apparent failure to act bona fide in the best interests of the company or for proper purposes)165 would likely preclude the application of a defence that is based on the ‘business judgment rule’.166 However, as will be discussed below, litigating the potential breaches of duty that might be associated with ‘earnings management’ could prove to be difficult in practice.167

1 Proving Actual Bad Faith

It is one thing to infer from the results of relevant academic studies168 that managers who are subject to pay for performance arrangements under which their remuneration is potentially influenced by the accounting profit of the company as reported in its financial statements169 may, in the preparation of these

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160 On the board’s monitoring role see, eg, AWA (1992) 7 ACSR 759, 865–6 (Rogers CJ). What is required by the duty to exercise due care and diligence is considered in Dovey v Cory [1901] AC 477, 485–6 (Halsbury LC) and 492–3 (Lord Davey); Dorchester [1989] BCLC 498, 502 (Foster J); Re City Equitable [1925] Ch 407, 426–9 (Romer J); Marquis of Bute’s Case [1872] 2 Ch 100, 109 (Stirling J); Dean (1878) 10 Ch D 450, 454 (Jessel MR); Brazilian Rubber [1911] 1 Ch 425, 437 (Neville J); Land Credit [1870] LR 5 Ch App 763, 770–2 (Hatherley LC); Denham [1883] 25 Ch D 752, 766–8 (Chitty J); Frisakis (1993) 11 ACSR 162, 215 (Ipp J, with whom Malcolm CJ agreed); and Overend & Gurney Co v Gibb (1872) LR 5 HL 480, 486–7, 495 (Lord Hatherley).

161 See Rehnert, above n 5, 1150, 1165.

162 See especially Rehnert, above n 5, 1167; and generally Malcolm, above n 100, 67–9.

163 See, eg, Baxt et al, above n 106, 29.
statements, choose between available accounting treatments not so as to most appropriately reflect the circumstances of the company but instead to maximise the reported profit of the company so as to maximise their performance-based remuneration. It is another thing to actually prove that this has taken place in individual cases.

The Accounting Standards allow for the exercise of a significant amount of discretion in the preparation of the financial statements. Even if managers are subject to performance arrangements under which their remuneration may be influenced by the accounting treatment of the company as reported in its financial statements, and the accounting treatments employed in the preparation of these statements in general are those that would increase the reported profit of the company rather than those which would have the opposite effect, it still does not necessarily follow (whether on the balance of probabilities or beyond reasonable doubt) that managers have managers as they are often the ones responsible for preparation of the financial statements, the principles discussed are equally applicable to executive directors who are subject to performance-based pay and who engage in ‘earnings management’.

On the drawing of inferences from broad ‘context’ evidence see, eg, Winthrop Investments Ltd v Winns Ltd (1979) 4 ACLR 207, 217, 221, 223 (Jacobs ACJ, Prior and Mullighan JJ); Smith [1942] Ch 304, 306, 308 (Lord Greene MR); Hindle (1919) 56 Scots LR 625, 630–1 (Viscount Finlay); and Richard Brady (1937) 58 CLR 112, 135 (Latham CJ), 138 (Rich J) and 144–5 (Dixon J). Cj J D Hannes v J H Pty Ltd (1992) 7 ACSR 8, 12 (Sheller JA); Grant v John Grant & Sons Ltd (1950) 82 CLR 1, 46 (Fullagar J); and Ampol Petroleum Ltd v R W Miller (Holdings) Ltd (1972) 2 NSWLR 850, 858 (Street J) (‘Ampol’).

See discussion in the text accompanying nn 46–59, above.

Performance under pay for performance arrangements may also be measured in terms of upward movement in the company’s share price, but research has shown that a company’s reported accounting profit can have an impact on the price of the company’s shares. See n 60 above, and accompanying text.

