

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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It is ... the ... rule that they [fiduciaries] cannot exercise ... powers for ... personal ... gain. ... These principles ... are so ... fixed ... they are not open to discussion, and so familiar ... authorities declaring them need not be cited.

Collin J

(*Pollitz v Wabash R Co*, 207 NY 113, 124 (1912))

Self interest is only one, though no doubt the commonest, instance of improper motive.

Lord Wilberforce

(*Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 835 ('Howard Smith'))

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

¹ K Murphy, 'Executive Compensation' in Orley Ashenfelter and David Card (eds), *Handbook of Labor Economics* (1999) 3. See, eg, Ruth Bender, 'Why Do Companies Use Performance-Related Pay For Their Executive Directors?' (2004) 12 *Corporate Governance: An International Review* 521; Catherine Smith, 'Pay For Performance' (2000) 114(2) *Journal of Banking and Financial Services* 22; Zoher Adenwala, 'Directors' Generous Remuneration: To Be Paid or Not To Be Paid?' (1991) 3 *Bond Law Review* 25; Andrew Griffiths, 'Directors' Remuneration: Constraining the Power of the Board' [1995] *Lloyd's Maritime and Commercial Law Quarterly* 372; J Parkinson, 'Directors' Remuneration' (1984) 34 *New Law Journal* 130; Richard Booth, 'The Other Side of the

Management Compensation Controversy' (1994) 22 *Securities Regulation Law Journal* 22; Carl Bogus, 'Excessive Executive Compensation and the Failure of Corporate Democracy' (1993) 41(1) *Buffalo Law Review* 1; Linda Barris, 'The Overcompensation Problem: A Collective Approach To Controlling Executive Pay' (1992) 68 *Indiana Law Journal* 59; and Detlev Vagts, 'Challenges To Executive Compensation: For the Markets or the Courts?' (1983) 8(2) *Journal of Corporation Law* 231.

² See especially Ian Ramsay, 'The Corporate Governance Debate and the Role of Directors' Duties' in Ian Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 2, 7; and Pamela Hanrahan, Ian Ramsay and Geof Stapledon, *Commercial Applications of Company Law* (2000) 123.

performance,³ 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.⁵ 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 these positions were not intended.⁶ It is argued that this use of 'creative accounting' also is inconsistent 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,⁷ 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.⁸ 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.⁹ This view of the world is not without its critics,¹⁰ but has also been

³ Geoffrey Rehnert, 'The Executive Compensation Contract: Creating Incentives To Reduce Agency Costs' (1985) 37 *Stanford Law Review* 1147, 1158; and Ian Ramsay, 'Directors and Officers' Remuneration: The Role of the Law' [1993] *Journal of Business Law* 351, 359.

⁴ Keryn Chalmers, Ping-Sheng Koh and Geof Stapledon, 'The Determinants of CEO Compensation: Rent Extraction or Labour Demand' (Working Paper, UQ Business School, The University of Queensland, 2003)

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.'

⁶ Cf Sarah Worthington, 'Fiduciaries: When Is Self-Denial Obligatory?' (1999) 58(3) *Cambridge Law Journal* 500; and Jennifer Hill and Charles Yablon, 'Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict' (2002) 25(2) *University of New South Wales Law Journal* 294.

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.

⁸ Michael Jensen, 'Organization Theory and Methodology' (1983) 58(2) *Accounting Review* 319, 328. See generally Ross Watts and Jerold Zimmerman, 'Agency Problems, Auditing and the Theory of the Firm: Some Evidence' (1983) 26 *Journal of Law and Economics* 613; David Ng, 'An Information Economics Analysis of Financial Reporting and External Auditing' (1978) 53(4) *Accounting Review* 910; Jere Francis and Earl Wilson, 'Auditor Changes: A Joint Test of Theories Relating To Agency Costs and Auditor Differentiation' (1988) 57(4) *Accounting Review* 663; Thomas Wilson Jr and Richard Grimlund, 'An Examination of the Importance of an Auditor's Reputation' (1990) 9(2) *Auditing: A Journal of Practice and Theory* 43; and Eugene Fama and Michael Jensen, 'Separation of Ownership and Control' (Working Paper No MERC 82-14, Graduate School of Management Managerial Economics Research Center, University of Rochester, 1983).

⁹ See, eg, Armen Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62 *American Economic Review* 777; Jayne Godfrey et al, *Accounting Theory* (2nd ed, 1994) 237, 239; and Francine Zhivov, Christine Jubb and Keith Houghton, 'Auditor Litigation: Reputation and Auditor Switching Effects' (Working Paper No 95-08, Department of Accounting and Finance, The University of Melbourne, 1995) 3.

¹⁰ For example, by C Arrington and Jere Francis, 'Letting the Chat Out of the Bag: Deconstruction, Privilege and Accounting Research' (1989) 14(1-2) *Accounting, Organizations and Society* 1; T Tinker, B Merino and M Neimark, 'The Normative Origins of Positive Theories: Ideology and Accounting Thought' (1982) 7 *Accounting, Organizations and Society* 167; C Christenson, 'The Methodology of Positive Accounting' (1983) 58 *Accounting Review* 1; R Hines,

shown to generally explain human behaviour.¹¹ 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.¹²

Despite its critics,¹³ the 'agency theory' propounded above and as popularised by Jensen and Meckling¹⁴ repeatedly finds empirical support.¹⁵ It is

true that managers experience utility from the satisfaction that follows a job well done,¹⁶ 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.¹⁷ 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.¹⁸ However, non-manager shareholders are worse off as their share of the company's actual or potential wealth diminishes without attendant benefit.¹⁹

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.²⁰ Shareholders might therefore be expected to act to preserve their own interests.²¹ For example, Simunic and Stein argue that managers who do not implement measures that appear to align their interests with those of shareholders could

'Popper's Methodology of Falsification and Accounting Research' (1988) 63 *Accounting Review* 657; Barry Cushing, 'A Kuhnian Interpretation of the Historical Evolution of Accounting' (1989) 16(2) *Accounting Historians Journal* 1; A McKee, T Bell and J Boatsman, 'Management Preferences Over Accounting Standards: A Replication and Additional Tests' (1984) 59 *Accounting Review* 647; R Holthausen and R Leftwich, 'The Economic Consequences of Accounting Choice: Implications of Costly Contracting and Monitoring' (1988) 10 *Journal of Accounting and Economics* 77; and R Leftwich, 'Aggregation of Test Statistics: Statistics Versus Economics' (1990) 12 *Journal of Accounting and Economics* 37.

¹¹ Andrew Christie, 'Aggregation of Test Statistics: An Evaluation of the Evidence On Contracting and Size Hypotheses' (1990) 12 *Journal of Accounting and Economics* 15, 25; Jayne Godfrey, Allan Hodgson and Scott Holmes, *Accounting Theory* (3rd ed, 1997) 292, 295; Godfrey et al, above n **Ошибка! Закладка не определена.**, 260–3; and Ng, above n **Ошибка! Закладка не определена.**, 197–9.

¹² Adam Smith, *An Inquiry Into the Wealth of Nations* (1776) 700. See to similar effect Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932); Eugene Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288; and A Amershi and S Sunder, 'Failure of Stock Prices To Discipline Managers In a Rational Expectations Economy' (1987) 25 *Journal of Accounting Research* 177.

¹³ See, eg, Stanley Baiman, 'Agency Research In Managerial Accounting: A Second Look' (1990) 15(4) *Accounting, Organizations and Society* 341, 345; J Coffee, 'Market Failure and the Economic Case For a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717, 740; and Jason Kyrgood, 'Disclosure of Forecasts In Prospectuses' (1998) 16 *Company and Securities Law Journal* 350, 355.

¹⁴ M Jensen and W Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

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.**, 25; Ng, 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

Adjustment Studies' (1994) 13 *Auditing: A Journal of Practice and Theory* 149.

¹⁶ K Murthy, *Corporate Strategy and Top Executive Compensation* (1977) 9–10; B Ellig, *Executive Compensation: A Total Pay Perspective* (1982) 20–4; Rehnert, above n 5, 1149, 1157; Clyne, above n **Ошибка! Закладка не определена.**, 6; and Baiman, above n 13, 345.

¹⁷ Even though this may not go so far as to threaten the company financially. Cf Ramsay, 'The Corporate Governance Debate', above n 4, 6; and Hanrahan, Ramsay and Stapledon, above n 4, 123.

¹⁸ Cf Michael Jensen and Kevin Murphy, 'Performance Pay and Top-Management Incentives' (1990) 98 *Journal of Political Economy* 225.

¹⁹ See generally Godfrey, Hodgson and Holmes, above n **Ошибка! Закладка не определена.**, 262–5; and Godfrey et al, above n **Ошибка! Закладка не определена.**, 236–40.

²⁰ Cf Kyungho Kim and Douglas Schroeder, 'Analysts' Use of Managerial Bonus Incentives In Forecasting Earnings' (1990) 13 *Journal of Accounting and Economics* 3.

²¹ Managerial 'shirking' is hard for labour markets to police because the separation of ownership and management that makes shirking viable also makes its detection difficult. See, eg, Michael Jensen and Jerold Zimmerman, 'Managerial Compensation and the Managerial Labor Market' (1985) 7 *Journal of Accounting and Economics* 3; A Raviv, 'Management Compensation and the Managerial Labour Market: An Overview' (1985) 9 *Journal of Accounting and Economics* 239.

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

pay for performance, company performance directly influences pay. Incentive pay therefore makes it in managers' best interests to minimise 'shirking' and to maximise instead their efforts to increase the wealth of the company. Pay for performance can take the form of cash, shares, warrants or combinations of these.²⁶

C The Role That Accounting Numbers Can Play In Performance-Based Pay

Accounting numbers may play an important role in performance-based pay arrangements, or 'bonus plans'.²⁷ Managerial performance is not usually measured *solely* by the change in the value of a company's shares, even though such changes clearly have an impact on shareholder wealth.²⁸ Share prices can be influenced by economy and industry-wide factors²⁹ and by the actions of competitors,³⁰ all of

²² Dan Simunic and Michael Stein, 'On the Economics of Product Differentiation In Auditing' (Paper presented at the 7th Touche Ross Auditing Symposium, University of Kansas, 1986) 85. It is worthwhile noting that directors have no *prima facie* right to remuneration. See, eg, *Hutton v West York Railway Co* (1883) 23 Ch D 654, 672 (Bowen LJ) ('Hutton'); *Guinness Plc v Saunders* [1990] 2 AC 663, 689–90 (Lord Templeman); *Re George Newman & Co* [1895] 1 Ch 674, 686 (Lindley LJ); *Sali v SPC* (1991) 9 ACLC 1511, 1520 (Ormiston J); and Jennifer Hill, "What Reward Have Ye?" Disclosure of Director and Executive Remuneration In Australia' (1996) 14 *Company and Securities Law Journal* 232, 234.

²³ See generally L Telser, 'A Theory of Self-Enforcing Agreements' (1980) 53 *Journal of Business* 27. Mark Beasley, 'An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud' (1996) 71(4) *Accounting Review* 443, 446; and S Grossman and O Hart, 'Takeover Bids, The Free-Rider Problem and the Theory of the Corporation' (1980) 2 *Bell Journal of Economics* 42 note that the marginal costs of shareholders monitoring management may outweigh the marginal benefits, in particular for shareholders whose holdings are not sufficiently large.

²⁴ S Sklivas, 'The Strategic Choice of Managerial Incentives' (1987) 18 *Rand Journal of Economics* 452; C Fershtman and K Judd, 'Equilibrium Incentives In Oligopoly' (Working Paper, J L Kellogg Graduate School of Management, Northwestern University, 1984); C Fershtman and K Judd, 'Strategic Incentive To Manipulation In Rivalrous Agency' (Working Paper, Institute For Mathematical Studies In the Social Sciences, Stanford University, 1986); C Fershtman, K Judd and E Kalai, 'Cooperation Through Delegation' (Working Paper, J L Kellogg Graduate School of Management, Northwestern University, 1987).

²⁵ Michael Jensen and Kevin Murphy, 'CEO Incentives: It's Not How Much You Pay, But How' (1990) 68(3) *Harvard Business Review* 138; A Coughlan and R Schmidt, 'Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation' (1985) 7 *Journal of Accounting and Economics* 43; and Clyne, above n **Ошибка! Закладка не определена.**, 6. For alternative views of performance-based pay see, eg, Charles Yablon, 'Bonus Questions: Executive Compensation In the Era of Pay For Performance' (1999) 75 *Notre Dame Law Review* 271; Geof Stapledon, 'The Pay For Performance Dilemma' (2004) 13 *Griffith Law Review* 57; Yablon and Hill, above n **Ошибка! Закладка не определена.**; and Hill and Yablon, above n **Ошибка!**

Закладка не определена.

²⁶ See Clifford Smith Jr and Ross Watts, 'Incentive and Tax Effects of Executive Compensation Plans' (1982) 7 *Australian Journal of Management* 139, 141–2; Rehnert, above n 5, 1178–9; and Vagts, above n 3, 243. Warrants are options issued by a company over its own shares.

²⁷ See Ross Watts and Jerold Zimmerman, 'Positive Accounting Theory: A Ten Year Perspective' (1990) 65 *Accounting Review* 208, 208; C Ittner, D Larcker and M Rajan, 'The Choice of Performance Measures In Annual Bonus Contracts' (1997) 72 *Accounting Review* 231; and J Gaver, K Gaver and J Austin, 'Additional Evidence On Bonus Plans and Income Management' (1995) 19 *Journal of Accounting and Economics* 3.

²⁸ See generally R Sloan, 'Accounting Earnings and Top Executive Compensation' (1993) 16 *Journal of Accounting and Economics* 55; R Banker and S Datar, 'Sensitivity, Precision and Linear Aggregation of Signals For Performance Evaluation' (1989) 27 *Journal of Accounting Research* 21; O Kim and Y Suh, 'Incentive Efficiency of Compensation Based On Accounting and Market Performance' (1993) 16 *Journal of Accounting and Economics* 25; R Bushman and R Indjejikian, 'Accounting Income, Stock Price and Managerial Compensation' (1993) 16 *Journal of Accounting and Economics* 3; and M Lawriwsky and S Leung, 'Employee Share Plans: Motivation and Performance Consequences' (Paper presented at the Australian and New Zealand Association of Management Educators' Conference, Gold Coast, December 1991).

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

³⁰ See G Foster, 'Intra-Industry Information Transfers Associated with Earnings Releases' (1981) 4 *Journal of Accounting and Economics* 201; G Clinch and N Sinclair, 'Intra-Industry Information Releases: A Recursive Systems Approach' (1987) 9 *Journal of Accounting and Economics* 89; and R Freeman and S Tse, 'Intercompany Information Transfers' (1992) 15 *Journal of Accounting and Economics* 509.

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 arrangements³² because producing financial information is costly. Understanding all the data required to create the final accounting figures requires much time and effort.³³ Listed companies (ie companies where the separation of ownership and management can be expected to be most pronounced)³⁴ are legally required to produce a set of financial statements.³⁵

These financial statements can be used to ascertain the performance of a company for pay for performance purposes,³⁶ avoiding considerable costs in producing a separate set of figures just for this purpose.³⁷ The *Corporations Act 2001* (Cth) requires the financial statements of listed companies to be audited.³⁸ Together with the considerable cost and effort involved in going behind these statements and 'unravelling' their numbers,³⁹ this has meant that the reported figures have mostly been used unchanged for bonus plan purposes,⁴⁰ even with the involvement of compensation committees.⁴¹

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.⁴² 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.⁴³

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.⁴⁴ This

³¹ Sloan, above n 28, 7.

³² See, eg, Rehnert, above n 5, 1151; Clyne, above n **Ошибка! Закладка не определена.**, 23; and Smith and Watts, above n 26, 141, 149–50.

³³ Godfrey et al, above n **Ошибка! Закладка не определена.**, 235; and Godfrey, Hodgson and Holmes, above n **Ошибка! 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.

³⁶ Ross Watts and Jerold Zimmerman, *Positive Accounting Theory* (1986) 208.

³⁷ See Godfrey et al, above n **Ошибка! Закладка не определена.**, 235; and Godfrey, Hodgson and Holmes, above n **Ошибка! Закладка не определена.**, 260.

³⁸ *Corporations Act 2001* (Cth) ss 301(1) and 302. Cf E Hirst, 'Auditors' Sensitivity To Earnings Management' (1994) 11 *Contemporary Accounting Research* 405.

³⁹ Cf S Liberty and J Zimmerman, 'Labour Union Contract Negotiations and Accounting Choices' (1986) 61 *Accounting Review* 692; Linda DeAngelo, 'Managerial Competition, Information Costs and Corporate Governance: The Use of Accounting Performance Measures In Proxy Contests' (1988) 10 *Journal of Accounting and Economics* 3; and Linda DeAngelo, 'Accounting Numbers As Market Valuation Substitutes: A Study of Management Buyouts of Public Stockholders' (1986) 61 *Accounting Review* 400.

⁴⁰ See P Healy, S Kang and K Palepu, 'The Effect of Accounting Procedure Changes On CEO's Cash Salary and Bonus Compensation' (1987) 9 *Journal of Accounting and Economics* 7.

⁴¹ Jayne Godfrey and Sasono Adi, 'Determinants of Income Smoothing' (1999) 6(2) *Asia-Pacific Journal of Accounting* 275, 277. Cf Smith and Watts, above n 26, 150. On board composition see, eg, Ken Peasnell, Peter

Pope and Steven Young, 'Outside Directors, Board Effectiveness and Abnormal Accruals' (Working Paper, Department of Accounting and Finance, Lancaster University, 1998); Ken Peasnell, Peter Pope and Steven Young, 'Accrual Management To Meet Earnings Targets: Did Cadbury Make a Difference?' (Working Paper, Department of Accounting and Finance, Lancaster University, 1999); T Warfield, J Wild and K Wild, 'Managerial Ownership, Accounting Choices and Informativeness of Earnings' (1995) 20 *Journal of Accounting and Economics* 61; and April Klein, 'Audit Committee, Board of Director Characteristics and Earnings Management' (Working Paper, Department of Accounting, New York University, 2000).

⁴² See, eg, L Gomez-Mejia, H Tsoi and T Hinkin, 'Managerial Control, Performance and Executive Compensation' [1987] *Academy of Management Journal* 51; Ramsay, 'Directors and Officers' Remuneration', above n **Ошибка! Закладка не определена.**, 359; Yablon and Hill, above n **Ошибка! Закладка не определена.**, 86; Hill and Yablon, above n **Ошибка! Закладка не определена.**, 317; Yablon, 'Bonus Questions', above n 25, 299; and Rehnert, above n 5, 1158.

⁴³ See, eg, Merton Miller and Myron Scholes, 'Executive Compensation, Taxes and Incentives' in W Sharpe and C Cootner (eds), *Financial Economics: Essays In Honor of Paul Cootner* (1980) 170; Bengt Holmstrom, 'Managerial Incentive Problems' in Swedish School of Economics (ed), *Essays In Economics and Management In Honour of Lars Wahlbeck* (1982) 209; and W Llewellyn, C Loderer and K Martin, 'Executive Compensation and Executive Incentive Problems: An Empirical Analysis' (1987) 9 *Journal of Accounting and Economics* 287.