Cf Briginshaw v Briginshaw (1938) 60 CLR 336; Rejek v McElroy (1965) 112 CLR 517; and Neat Holdings Pty Ltd v Karajan Holdings Pty Ltd (1992) 110 ALR 449. Section 1317L of the Corporations Act 2001 (Cth) sets out the standard of proof that must be met before declarations of the arguable contraventions of ss 181 and 182 (as discussed in the text accompanying nn 107–119, 137–140 and 142–145, above) may be made in civil penalty proceedings brought by the Australian Securities and Investments Commission (‘ASIC’) under s 1317J. For a discussion of the circumstances in which ASIC has brought civil penalty proceedings see, eg, Michelle Welsh, ‘Eleven Years On: An Examination of ASIC’s Use of an Expanding Civil Penalty Regime’ (2004) 17 Australian Journal of Corporate Law 175.

2 ‘Mixed Purposes’

The problem of ‘mixed purposes’ presents itself if the proper purposes doctrine is invoked in the context of ‘earnings management’, as it would appear to be unlikely that a manager would choose one accounting treatment over another solely for the purpose of potentially increasing his or her remuneration under a pay for performance arrangement. As noted above, listed companies are legally required by the Corporations Act 2001 (Cth) to prepare financial statements. Compliance with this obligation requires the making of choices between different accounting treatments, as the Accounting Standards allow for the exercise of a significant amount of discretion in the preparation of the financial statements.

The phenomena of ‘earnings management’ could therefore be said to reflect the combination of the need to choose accounting treatments in the first place, and the actual selection of treatments that in general have the relative effect of

170 On the relevant requirements of proof in litigation raising issues of bona fide and proper purposes see, eg, Gordon v Australian & New Zealand Theatres Ltd (1940) 40 SR (NSW) 512, 517 (Jordan CJ); Southern Resources Ltd v Residues Treatment & Trading Co Ltd (1990) 3 ACSR 207, 217, 221, 223 (Jacobs ACJ, Prior and Mullighan JJ); Smith [1942] Ch 304, 306, 308 (Lord Greene MR); Hindle (1919) 56 Scots LR 625, 630–1 (Viscount Finlay); and Richard Brady (1937) 58 CLR 112, 135 (Latham CJ), 138 (Rich J) and 144–5 (Dixon J). Cj J D Hannes v J H Pty Ltd (1992) 7 ACSR 8, 12 (Sheller JA); Grant v John Grant & Sons Ltd (1950) 82 CLR 1, 46 (Fullagar J); and Ampol Petroleum Ltd v R W Miller (Holdings) Ltd (1972) 2 NSWLR 850, 858 (Street J) (‘Ampol’).

171 See discussion in the text accompanying nn 46–59, above.

172 Performance under pay for performance arrangements may also be measured in terms of upward movement in the company’s share price, but research has shown that a company’s reported accounting profit can have an impact on the price of the company’s shares. See n 60 above, and accompanying text.

173 Cf Briginshaw v Briginshaw (1938) 60 CLR 336; Rejek v McElroy (1965) 112 CLR 517; and Neat Holdings Pty Ltd v Karajan Holdings Pty Ltd (1992) 110 ALR 449. Section 1317L of the Corporations Act 2001 (Cth) sets out the standard of proof that must be met before declarations of the arguable contraventions of ss 181 and 182 (as discussed in the text accompanying nn 107–119, 137–140 and 142–145, above) may be made in civil penalty proceedings brought by the Australian Securities and Investments Commission (‘ASIC’) under s 1317J. For a discussion of the circumstances in which ASIC has brought civil penalty proceedings see, eg, Michelle Welsh, ‘Eleven Years On: An Examination of ASIC’s Use of an Expanding Civil Penalty Regime’ (2004) 17 Australian Journal of Corporate Law 175.

174 Parsons, above n 103, 425–6 recognises that such evidence might be hard to find.

175 See, eg, Smith [1942] Ch 304, 308 (Lord Greene MR); Shuttleworth [1927] 2 KB 9, 18 (Bankes LJ); Wheeler (1994) 14 ACSR 109, 137–48 (Ipp J, with whom Malcolm CJ and Seaman J agreed); Hindle (1919) 56 Scots LR 625, 630–1 (Viscount Finlay); Richard Brady (1937) 58 CLR 112, 136 (Latham CJ); Pine Vale (1983) 8 ACSR 199, 207, 209 (McPherson J); Darvall (1989) 15 ACLR 230, 239 (Kirby P); Advance Bank (1987) 12 ACLR 118, 137 (Kirby P); Morgan (1983) 1 ALCR 831, 838 (White J); and Ampol [1972] 2 NSWLR 850, 874 (Street J).