⁴⁴ Paul Healy, 'The Effect of Bonus Schemes On Accounting Decisions' (1985) 7 *Journal of Accounting*

'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

natural one.⁴⁷ What this involves is best illustrated by an example.

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

and *Economics* 85.

⁴⁵ Christie, above n **Ошибка! Закладка не определена.**, 25. For research consistent with the 'bonus plan hypothesis', see, eg, Mark Zmijewski and Robert Hagerman, 'An Income Strategy Approach To the Positive Theory of Accounting Standard Setting/Choice' (1981) 3 *Journal of Accounting and Economics* 129; Ross Watts and Jerold Zimmerman, 'Towards a Positive Theory of the Determination of Accounting Standards' (1978) 53 *Accounting Review* 112; Robert Hagerman and Mark Zmijewski, 'Some Economic Determinants of Accounting Policy Choice' (1979) 1 *Journal of Accounting and Economics* 141; S Lilien and V Pastena, 'Determinants of Intramethod Choice In the Oil and Gas Industry' (1983) 5 *Journal of Accounting and Economics* 145; D Dhaliwal, 'The Effect of the Firm's Capital Structure On the Choice of Accounting Methods' (1980) 55 *Accounting Review* 78; L Daley and R Vigeland, 'The Effects of Debt Covenants and Political Costs On the Choice of Accounting Methods: The Case of Accounting For R&D Costs' (1985) 5 *Journal of Accounting and Economics* 195; D Dhaliwal, G Salamon and E Smith, 'The Effect of Owner Versus Management Control On the Choice of Accounting Methods' (1982) 4 *Journal of Accounting and Economics* 41; Robert Holthausen et al, 'Annual Bonus Schemes and the Manipulation of Earnings' (1995) 19 *Journal of Accounting and Economics* 29; Michael Weisbach, 'Outside Directors and CEO Turnover' (1988) 20 *Journal of Financial Economics* 431; and Robert Bowen, Eric Noreen and John Lacey, 'Determinants of the Corporate Decision To Capitalise Interest' (1981) 3 *Journal of Accounting and Economics* 151. Compensation committees are not necessarily contractually able to withhold bonus plan payouts. See, eg, Watts and Zimmerman, *Positive Accounting Theory*, above n 36, 205, 207–8; Godfrey, Hodgson and Holmes, above n **Ошибка! Закладка не определена.**, 283–4; Godfrey and Adi, above n 41, 277; and Godfrey et al, above n **Ошибка! Закладка не определена.**

⁴⁶ See, eg, Mark Blair and Ian Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in G Walker, B Fisse and I Ramsay (eds), *Securities Regulation In Australia and New Zealand* (2nd ed, 1998) 264, 282; and Gregory Rowland, 'Earnings Management, the SEC, and Corporate Governance: Director Liability Arising From the Audit Committee Report' (2002) 102 *Columbia Law Review* 168, 169.

⁴⁷ See especially T Tinker, *Paper Prophets: A Social Critique of Accounting* (1985).

⁴⁸ This analogy draws on E Brunswik, *The Conceptual Framework of Psychology* (1952); R Ashton, *Human Information Processing In Accounting: Studies In Accounting Research* (1982); R Libby, *Human Information Processing: Theory and Applications* (1981); R Ashton, 'Human Information Processing Research In Auditing: A Review and Synthesis' in D Nichols and H Stettler (eds), *Auditing Symposium* (1982) 80; and R Libby and B Lewis, 'Human Information Processing Research In Accounting: The State of the Art' (1977) 2(3) *Accounting, Organizations and Society* 245.

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, Trevor Johnston, Martin Jager and Reginald Taylor, *The Law and Practice of Company Accounting In Australia* (6th ed, 1987) 156–7; Peter Jubb and Stephen Haswell, *Company Accounting* (1993) 20; R Gibson, *Disclosure By Australian Companies* (1971) 3–4; Fred Phillips, 'Auditor Attention To and Judgments of Aggressive Financial Reporting' (1999) 37(1) *Journal of Accounting Research* 167, 168; Louis Lowenstein, 'Financial Transparency and Corporate Governance: The United States As a Model?' in Charles Rickett and Ross Grantham (eds), *Corporate Personality In the 20th Century* 279, 284–5; and J Kennedy, D Kleinmuntz and M Peecher, 'Determinants of the Justifiability of Performance In Ill-Structured Audit Tasks' (1997) 35 *Journal of Accounting Research* 105, 105.

⁵¹ See, eg, Franklin Gevurtz, 'Earnings Management and the Business Judgment Rule: An Essay On Recent Corporate Scandals' (2004) 30 *William Mitchell Law Review* 1261, 1274; and Rowland, above n 46, 169. On what constitutes such conduct, see especially *Snook v London & West Riding Investments Ltd* [1967] 2 QB

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

786, 802 (Diplock LJ).

⁵² See generally Joshua Ronen and Simcha Sadan, *Smoothing Income Numbers: Objectives, Means and Implications* (1981); and M DeFond and C Park, 'Smoothing Income In Anticipation of Future Earnings' (1997) 19 *Journal of Accounting and Economics* 29.

⁵³ Gary Biddle, 'Accounting Methods and Management Decisions: The Case of Inventory Costing and Inventory Policy' (1980) 18 *Journal of Accounting Research* 235; A Abdel-khalik, 'The Effect of LIFO-Switching and Firm Ownership On Executives' Pay' (1985) 23 *Journal of Accounting Research* 447; and Healy, above n 44, 85, 89.

⁵⁴ Robert Holthausen, 'Evidence On the Effect of Bond Covenants and Management Compensation Contracts On the Choice of Accounting Techniques: The Case of the Depreciation Switch-Back' (1981) 3 *Journal of Accounting and Economics* 73; and Healy, above n 44, 85, 89.

⁵⁵ See especially Mark DeFond and K Subramanyam, 'Auditor Changes and Discretionary Accruals' (1998) 25 *Journal of Accounting and Economics* 35, 63; Connie Becker et al, 'The Effect of Audit Quality On Earnings Management' (1998) 15(1) *Contemporary Accounting Research* 1, 6-7; Jennifer Jones, 'Earnings Management During Import Relief Investigations' (1991) 29 *Journal of Accounting Research* 193; M DeFond and J Jiambalvo, 'Debt Covenant Violation and Manipulation of Accruals' (1994) 17 *Journal of Accounting and Economics* 145; K Subramanyam, 'The Pricing of Discretionary Accruals' (1996) 22 *Journal of Accounting and Economics* 249; Yablon and Hill, above n **Ошибка! Закладка не определена.**, 86; and

W Guay, S Kothari and R Watts, 'A Market-Based Evaluation of Discretionary-Accrual Models' (1996) 34 *Journal of Accounting Research* 83.

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.

⁵⁸ Under *Australian Accounting Standard AASB 1018*. See Johnston, Jager and Taylor, above n 50, 211-2; and Jubb and Haswell, above n 50, 165. On the legal status of *Accounting Standards*, see *Corporations Act 2001* (Cth) ss 296, 304, 334, 337 and 338. See further *QBE Insurance Group Ltd v Australian Securities Commission* (1992) 38 FCR 270 ('*QBE*'); and W McGregor, 'New ARSB Approved Accounting Standards: Legal Backing For the Profession's Standards!' (1985) 56(6) *Chartered Accountant In Australia* 27. *Australian Accounting Standard AASB 101* specifically prohibits the presentation of any items of income or expense as extraordinary items.

⁵⁹ See especially J Ryan, C Heazlewood and B Andrew, *Australian Company Financial Reporting: 1980* (1980) 27; and Russell Craig and Paul Walsh, 'Adjustments For "Extraordinary Items" In Smoothing Reported Profits of Listed Australian Companies: Some Empirical Evidence' (1989) 16(2) *Journal of Business Finance and Accounting* 229, 232.

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

Brown, 'The Impact of the Annual Net Profit Report On the Stock Market' [1970] *Australian Accountant* 273; Peter Easton, 'The Stockmarket's Perception of Accounting Information' (1991) 1(1) *Australian Accounting Review* 20; G Foster, 'Quarterly Accounting Data: Time-Series Properties and Predictive-Ability Results' (1975) 50 *Accounting Review* 686; S Easton and N Sinclair, 'The Impact of Unexpected Earnings and Dividends On Abnormal Returns To Equity' (1989) 29 *Accounting and Finance* 1; W Beaver, R Clarke and W Wright, 'The Association Between Unsystematic Security Returns and the Magnitude of Earnings Forecast Errors' (1979) 17 *Journal of Accounting Research* 316; W Beaver, R Lambert and D Morse, 'The Information Content of Security Prices' (1980) 2 *Journal of Accounting and Economics* 3; Peter Easton and Mark Zmijewski, 'Cross-Sectional Variation In the Stock Market Response To Accounting Earnings Announcements' (1989) 11 *Journal of Accounting and Economics* 117; G Benston, 'The Self-Serving Management Hypothesis: Some Evidence' (1985) 7 *Journal of Accounting and Economics* 67; R Freeman, 'The Association Between Accounting Earnings and Security Returns For Large and Small Firms' (1987) 9 *Journal of Accounting and Economics* 57; R Atiase, 'Pre-Disclosure Information, Firm Capitalization and Security Price Behaviour Around Earnings Announcements' (1985) 23 *Journal of Accounting Research* 57; D Shores, 'The Association Between Interim Information and Security Returns Surrounding Earnings Announcements' (1990) 28(1) *Journal of Accounting Research* 57; P Brown and J Kennelly, 'The Informational Content of Quarterly Earnings: An Extension and Some Further Evidence' (1972) 45 *Journal of Business* 403; J Patell and M Wolfson, 'The Intraday Speed of Adjustment Stock Prices To Earnings and Dividend Announcements' (1984) 13 *Journal of Financial Economics* 222; J Francis, D Pagach and J Stephan, 'The Stock Market Response To Earnings Announcements Released During Trading Versus Nontrading Periods' (1992) 30(2) *Journal of Accounting Research* 165; A Ali and P Zarowin, 'Annual Earnings and Estimation Error In ERCs' (1992) 14 *Journal of Accounting and Economics* 249; S Choi and D Jeter, 'The Effects of Qualified Audit Opinions On Earnings Response Coefficients' (1992) 14 *Journal of Accounting and Economics* 230; W Beaver, 'The Information Content of Annual Earnings Announcements' (1968) 6 *Journal of Accounting Research* 67; J Patell and M Wolfson, 'Anticipated Information Releases Reflected In Call Option Prices' (1979) 1 *Journal of Accounting and Economics* 117; J Patell and M Wolfson, 'The Ex Ante and Ex Post Price Effects of Quarterly Earnings Announcements Reflected In Option and Stock Prices' (1981) 19 *Journal of Accounting Research* 434; P Brown, F Finn and P Hancock, 'Dividend Changes, Earnings Reports and Share Prices: Some Australian Findings' (1977) 2 *Australian Journal of Management* 127; R Bowen, D Burgstahler and L Daley, 'The Incremental Information Content of Accrual Versus Cash Flows' (1987) 62

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

Accounting Review 723; Peter Easton, 'Accounting Earnings and Security Valuation: Empirical Evidence of the Fundamental Links' (1985) 23 *Journal of Accounting Research* 54; J Rayburn, 'The Association of Operating Cash Flow and Accruals with Security Returns' (1986) 24 *Journal of Accounting Research* 112; J Jennings, 'A Note On Interpreting Incremental Information Content' (1990) 65 *Accounting Review* 925; and E Grant, 'Market Implications of Differential Amounts of Interim Information' (1980) 18 *Journal of Accounting Research* 255. See generally Baruch Lev, 'On the Usefulness of Earnings and Earnings Research: Lessons and Directions From Two Decades of Empirical Research' (1989) 27 *Journal of Accounting Research* 1; Jeffrey Gordon, 'What Enron Means For the Management and Control of the Modern Business Corporation: Some Initial Reflections' (2002) 69 *University of Chicago Law Review* 1233; Anthony Catanach Jr and Shelley Rhoades-Catanach, 'Enron: A Financial Reporting Failure?' (2003) 48 *Villanova Law Review* 1057; and N Strong, 'The Relation Between Returns and Earnings: Evidence For the UK' (1993) 24 *Accounting and Business Research* 93.

⁶¹ Andrew Defina, Thomas Harris and Ian Ramsay, 'What Is Reasonable Remuneration For Corporate Officers? An Empirical Investigation Into the Relationship Between Pay and Performance In the Largest Australian Companies' (1994) 12 *Company and Securities Law Journal* 341. Strictly, their use of a one year time period is problematic because performance-based pay relates to how pay changes as performance changes. Such changes cannot be determined from figures for just one year. See Tod Perry and Marc Zenner, 'CEO Compensation In the 1990s: Shareholder Alignment Or Shareholder Expropriation?' (2000) 35 *Wake Forest Law Review* 123, 132-3.

⁶² H Izan, Baljit Sidhu and Stephen Taylor, 'Does CEO Pay Reflect Performance? Some Australian Evidence' (1998) 6(1) *Corporate Governance: An International Review* 39.

⁶³ Zoltan Matolcsy, 'Executive Cash Compensation and

This finding may explain the results observed by Defina, Harris and Ramsay⁶⁴ 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

Corporate Performance During Different Economic Cycles' (2000) 17(4) *Contemporary Accounting Research* 671.

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.

⁶⁶ Matolcsy and Wright, below n 67, 15. Cf R Evans and T Stromback, 'Australian Executive Remuneration: Evidence On Structure and Accounting Determinants' (1994) 2(1) *Asian Review of Accounting* 22; J Coulton and S Taylor, 'Option Awards For Australian CEOs: The Who, What and Why' (2002) 12(1) *Australian Accounting Review* 25; Graham O'Neill and Mark Job, 'Determinants of Executive Remuneration In Australian Organisations: An Exploratory Study' (1999) 37(1) *Asia Pacific Journal of Human Resources* 65; and G Fleming and G Stellios, 'CEO Compensation, Managerial Agency and Boards of Directors In Australia' (2002) 15(2) *Accounting Research Journal* 126. A failure to detect, in the words of Stapledon, 'Pay For Performance', above n 25, 63, a 'consistent, statistically significant, relationship' between pay and performance merely suggests that bonus plans are not in general used by the firms studied during the period of the study. It therefore does not rule out the existence of pay for performance arrangements in groups of firms or individual companies.

⁶⁷ Zoltan Matolcsy and Anna Wright, 'The Relation Between the Structure of CEO Pay and Firm Performance: The Australian Evidence' (Working Paper, School of Accounting, University of Technology, Sydney, 2004), a study apparently overlooked by Stapledon, 'Pay For Performance', above n 25, 63. For other evidence of the use of performance-based pay in Australia, see, eg, Greg Whittred, Ian Zimmer and Stephen Taylor, *Financial Accounting: Incentive Effects and Economic Consequences* (4th ed, 1996) 43; Greg Whittred and Ian Zimmer, *Financial Accounting: Incentive Effects and Economic Consequences* (3rd ed, 1992) 33; Margaret Lyons, 'Executive Pay: How Much Is Too Much?' [1995] 3 *Australian Business Monthly* 60, 62; A Sampson, 'Executive Salaries: Paying Their Way?' [1992] 10 *Australian Business Monthly* 60, 60–70; Hay Group, *Survey of Short Term Incentive Plan Practice* (1991) 17; Chandler and Macleod Consultants Pty Ltd, *Report On Salaries and Executive Remuneration: Chief Executive and General Management* (1981) 27; Hay

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

Group, *Handbook On Compensation and Benefits Planning In Australia* (1989); Australian Institute of Management, *National Salary Survey: Australian Salaries, Wages and Benefits 1991* (1991); Chandler and Macleod Consultants Pty Ltd, *Report On Salaries and Executive Remuneration* (1978); and Smith and Watts, above n 26, 140.

⁶⁸ Craig Deegan, 'A Review of Australian Management Remuneration Plans: The Aims; The Components; The Potential Limitations' (1994) 7(1) *Accounting Research Journal* 20, 27–8, 30. See also Smith and Watts, above n 26, 140.

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.

⁷¹ Paul Walsh, Russell Craig and Frank Clarke, "Big Bath Accounting" Using Extraordinary Items Adjustments: Australian Empirical Evidence' (1991) 18(2) *Journal of Business Finance and Accounting* 173, 182–4. *Australian Accounting Standard AASB 101* now specifically prohibits the classification of any items of income or expense as extraordinary items.

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 extraordinary),⁷³ and that Easton, Edey and Harris have demonstrated that, as might be expected, managers in Australia do act in ways consistent with their own self-interest.⁷⁴ In the words of Hoffman and Zimmer:

[R]emuneration schemes ... typically in place ... provid[e] incentives to manage earnings ... such contracts are ... in ... operating rather than total earnings ... provid[ing] incentives to classify losses as extraordinary rather than operating. ... [H]igh ... remuneration is likely ... the result of ... performance based ... remuneration ... this ... is associated with accounting choices ... maximis[ing] operating rather than total earnings.⁷⁵

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),⁷⁶ 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:⁷⁷

An expectation that ... all managers tended to classify recurring losses as extraordinary but recurring gains as operating ... predicts ... the sign of ... 'recurring' should be significantly negative. However this was not significant (t = 0.045, p = 0.965).⁷⁸

V Earnings Management and Legal Duties

A The Power To Prepare Financial Reports

As previously noted, the *Corporations Act 2001* (Cth) requires listed companies to prepare financial statements.⁷⁹ The power to prepare financial statements thus is, in many cases, a power conferred by statute.⁸⁰ The directors of a company are required to take all reasonable steps to ensure that the company complies with its reporting obligations.⁸¹ 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*⁸² and under many company constitutions.⁸³

⁷³ *Finance* 35, 35–6, 42–3, 45–6.

⁷³ Smith and Watts, above n 26, 141. See also Deegan, above n 68, 27–8; Godfrey and Adi, above n 41, 279; and Healy, above n 44, 93–4. *Australian Accounting Standard AASB 101* now specifically prohibits the classification of any items of income or expense as extraordinary items.

⁷⁴ Peter Easton, Peter Edey and Trevor Harris, 'An Investigation of Revaluations of Tangible Long-Lived Assets' (1993) 31 *Journal of Accounting Research* 1. Cf Adam Steen and William Horrigan, 'Self-Serving Behaviour Amongst Company Directors: An Australian Investigation' (1995) 3(1) *Corporate Governance: An International Review* 30, 30.

⁷⁵ Hoffman and Zimmer, above n 72, 39. *Australian Accounting Standard AASB 101* now specifically prohibits the classification of any items of income or expense as extraordinary items.

⁷⁶ Ibid 43–6. On the effect of such factors, see, eg, Jilnaught Wong, 'Political Costs and an Intraperiod Accounting Choice For Export Tax Credits' (1988) 10 *Journal of Accounting and Economics* 37; Jilnaught Wong, 'Economic Incentives For the Voluntary Disclosure of Current Cost Financial Statements' (1988) 10 *Journal of Accounting and Economics* 151; K Lemke and M Page, 'Economic Determinants of Accounting Policy Choice: The Case of Current Cost Accounting In the UK' (1992) 15 *Journal of Accounting and Economics* 87; W Blacconiere et al, 'Determinants of the Use of Regulatory Accounting Principles by Savings and Loans' (1991) 14 *Journal of Accounting and Economics* 168; A Ali and K Kumar, 'The Magnitudes of Financial Statement Effects and Accounting Choice: The Case of the Adoption of SFAS 87' (1994) 18 *Journal of Accounting and Economics* 89; R Leftwich, 'Accounting Information In Private Markets: Evidence From Private Lending Agreements'

(1983) 58 *Accounting Review* 23; and Greg Whittred and Ian Zimmer, 'Accounting Information In the Market For Debt' (1986) 26 *Accounting and Finance* 19. Cf T John and K John, 'Top-Management Compensation and Capital Structure' (1993) 48 *Journal of Finance* 949.