177 Under Corporations Act 2001 (Cth) ss 111AC(1), 111AE(1), 286(1) and 292.

178 See the discussion in the text accompanying nn 46–59.
increasing the accounting profit of the company as reported in its financial statements.

It might therefore be said that conduct amounting to ‘earnings management’ may potentially be motivated by mixed ‘compliance’ and ‘remuneration increasing’ purposes.\(^{180}\) If this is the case, it would appear that the conduct in question would fall foul of the proper purposes doctrine only if the desire to potentially increase the amount of performance-based remuneration was the ‘substantial reason’\(^{181}\) for choosing some accounting treatments over others, or this desire was a significant reason ‘but for’ which the relevant accounting treatments would not have been chosen. It could prove to be very hard to establish the existence of either of the above in individual cases. As previously noted, the Accounting Standards allow the preparers of financial statements to exercise a significant amount of discretion in the process of preparing these statements. The significant amount of discretion allowed for by the Standards in the exercise of preparing the statements could mean that the treatments ultimately chosen for the purposes of preparing the statements might generally be those that have the relative effect of increasing the accounting profit of the company, even absent ‘substantial’ or ‘significant’ bad faith on the part of the statement preparers.\(^{183}\) Again, too much could depend on the credibility of the individuals in question.\(^{184}\)

3 The Loss or Profit From Earnings Management May Be Difficult To Prove

It could be said that managers who deliberately increase the paper wealth of the company with the intention of increasing the real wealth that flows out of the company to them in the form of managerial compensation are furthering their own interests at the expense of the company. However, quantifying the amount of this gain which has occurred at the company’s expense would appear to rest on the answer to the following question: if managerial self-interest had not coloured the selection of the relevant accounting treatments, what treatments might have been chosen?\(^{185}\)

Unfortunately, the answer to this question does not contain enough information. Further research or a new question may be necessary to determine the answer.
not appear to readily present itself, because the same accounting choices could still have been made. As previously noted, the accounting treatments chosen for the purposes of preparing the company’s financial statements might generally be those that have the relative effect of increasing the accounting profit of the company, even absent a desire on the part of the preparers of these statements to potentially increase their performance-based pay in instances where they are subject to pay for performance arrangements under which their remuneration is influenced by the accounting profit of the company as reported in its financial statements. The Accounting Standards give the preparers of financial statements a not insignificant degree of discretion in the choice of the accounting treatments used in the preparation of these statements.\(^{186}\) It could therefore be said that choosing treatments that have the relative effect of increasing the reported profit of the company itself would not appear to be improper, unless this choice was motivated by reasons other than the desire to most appropriately reflect the circumstances of the company (eg the desire to increase the amount of remuneration influenced by the performance of the company).\(^{187}\) As discussed above, establishing the presence of the latter intention as one of the reasons for the accounting choices made could prove to be difficult in practice as it appears that, absent direct evidence of managerial bad faith, too much would depend on the credibility of the individuals in question.\(^{188}\)

The loss to the company and the gain to the manager from ‘earnings management’ can be said to be the increase in the amount of the remuneration paid to the manager as a result of the accounting treatments that were chosen out of self interest, compared to the amount of remuneration that would have been paid if self interest had not motivated the selection of these treatments.\(^{189}\) As previously noted, the significant amount of discretion allowed for by the Accounting Standards in the exercise of preparing the financial statements could mean that the treatments ultimately chosen for the purposes of preparing the statements might generally be those that have the relative effect of increasing the accounting profit of the company (and accordingly the amount of the remuneration that is influenced by the company’s accounting performance), even absent ‘substantial’ or ‘significant’ bad faith on the part of the statement preparers. The significant discretion given by the Standards to the preparers of the financial statements in terms of the accounting treatments that may be utilised in the preparation of such statements might also carry with it the result that the ‘objective circumstances’ surrounding the exercise of the discretion (eg the presence of pay for performance arrangements under which remuneration is influenced by the performance of the company as reported in its financial statements, and the actual selection of treatments that in general have the relative effect of increasing the reported profit of the company) could conceivably be said to be of less evidentiary assistance here when compared to disputes over bona fides and proper purposes that occur in other contexts.\(^{190}\)