⁷⁷ Hoffman and Zimmer, above n 72, 35–6, 38–9, 42–3, 45–6.

⁷⁸ Ibid 42–3 (emphasis added).

⁷⁹ *Corporations Act 2001* (Cth) ss 111AC(1), 111AE(1), 286(1) and 292.

⁸⁰ On how the obligation to prepare financial statements creates a power to do so, see Sarah Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121, 124–6.

⁸¹ See *Corporations Act 2001* (Cth) ss 344(1) and 1317DA and cf ss 1308 and 1309; *Australian Securities Commission v Fairlie* (1993) 11 ACLC 669; and *Dwyer v Fairlie* (Unreported, Supreme Court of Tasmania, Crawford J, 9 June 1995).

⁸² Namely s 198A(1) of the *Corporations Act 2001* (Cth). Companies whose shares are listed for quotation on the Australian Stock Exchange cannot be governed solely by the *Replaceable Rules*, as Australian Stock Exchange Listing Rule 15.11 provides that such companies must have a constitution.

⁸³ See J Corkery, *Directors' Powers and Duties* (1987) 39–40, 44–8; Hanrahan, Ramsay and Stapledon, above n 4, 111, 116; and Johnston, Jager and Taylor, above n 50, 23. Cf *White v Lincoln* (1803) 8 Ves Jun 363; *Re City Equitable Fire Insurance Co Ltd* [1925] 1 Ch 407 ('*Re City Equitable*'); *Leeds Estate, Building & Investment Co v Shepherd* (1887) 36 Ch D 787; *Gray v*

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.⁸⁴ Frequently, senior management finalise the financial statements and CEOs ultimately present these statements for inclusion in the company's financial reports.⁸⁵ The financial statements must give a 'true and fair view' of the financial position and performance of the company.⁸⁶ However, this rider may in fact be empty as the phrase 'true and fair view' awaits authoritative definition⁸⁷ and apparently means

Haig (1855) 20 Beav 219; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 ('*Friedrich*'); and *Daniels v Anderson* (1995) 37 NSWLR 438.

⁸⁴ Working Group on Corporate Practices and Conduct, *Corporate Practices and Conduct* (3rd ed, 1995). See also Geof 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.

⁸⁵ 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.

⁸⁶ *Corporations Act 2001* (Cth) ss 295(3)(c), 297, 303(3)(c) and 305. See *QBE* (1992) 38 FCR 270; and generally National Companies and Securities Commission, *A 'True and Fair View' and the Reporting Obligations of Directors and Auditors* (1984); F Ryan, "'A True and Fair View'" (1967) 3 *Abacus* 95; B Walker, 'A "True and Fair View" Revisited' (1986) 56(3) *Australian Accountant* 34; and R Chambers and P Wolnizer, 'A True and Fair View of Financial Position' (1990) 8 *Company and Securities Law Journal* 353.

⁸⁷ See especially R Baxt, 'True and Fair Accounts: A Legal Anachronism' (1970) 44 *Australian Law Journal* 541, 550; and A Slater, 'The Accounts Provisions and

complying with generally accepted accounting principles,⁸⁸ which is what the *Australian Accounting Standards* are already intended to reflect.⁸⁹

As previously discussed, the *Standards* allow considerable discretion by enabling apparently similar business facts to be portrayed in different ways for accounting purposes.⁹⁰ This flexibility in theory exists in order to accommodate the diverse environments in which businesses operate.⁹¹ 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.⁹²

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.⁹³ As noted above,⁹⁴ 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.⁹⁵

It can be argued from the research previously

Accounting Standards' in R Austin and R Vann (eds), *The Law of Public Company Finance* (1986) 100, 107.

⁸⁸ Baxt, 'True and Fair Accounts', above n 87, 548; and Slater, above n 87, 109. See, eg, *Marra Developments Ltd v B W Rofo Pty Ltd* [1977] 2 NSWLR 616, 629 (Mahoney JA). Cf *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29; and *Cambridge Credit Corporation Ltd v Hutcheson* (1985) 3 ACLC.

⁸⁹ Cf Baxt, 'True and Fair Accounts', above n 87, 548, 550; and Slater, above n 87, 107, 109.

⁹⁰ In the text accompanying nn 46–59, above. See Rowland, above n 46, 169; and Yablon and Hill, above n **Ошибка! Закладка не определена.**, 121.

⁹¹ Rowland, above n 46, 169; and LBC, *Laws of Australia*, vol 4 (at 16 September 2005) 4 Business Organisations, '4.2 Company Management' [312].

⁹² LBC, above n 91, [307]. See, eg, V Mazay, T Wilkins and I Zimmer, 'Determinants of the Choice of Accounting For Investments In Associated Companies' (1993) 10(1) *Contemporary Accounting Research* 31; and Rowland, above n 46, 169. D Skinner, 'The Investment Opportunity Set and Accounting Procedure Choice: Preliminary Evidence' (1993) 16 *Journal of Accounting and Economics* 407 points out that management may not always choose the accounting treatment that best reflects company performance, for example because of the desire to maximise remuneration under performance-based pay.

⁹³ 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.

⁹⁴ In the text accompanying nn 27–41.

⁹⁵ Executive directors may also be subject to performance-based pay.

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.⁹⁶ 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.⁹⁷

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.⁹⁸ While this does not mean that a court will closely scrutinise the merits of board decisions,⁹⁹ it

does mean that directors generally may not benefit themselves at the expense of the company.¹⁰⁰ 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.¹⁰¹

Senior company managers like CEOs would stand in a fiduciary relationship vis-à-vis their company¹⁰² as a result of their top level 'decision-making discretion and responsibility' over management matters.¹⁰³ One such discretion is the power to select

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 **Ошибка! Закладка не определена.**; and Yablon, 'Bonus Questions', above n 25.

⁹⁸ See, eg, *Re Smith & Fawcett Ltd* [1942] Ch 304, 306 (Lord Greene MR) ('*Smith*'); *Ngurli Ltd v McCann* (1953) 90 CLR 425, 438 (Williams ACJ, Fullagar and Kitto JJ) ('*Ngurli*'); *Richard Brady Franks Ltd v Price* (1937) 58 CLR 112, 135 (Latham CJ) ('*Richard Brady*'); *Ashburton Oil NL v Alpha Minerals* (1971) 123 CLR 614, 620 (Barwick CJ) ('*Ashburton*'); *Marchesi v Barnes* [1970] VR 434, 438 (Gowans J); *Australian Metropolitan Life Assurance Co Ltd v Ure* (1923) 33 CLR 199, 217 (Isaacs J) ('*Ure*'); *Australian Growth Resources v van Reesma* (1988) 13 ACLR 261, 271 (King CJ); *Provident International Corporation v International Leasing Corporation* [1969] 1 NSW 424, 436 (Helsham J) ('*International Leasing*'); and *Corporations Act 2001* (Cth) s 181. For a detailed discussion of the content of this duty, see Robert Austin, Harold Ford and Ian Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005) 271–88. The position in the United States of America is explored in C Hintmann, 'You Gotta Have Faith: Good Faith In the Context of Directorial Fiduciary Duties and the Future Impact On Corporate Culture' (2005) 49 *St Louis University Law Journal* 571.

⁹⁹ *Harlowe's Nominees Pty Ltd v Woodside NL* (1968) 121 CLR 483 ('*Harlowe's*').

¹⁰⁰ Cf *Mills v Mills* (1938) 60 CLR 150, 185 (Dixon J) ('*Mills*'). For a discussion of what acting bona fide in the best interests of the company requires see, eg, Len Sealy, "'Bona Fides" and "Proper Purposes" In Corporate Decisions' (1989) 15 *Monash University Law Review* 265; J Birds, 'Proper Purposes As a Head of Directors' Duties' (1974) 37 *Modern Law Review* 580; J D Heydon, 'Directors' Duties and the Company's Interests' in Paul Finn (ed), *Equity and Commercial Relationships* (1987) 120; David Bennett, 'The Ascertainment of Purpose When Bona Fides Are In Issue: Some Logical Problems' (1989) 12 *Sydney Law Review* 5; Chief Justice David Malcolm, 'Directors' Duties: The Governing Principles' in Ian Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 60; and Sir Douglas Menzies, 'Company Directors' (1959) 33 *Australian Law Journal* 156, 157.

¹⁰¹ Cf Corkery, above n 83, 109; and Worthington, 'Directors' Duties', above n 80, 122, 124. On the view that the duty to act bona fide in the best interests of a beneficiary applies generally to fiduciaries who exercise discretionary powers see, eg, *Duke of Portland v Lady Topham* (1864) 11 HLC 32, 54 (Westbury LC) ('*Topham*'); *Cameron v Murdoch* (1886) 60 ALJR 280, 287 (Lord Brandon) ('*Cameron*'); and *Gisborne v Gisborne* (1877) 2 App Cas 300. This view is discussed in Paul Finn, 'The Fiduciary Principle' in T Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1, 1, 27; Dennis Ong, 'Fiduciaries: Identification and Remedies' (1986) 8 *University of Tasmania Law Review* 311, 320; R Austin, 'Commerce and Equity: Fiduciary Duty and Constructive Trust' (1986) 6 *Oxford Journal of Legal Studies* 444, 447; J Lehane, 'Fiduciaries In a Commercial Context' in Paul Finn (ed), *Essays In Equity* (1985) 95, 96; and R Austin, 'Fiduciary Accountability For Business Opportunities' in Paul Finn (ed), *Equity and Commercial Relationships* (1987) 141, 172.

¹⁰² See, eg, *Consul Development Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373, 394–5 (Gibbs J); *Canadian Aero Service Ltd v O'Malley* (1973) 40 DLR (3d) 371, 381–2 (Laskin J); *Timber Engineering Co Pty Ltd v Anderson* [1980] 2 NSWLR 488; *Green v Bestobell Industries Pty Ltd* [1982] WAR 1; and *McFayden v Australian Securities Commission* (1995) 17 ACSR 415.

¹⁰³ B Creighton and A Stewart, *Labour Law: An Introduction* (2nd ed, 1994) 164–5. See also Ross Parsons, 'The Director's Duty of Good Faith' (1967) 5 *Melbourne University Law Review* 395, 397, 409;

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.¹⁰⁴ Senior managers like CEOs also arguably are 'officers' of the company¹⁰⁵ 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.¹⁰⁶

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,¹⁰⁷ if one borrows from notions of

'relevant' and 'irrelevant' considerations from public law.¹⁰⁸ 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.¹⁰⁹

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.¹¹⁰ 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.¹¹¹ 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.¹¹² This would appear to be

Hanrahan, Ramsay and Stapledon, above n **Ошибка! Закладка не определена.**, 209–10; and Austin, 'Fiduciary Accountability', above n 101, 141, 172.

¹⁰⁴ Discussed in the text accompanying nn 84–85, above.

¹⁰⁵ Within the meaning of *Corporations Act 2001* (Cth) s 9. Cf *CCA (Vic) v Bracht* (1988) 14 ACLR 728, 733–4 (Ormiston J); *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766, 782; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1, 66; *Holpitt Pty Ltd v Schwab* (1992) 33 FCR 474; and *R v Scott* (1990) 2 ACSR 470.

¹⁰⁶ See *Corporations Act 2001* (Cth) s 9, and generally Robert Baxt et al, 'CLERP' Explained: *The Corporate Law Economic Reform Program Act 1999* (2000) 8–9; and Hanrahan, Ramsay and Stapledon, above n **Ошибка! Закладка не определена.**, 209–10. They might also be de facto or shadow directors under s 9 of the Act, if the board uses their figures unchanged. See generally *Harris v S* (1976) 2 ACLR 51, 63 (Wells J) and 71 (Sangster J); *Australian Securities Commission v A S Nominees Ltd* (1995) 18 ACSR 459, 509; *Re Lo-Line Electric Motors Ltd* (1988) 4 BCC 415, 421; *Mistmorn Pty Ltd (in liq) v Yasseen* (1996) 21 ACSR 173; and *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR.

¹⁰⁷ 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 ACLR 465, 471 (McPherson J); *Corporate Affairs Commission v Papoulias* (1990) 2 ACSR 655, 657 (Allen J); *Flavel v Roget* (1990) 1 ACSR 595, 607, 609 (O'Loughlin J); *Morgan v Flavel* (1983) 1 ACLC 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,

32–4; and Worthington, 'Directors' Duties'.

¹⁰⁸ 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.

¹⁰⁹ Cf *Vatcher v Paull* [1915] AC 372, 378 (Lord Parker) ('Vatcher'); and *Feil v Commissioner of Corporate Affairs* (1991) 9 ACLC 811, 818 (O'Bryan J). Compare Worthington, 'Self-Denial', above n **Ошибка! Закладка не определена.**, 502.

¹¹⁰ Cf Gevurtz, above n 51, 1276–7.

¹¹¹ 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.

¹¹² 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 reported profit of the company in order 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

Method Choice: Opportunistic Behaviour, Efficient Contracting and Information Perspectives' (1990) 12 *Journal of Accounting and Economics* 207. Cf Gevurtz, above n 51, 1277.

¹¹³ Rehnert, above n 5, 1157, 1168.

¹¹⁴ On the relevance of intelligence and honesty in this context see, eg, *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Pty Ltd* (1972) 5 SASR 386, 402; *Linter Group Ltd v Goldberg* (1992) 7 ACSR 580, 622 (Southwell J); *Farrow Finance Company Ltd (in liq) v Farrow Properties Pty Ltd (in liq)* (1997) 26 ACSR 544, 581 (Hansen J); and *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74 (Pennycuik J). Compare *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50, 146-8 (Clarke and Cripps JJA).

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.

¹¹⁶ *Hospital Products Ltd v United States Surgical Corporation* (1984) 156 CLR 41, 68-9 (Gibbs CJ) and 96-7 (Mason J). This alignment of interests is discussed in Patricia Loughlan, 'The Historical Role of the Equitable Jurisdiction' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 3, 38; and Patrick Parkinson, 'Fiduciary Obligations' in Patrick Parkinson (ed), *The Principles of Equity* (1996) 342, 361-77.

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.

¹¹⁹ See, eg, Patricia Dechow and Robert Sloan, 'Executive Incentives and the Horizon Problem: An Empirical Investigation' (1991) 14 *Journal of Accounting and Economics* 51. Cf Gevurtz, above n 51, 1277.

¹²⁰ Cf Loughlan, above n 116, 31, 49. Compare *Allen v Flood* [1898] AC 1, 46 (Wills J). On fiduciaries and contract generally, see Victor Brudney, 'Corporate Governance, Agency Costs and the Rhetoric of Contract' (1985) 85(7) *Columbia Law Review* 1403; Paul Finn, 'Contract and the Fiduciary Principle' (1989) 12 *University of New South Wales Law Journal* 76; and Thomas Hazen, 'The Corporate Persona, Contract (and Market) Failure, and Moral Values' (1991) 69 *North Carolina Law Review* 273.

¹²¹ *Meinhard v Salmon*, 249 NY 458, 464 (1928).

¹²² Paul Finn, 'Unconscionable Conduct' (1994) 8 *Journal of Contract Law* 37, 39; and Loughlan, above n 116, 31, 47, 49. Cf Matthew Conaglen, 'The Nature and Function of Fiduciary Loyalty' (2005) 121 *Law Quarterly Review* 452.

¹²³ Anthony Duggan, 'Is Equity Efficient?' (1997) 113 *Law Quarterly Review* 601, 624, 631. See also Frank Easterbrook and Daniel Fischel, 'Contract and Fiduciary Duty' (1993) 36 *Journal of Law and Economics* 425, 427. Cf Chief Justice Murray Gleeson, 'Individualised Justice: The Holy Grail' (1995) 69 *Australian Law Journal* 421, 422; Michael Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements In Corporate Law' (1999) 19(1) *Oxford Journal of Legal Studies* 19; and C Riley, 'Designing Default Rules In Contract Law: Consent, Conventionalism, and Efficiency' (2000) 20(3) *Oxford Journal of Legal Studies* 367.

¹²⁴ 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.¹²⁵ This principle has predominantly been considered in the context of hostile takeovers¹²⁶ but is one of general application.¹²⁷ Further, while the principle has mostly been applied to directors,¹²⁸ they are not the only ones who are bound by this rule.¹²⁹ As Corkery and

Worthington point out, the principle is applicable to all donees who exercise limited powers.¹³⁰

As previously noted,¹³¹ 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.¹³²

Disputes in relation to proper and improper purposes have predominantly arisen in the context of the issuing of shares,¹³³ 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.¹³⁴ 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.¹³⁵ 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.¹³⁶

Case of Remedies' (1988) 53 *Brooklyn Law Review* 919, 941–8; J Gordon, 'The Mandatory Structure of Corporate Law' (1989) 89 *Columbia Law Review* 1549, 1594–5; Paul Finn, 'Fiduciary Law and the Modern Commercial World' in W McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (1995) 7, 10, 41; Loughlan, above n 116, 38; and Duggan, above n 123, 624. Compare Worthington, 'Self-Denial', above n **Ошибка! Закладка не определена.**, 506–7.

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 NSWR 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, 378 (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. For a detailed discussion of the content of this duty, see Austin, Ford and Ramsay, above n 98, 288–305.

¹²⁶ See, eg, *Harlowe's* (1968) 121 CLR 483; *Howard Smith* [1974] AC 821; *Pine Vale Investments Ltd v McDonnell & East Ltd* (1983) 8 ACLR 199 ('Pine Vale'); *Condraulics Pty Ltd v Barry & Roberts Ltd* (1984) 8 ACLR 915 ('Condraulics'); *McGuire v Ralph McKay Ltd* (1987) 12 ACLR 107 ('McGuire'); and *Ashburton* (1971) 123 CLR 614. See generally N Franzl, 'The Subjective and Objective Elements of a Company Board's Power To Issue Shares' (1976) 10 *Melbourne University Law Review* 392.

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.

¹³⁰ Corkery, above n 83, 109; and Worthington, 'Directors' Duties', above n 80, 121–6, 130, 151–2. See also *Advance Bank Australia Ltd v FAI Insurances Ltd* (1987) 9 NSWLR 464, 473 (Kirby P) and 493–4 (Mahoney JA) ('Advance Bank'); R Austin, 'Moulding the Content of Fiduciary Duties' in A Oakley (ed), *Trends In Contemporary Trust Law* (1996) 153; and Len Sealy, 'Fiduciary Obligations: Forty Years On' (1995) 9 *Journal of Contract Law* 37.

¹³¹ In the text accompanying nn 79–83.