186 See, eg, Johnston, Jager and Taylor, above n 50, 156–7; Jubb and Haswell, above n 50, 20; Gibson, above n 50, 3–4; Phillips, above n 50, 168; Lowenstein, above n 50, 284–5; Hoffman and Zimmer, above n 72, 36; Baxt, ‘True and Fair Accounts’, above n 87, 549; Craig and Walsh, above n 59, 232; Walsh, Craig and Clarke, above n 71, 175–6, 178–9, 187; Blair and Ramsay, above n 46, 282; Kennedy, Kleinmuntz and Peecher, above n 50, 105; Healy, above n 44, 89; Rowland, above n 46, 169; Yablon and Hill, above n Ошибкa! Закладка не определена., 121; and Watts and Zimmerman, Positive Accounting Theory, above n 36, 204–5, 207–10.


188 See, eg, Smith [1942] Ch 304, 308 (Lord Greene MR); Shuttleworth [1927] 2 KB 9, 18 (Bankes LJ); Wheeler (1994) 14 ACSR 109, 137–48 (Ipp J, with whom Malcolm CJ and Seaman J agreed); Hindle (1919) 56 Scots LR 625, 630–1 (Viscount Finlay); Richard Brady (1937) 58 CLR 112, 136 (Latham CJ); Pine Vale (1983) 8 ACLR 199, 207, 209 (McPherson J); Darvall (1989) 15 ACLR 230, 239 (Kirby P); Advance Bank (1987) 12 ACLR 118, 137 (Kirby P); Morgan (1983) 1 ALC 831, 838 (White J); and Ampol [1972] 2 NSWLR 850, 874 (Street J).

189 Cf Re Dawson; Union Fidelity Trustee Co Ltd v Perpetual Trustee Co Ltd (1966) 84 WN (Pt 1) (NSW) 399, 409 (Street J); McKenzie v McDonald [1927] VLR 134, 146 (Dixon AJ); Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd (1983) 2 Qd R 508, 522–4 (Thomas J); Tavistock Pty Ltd v Saulman (1990) 3 ACSR 502, 510 (Anderson J); and Maschinski v Dodds (1985) 160 CLR 583, 607 (Brennan J) and 624–5 (Dawson J).

190 On the evidentiary role of such circumstances see, eg, Shuttleworth [1927] 2 KB 9, 18 (Bankes LJ); Wheeler (1994) 14 ACSR 109, 137–48 (Ipp J, with whom Malcolm CJ and Seaman J agreed); Winthrop (1979) 4 ACLR 1, 12 (Waddell J); Darvall (1989) 15 ACLR 230, 239 (Kirby P); Advance Bank (1987) 12 ACLR 118, 137 (Kirby P); Hindle (1919) 56 Scots LR 625, 630–1 (Viscount Finlay); Ampol [1972] 2 NSWLR 850, 874 (Street J); Pine Vale (1983) 8 ACLR 199, 207, 209.
Conduct amounting to ‘earnings management’ as discussed of itself also might not in fact end up bringing about a loss to the company or a gain to those who engage in such conduct. The effect on the amount of performance-based remuneration of a relative increase in the accounting profit of the company as reported in the company’s financial statements may be overshadowed by the results of other, non-accounting indicators of the company’s performance.191 Lambert and Larcker have observed that, while the accounting profit of a company might have a not insignificant influence on the amount of remuneration ultimately provided under a pay for performance arrangement, this profit figure is unlikely to be the only measure of company performance used for the purposes of determining the level of performance-based pay.192

4 The Economic Incentive To Litigate May Be Small

The preceding discussion has noted what appear to be some of the considerable difficulties associated with establishing the actual presence of bad faith in the context of earnings management that has performance-based pay as its catalyst, and in proving context of earnings management that has establishing the actual presence of bad faith in the some of the considerable difficulties associated with determining the level of performance-based pay.192

Considering that complex litigation of this kind could be expected to involve high direct and opportunity costs,196 but nevertheless carry with it a real likelihood of failure,197 those who might otherwise take action against the perpetrators of earnings management that is motivated by the presence of pay for performance arrangements may reasonably come to the view that the resources that might otherwise be spent on such an exercise could be better utilised.198 With the practical and legal difficulties that have been explored in relation to litigating the potential breaches of the law that may be associated with ‘earnings management’ as previously discussed,199 stamping out this practice through the courts might end up costing more in economic terms than the cost wrought by the practice of earnings management of itself on the company, its shareholders and society.200 Arguably, the suggested existence of


Cf Whincop, ‘Directors’ Statutory Duties’, above n 141, 143; Blanchard, above n 141, 11–2; and Whincop, ‘Developments In Directors’ Statutory Duties’, above n 141, 170.