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

¹³³ See, eg, *Harlowe's* (1968) 121 CLR 483; *Howard Smith* [1974] AC 821; *Pine Vale* (1983) 8 ACLR 199; *Condraulics* (1984) 8 ACLR 915; *Darvall* (1987) 12 ACLR 537; *McGuire* (1987) 12 ACLR 107; and *Ashburton* (1971) 123 CLR 614.

¹³⁴ See, eg, *Kamin v American Express Co*, 383 NYS 2d 807 (1976) ('Kamin').

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 Handley JJA agreed); and *Re Burton's Settlements* [1955] Ch 82, 100 (Lord Upjohn). Cf *Brady v Brady* [1988] BCLC 20, 38 (Nourse LJ).

¹³⁶ 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'.¹³⁷ 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.¹³⁸ The fiduciary position occupied by senior managers who in practice are largely charged with the preparation of the financial statements has been noted above,¹³⁹ 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.¹⁴⁰

D Improper Use of Position

Section 182 of the *Corporations Act 2001* (Cth) proscribes the making of improper use of a corporate position.¹⁴¹ 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 182.¹⁴² 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.¹⁴³ The cases suggest that such wrongs would constitute impropriety for the purposes of s 182,¹⁴⁴ 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.¹⁴⁵

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.¹⁴⁶

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.¹⁴⁷ 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.¹⁴⁸ The company's enhanced

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).

¹⁴¹ For academic discussion of what an improper use of position entails see, eg, Michael Whincop, 'Directors' Statutory Duties of Honesty and Propriety' in Ian Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 125, 133–47; Julian Blanchard, 'Honesty In Corporations' (1996) 14 *Company and Securities Law Journal* 4; R Baxt, 'Director's Misuse of Position and the Utility of the Corporations Law' (1993) 11 *Company and Securities Law Journal* 450; and Michael Whincop, 'Developments In Directors' Statutory Duties of Honesty and Propriety' (1996) 14 *Company and Securities Law Journal* 157, 163–73.

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, 278–9.

¹⁴³ 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 **Ошибка! Залка не определена.**; and Yablon, 'Bonus Questions', above n 25.

¹⁴⁴ See, eg, *Chew v The Queen* (1992) 10 ACLC 816, 819–20 (Mason CJ, Brennan, Gaudron and McHugh JJ), 823–5 (Dawson J) and 827 (Toohey J); *Jeffrey v National Companies and Securities Commission* (1989) 7 ACLC 556, 560 (Wallace J) and 564–5 (Brinsden J); *R v Byrnes* (1995) 17 ACSR 551, 559–61 (Brennan, Deane, Toohey and Gaudron JJ) and 566 (McHugh J); *Edwards v The Queen* (1992) 10 ACLC 859, 861 (Mason CJ, Brennan, Gaudron and McHugh JJ) and 863 (Dawson J); and *Australian Securities Commission v Matthews* (1995) 16 ACSR 313, 317 (Steytler J).

¹⁴⁵ For a 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.

¹⁴⁶ For academic discussion of this section see, eg, Austin, Ford and Ramsay, above n 98, 392.

¹⁴⁷ 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.

¹⁴⁸ 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.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(2).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.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.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).¹⁵³

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.

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.

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.

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

¹⁵² See text accompanying nn 98–140, above.

¹⁵³ The notion of dishonesty as it was understood prior to the amendments made by the *Corporate Law Economic Reform Program Act 1999* (Cth) is considered in detail in B Fisse, 'The Criminal Liability of Directors: Honesty and Dishonesty In Law and Corporate Law Reform' (1992) *Journal of Banking and Finance Law and Practice* 151, 155, 157; V Mitchell, 'The Concept of Honesty Under Section 232(2) of the Corporations Law' (1994) 12 *Company and Securities Law Journal* 231, 232–3; and R Carroll, 'The Test of Honesty In Civil Proceedings Under Section 232(2) of the Corporations Law' (1995) 5 *Australian Journal of Corporate Law* 214, 221–8. The meaning of the term 'dishonest' for the purposes of s 184(1) does not appear

E Board Liability For Managers' Actions

As previously noted,¹⁵⁴ it is not unusual for the board of directors of a company to delegate the responsibility for preparation of the company's financial statements to senior managers of the company. The question then arises as to what extent the board may be liable, under s 190 of the *Corporations Act 2001* (Cth)¹⁵⁵ and under the duty to exercise care, skill and diligence,¹⁵⁶ for the potentially wrongful conduct by managers as discussed above and as predicted by the bonus plan hypothesis.¹⁵⁷

The many studies which appear to confirm the incidence of the behaviour predicted by the bonus plan hypothesis¹⁵⁸ might mean that boards may lack

to have been judicially considered.

¹⁵⁴ In the text accompanying nn 84–85, above.

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.

¹⁵⁶ On the nature of this duty see, eg, *Wheeler* (1994) 14 ACSR 109, 156–8, 161–7, 287–8 (Ipp J, with whom Malcolm CJ and Seaman J agreed); *AWA* (1995) 16 ACSR 607, 658–9, 664–7 (Clarke and Sheller JJA); *Permanent Building Society v McGee* (1993) 11 ACSR 260, 287–8 (Anderson J); *Lagunas Nitrate Co v Lagunas Syndicate* [1899] 2 Ch 392, 418 (Romer J) and 435 (Lindley MR); *Vrisakis v Australian Securities Commission* (1993) 11 ACSR 162, 212 (Ipp J, with whom Malcolm CJ agreed) ('Vrisakis'); *Overend & Gurney Co v Gibb* (1872) LR 5 HL 480, 486–7, 494–5 (Lord Hatherley); *Re City Equitable* [1925] Ch 407, 427–9 (Romer J); *Re Brazilian Rubber Plantations & Estates Ltd* [1911] 1 Ch 425, 436–7 (Neville J) ('Brazilian Rubber'); *Re Forest of Dean Coal Mining Co* (1878) 10 Ch D 450, 454 (Jessel MR) ('Dean'); *Friedrich* (1991) 5 ACSR 115, 126 (Tadgell J); *Gamble v Hoffman* (1997) 24 ACSR 369, 373 (Carr J); *Dorchester Finance Company v Stebbings* [1989] BCLC 498, 501–2 (Foster J) ('Dorchester'); *Re Cardiff Savings Bank* [1872] 2 Ch 100, 109 (Stirling J) ('Marquis of Bute's Case'); *Re Denham & Co* (1883) 25 Ch D 752, 766–8 (Chitty J) ('Denham'); *Land Credit Company of Ireland v Lord Fermoy* (1870) LR 5 Ch App 763, 770–2 (Hatherley LC) ('Land Credit'); *Francis v United Jersey Bank*, 432 A 2d 814, 821–2 (Pollock J) (1981); and s 180 of the *Corporations Act 2001* (Cth).

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 **Ошибка! Залка не определена.**; and Yablon, 'Bonus Questions', above n 25.

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

Zmijewski and Hagerman, above n 45; Watts and Zimmerman, 'Towards a Positive Theory', above n 45; Hagerman and Zmijewski, above n 45; Lilien and Pastena, above n 45; Dhaliwal, above n 45; Daley and Vigeland, above n 45; Dhaliwal, Salamon and Smith, above n 45; Hoffman and Zimmer, above n 72; and Bowen, Noreen and Lacey, above n 45.

¹⁵⁹ As required under s 190 of the *Corporations Act 2001* (Cth). Cf *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

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); *Vrisakis* (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, 1167; and Slater, above n 87.

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.

¹⁶⁴ Rehnert, above n 5, 1150, 1165.

¹⁶⁵ 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 **Ошибка! Залка не определена.**; and Yablon, 'Bonus Questions', above n 25.

¹⁶⁶ Compare *Kamin*, 383 NYS 2d 807 (1976), criticised in Gevurtz, above n 51. On the requirements and nature of this defence see, eg, *Corporations Act 2001* (Cth) s 180(2); *Harlowe's* (1968) 121 CLR 483, 493 (Barwick CJ, McTiernan and Kitto JJ); *Darvall* (1989) 15 ACLR 230, 250 (Kirby P); and *Howard Smith* [1974] AC 821, 832 (Lord Wilberforce).

¹⁶⁷ Cf Gevurtz, above n 51, 1277. On the problems associated with litigating breaches of fiduciary duty in general, see Finn, 'Fiduciary Law', above n 124, 41. Difficulties arising in a different context in relation to challenging executive pay through the courts in the United States are discussed in Randall Thomas and Kenneth Martin, 'Litigating Challenges To Executive Pay: An Exercise In Futility?' (2001) 79 *Washington University Law Quarterly* 569.

¹⁶⁸ For example, Healy, above n 44; Christie, above n 45; Zmijewski and Hagerman, above n 45; Watts and Zimmerman, 'Towards a Positive Theory', above n 45; Hagerman and Zmijewski, above n 45; Lilien and Pastena, above n 45; Dhaliwal, above n 45; Daley and Vigeland, above n 45; Dhaliwal, Salamon and Smith, above n 45; Hoffman and Zimmer, above n 72; and Bowen, Noreen and Lacey, above n 45.

¹⁶⁹ As noted above, although this paper focuses on senior

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.¹⁷⁰ It is another thing to actually *prove* that this has taken place in individual cases.¹⁷¹

The *Accounting Standards* allow for the exercise of a significant amount of discretion in the preparation of the financial statements.¹⁷² Even if managers are subject to pay for performance arrangements under which their remuneration may be influenced by the accounting profit of the company as reported in its financial statements,¹⁷³ 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)¹⁷⁴ that managers have

chosen these treatments out of self-interest in order to maximise their performance-based pay. Without other evidence which might suggest actual bad faith,¹⁷⁵ too much will depend on the credibility of the individual in question.¹⁷⁶

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.¹⁷⁷ As noted above, listed companies are legally required by the *Corporations Act 2001* (Cth) to prepare financial statements.¹⁷⁸ 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.¹⁷⁹ 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

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'.