In the text accompanying nn 167–192, above.

Cf Rehnert, above n 5, 1163–4. The general approach to cost–benefit analysis is discussed in Richard Johnstone, ‘Economic and Sociological Approaches To Law’ in Rosemary Hunter, Richard Ingleby and Richard Johnstone (eds), Thinking About Law:
the practice of earnings management as noted above could by definition unfortunately indicate that non-litigious methods of policing earnings management might not always potentially be effective or efficient.\textsuperscript{201} If all else is going well in the company, it could very well be that earnings management that is driven by performance-based pay might simply be acknowledged begrudgingly as a potential ‘agency cost’ of corporate life.\textsuperscript{202}

VI Conclusion: A Note On a Potential Corporate Governance Role For Legal Advisers

This paper has sought to query what appears to be an assumption to the effect that the practice of ‘earnings management’, while potentially morally questionable, is not legally problematic. Beginning with an economic analysis of performance-based pay and earnings management that for the most part appears to have been absent from the legal pay for performance literature to date, it has attempted to demonstrate that earnings management that is motivated by the presence of a pay for performance arrangement would appear to contravene the equitable and statutory duties to which the preparers of financial statements are subject. Difficulties of proof and disincentives to litigation affect not the conclusion that company managers who exercise their accounting discretions with the aim of maximising their performance-based remuneration could arguably be said to be misusing their position and contravening their duties to act bona fide in the best interests of the company and for proper purposes.

It is in this respect that legal advisers may have a corporate governance role\textsuperscript{203} that Ramsay and others appear to have overlooked.\textsuperscript{204} Ingleby and Johnstone point out that lawyers perform a ‘gatekeeper’ function in relation to the legal system,\textsuperscript{205} and Yablon has alluded to the potential influence that legal advice may have in terms of shaping the making of corporate decisions.\textsuperscript{206} As the suggestion is that earnings management that is motivated by the presence of a pay for performance arrangement would appear to contravene the equitable and statutory duties to which the preparers of financial statements are subject, it may be that far-sighted lawyers who truly are acting in the best interests of their clients would conduct themselves so as to alert those concerned to this possibility in as tactful and diplomatic a manner as possible, especially in light of the research that appears to suggest that company managers might be expected to exercise their accounting discretions with the aim of maximising their performance-based remuneration. As noted above, difficulties of proof and disincentives to litigation affect not the conclusion that such conduct would amount to a misuse of position and a contravention of the duties to act bona fide in the best interests of the company and for proper purposes.

\textsuperscript{201} See, eg, Watts and Zimmerman, Positive Accounting Theory, above n 36, 205, 207–8; Godfrey and Adi, above n 41, 277; Rehnert, above n 5, 1163; Godfrey, Hodgson and Holmes, above n Ошибка! Закладка не определена., 268–9, 283–5; Godfrey et al, above n Ошибка! Закладка не определена., 241–2, 253–5; and Smith and Watts, above n 26, 150. The considerable cost and effort involved in going behind the financial statements and ‘unravelling’ the accounting numbers has been discussed in the text accompanying nn 39–41, above.

\textsuperscript{202} Compare Parsons, above n 103, 402. For a discussion of the notion of agency costs see, eg, Ng, above n Ошибка! Закладка не определена., 103.


\textsuperscript{204} As the absence of discussion in Ramsay, ‘The Corporate Governance Debate’, above n 4, 6 would suggest. See also Hanrahan, Ramsay and Stapledon, above n 4, 123.


\textsuperscript{206} Yablon, ‘Overcompensating’, above n 203, 1867, 1870.