¹⁷⁰ On the drawing of inferences from broad 'context' evidence see, eg, *Winthrop Investments Ltd v Winns Ltd* (1979) 4 ACLR 1, 12 (Waddell J) ('*Winthrop*'); and Justice Alex Chernov, 'The Role of Corporate Governance Practices In the Development of Legal Principles Relating To Directors' in Ian Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 33, 47.

¹⁷¹ On the relevant requirements of proof in litigation raising issues of bona fides 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). Cf *J D Hannes v M 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*').

¹⁷² See discussion in the text accompanying nn 46-59, above.

¹⁷³ 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.

¹⁷⁴ Cf *Briginshaw v Briginshaw* (1938) 60 CLR 336; *Rejtek 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.

¹⁷⁵ Parsons, above n 103, 425-6 recognises that such evidence might be hard to find.

¹⁷⁶ See, eg, *Smith* [1942] Ch 304, 308 (Lord Greene MR); *Shuttleworth* [1927] 2 KB 9, 18 (Banks 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 ACLC 831, 838 (White J); and *Ampol* [1972] 2 NSWLR 850, 874 (Street J).

¹⁷⁷ On the complications posed by the presence of 'mixed purposes' see, eg, *Haselhurst v Wright* (1991) 4 ACSR 527, 531 (Owen J) ('*Haselhurst*'); and *Hirsche v Sims* [1894] AC 654, 660.

¹⁷⁸ Under *Corporations Act 2001* (Cth) ss 111AC(1), 111AE(1), 286(1) and 292.

¹⁷⁹ 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' which¹⁸² 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

¹⁸⁰ Cf the problem of mixed purposes discussed in *Harlowe's* (1968) 121 CLR 483, 493 (Barwick CJ, McTiernan and Kitto JJ); *Hindle* (1919) 56 Scots LR 625, 630 (Viscount Finlay); and *Ampol* [1972] 2 NSWLR 850, 872, 879 (Street J).

¹⁸¹ See, eg, *Mills* (1938) 60 CLR 150, 185–6 (Dixon J); *Howard Smith* [1974] AC 821, 835 (Lord Wilberforce); *Advance Bank* (1987) 12 ACLR 118, 136–7 (Kirby P); *Condraulics* [1984] 2 Qd R 198, 206 (McPherson J); *Ngurli* (1953) 90 CLR 425, 440 (Williams ACJ, Fullagar and Kitto JJ); and *Whitehouse* (1987) 162 CLR 285, 293–4 (Mason, Deane and Dawson JJ).

¹⁸² See, eg, *Mills* (1938) 60 CLR 150, 186 (Dixon J); *Haselhurst* (1991) 4 ACSR 527, 531 (Owen J); *Darvall* (1989) 16 NSWLR 260, 281–2 (Kirby P) and 340 (Clarke JA); *Winthrop* (1979) 4 ACLR 1, 11–3 (Waddell J); *Wheeler* (1994) 14 ACSR 109, 137 (Ipp J, with whom Malcolm CJ and Seaman J agreed); *Pine Vale* (1983) 8 ACLR 199, 209–10 (McPherson J); and *Whitehouse* (1987) 162 CLR 285, 294 (Mason, Deane and Dawson JJ).

¹⁸³ See, for instance, the examples given in K Chen and C Lee, 'Executive Bonus Plans and Accounting Trade-Offs: The Case of the Oil and Gas Industry, 1985–86' (1995) 70 *Accounting Review* 91; W Johnson and R Ramanan, 'Discretionary Accounting Changes From "Successful Efforts" To "Full Cost" Methods: 1970–76' (1988) 63 *Accounting Review* 96; R Kasznik and B Lev, 'To Warn or Not To Warn: Management Disclosures In the Face of an Earnings Surprise' (1995) 70 *Accounting Review* 113; B Lev and J Ohlson, 'Market-Based Empirical Research In Accounting: A

Review, Interpretation and Extension' (1982) 22 *Journal of Accounting Research* 249; W Llewellyn, C Loderer and A Rosenfield, 'Merger Decisions and Executive Stock Ownership In Acquiring Firms' (1985) 7 *Journal of Accounting and Economics* 287; Shezhad Main and Clifford Smith Jr, 'Incentives For Unconsolidated Financial Reporting' (1990) 12 *Journal of Accounting and Economics* 141; Mary Mohrman, 'Debt Contracts and FAS No 19: A Test of the Debt Covenants Hypothesis' (1993) 78 *Accounting Review* 273; D Patz and J Boatsman, 'Accounting Principle Formulation In an Efficient Markets Environment' (1972) 12 *Journal of Accounting Research* 392; H Tehranian, N Travlos and J Waegelein, 'Management Compensation Contracts and Merger-Induced Abnormal Return' (1987) 27 *Journal of Accounting Research* 51; and R Verrecchia, 'Discretionary Disclosure' (1983) 5 *Journal of Accounting and Economics* 179.

¹⁸⁴ 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 ACLC 831, 838 (White J); and *Ampol* [1972] 2 NSWLR 850, 874 (Street J).

¹⁸⁵ On the difficulties inherent in 'counterfactual' inquiries of this kind see, eg, Richard Wright, 'Causation, Responsibility, Risk, Probability, Naked Statistics and Proof: Pruning the Bramble Bush By Clarifying the Concepts' (1988) 73 *Iowa Law Review* 1001, 1029, 1041–2; David Hamer, "'Chance Would Be a Fine Thing": Proof of Causation and Quantum In an Unpredictable World' (1999) 23(3) *Melbourne University Law Review* 557, 567, 573–5; and B Robertson and G Vignaux, 'Probability: The Logic of the Law' (1993) 13 *Oxford Journal of Legal Studies* 457, 460, 470.

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 of 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 **Ошибка! Закладка не определена.**, 121; and Watts and Zimmerman, *Positive Accounting Theory*, above n 36, 204–5, 207–10.

¹⁸⁷ On other potential reasons for choosing accounting treatments that would have the relative effect of increasing the reported profit of a company see, eg, C Smith Jr and J Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 *Journal of Financial Economics* 117; D Stokes and K Tay, 'Restrictive Covenants and Accounting Information In the Market For Convertible Notes: Further Evidence' (1988) 28 *Accounting and Finance* 57; and O Williamson, 'Corporate Finance and Corporate Governance' (1988) 43 *Journal of Finance* 567.

¹⁸⁸ See, eg, *Smith* [1942] Ch 304, 308 (Lord Greene MR); *Shuttleworth* [1927] 2 KB 9, 18 (Banks 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 ACLC 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 Saulsman* (1990) 3 ACSR 502, 510 (Anderson J); and *Muschinski 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 (Banks 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 that this lack of bona fides ultimately resulted in a gain to the manager(s) at the expense of the company. When considered in combination with the highly discretionary and 'contingent' nature of accounting,¹⁹³ the complex 'counterfactual' inquiry that arguably would inevitably become necessary¹⁹⁴ could mean that successfully taking action against those involved in earnings management might prove to be just as difficult as succeeding in actions against those who engage in 'insider trading', if not more.¹⁹⁵

Considering that complex litigation of this kind could be expected to involve high direct and opportunity costs¹⁹⁶ 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

(McPherson J); *Morgan* (1983) 1 ACLC 831, 838 (White J); and *Richard Brady* (1937) 58 CLR 112, 136 (Latham CJ).

¹⁹¹ Perry and Zenner, above n 61, 10.

¹⁹² R Lambert and D Larcker, 'An Analysis of the Use of Accounting and Market Measures of Performance In Executive Compensation Contracts' (1987) 25 *Journal of Accounting Research* 85. See also Kevin Murphy, 'Performance Standards In Incentive Contracts' (2001) 30 *Journal of Accounting and Economics* 245.

¹⁹³ See the discussion in the text accompanying nn 46–59, above.

¹⁹⁴ As noted in the discussion accompanying nn 185–190, above.

¹⁹⁵ Cf Finn, 'Fiduciary Law', above n 124, 41. On some of the difficulties associated with taking action in relation to insider trading see, eg, Michael Gething, 'Insider Trading Enforcement: Where Are We Now and Where Do We Go From Here?' (1998) 16 *Company and Securities Law Journal* 607; Charles Qu, 'Efficacy of Insider Trading Civil Liability Regime In the Corporations Act' (2002) 14(2) *Australian Journal of Corporate Law* 161; and Mark Freeman and Michael

Adams, 'Australian Insiders' Views On Insider Trading' (1999) 10(2) *Australian Journal of Corporate Law* 148. Compare R Clark, *Corporate Law* (1986).

¹⁹⁶ See, eg, Whincop, 'Directors' Statutory Duties', above n 141, 143; Whincop, 'Developments In Directors' Statutory Duties', above n 141, 170; and Mark Lawson, 'After Legal Fees Settlements Look Meagre', *The Australian Financial Review* (Melbourne), 2 April 1993, 2, 2.

¹⁹⁷ 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.

¹⁹⁸ For a discussion of the economics of litigation see, eg, Neil Chenoweth, 'The Big Payback', *The Bulletin* (Melbourne), 21 April 1992, 84, 85; K St Pierre and J Anderson, 'An Analysis of the Factors Associated with Lawsuits Against Public Accountants' (1984) 59 *Accounting Review* 242; Randolph Beatty, 'The Economic Determinants of Auditor Compensation In the Initial Public Offerings Market' (1993) 31(2) *Journal of Accounting Research* 294; Zoe-Vonna Palmrose, 'An Analysis of Auditor Litigation and Audit Service Quality' (1988) 63(1) *Accounting Review* 55; Thomas Lys and Ross Watts, 'Lawsuits Against Auditors' (1994) 32 *Journal of Accounting Research* 65; and Zoe-Vonna Palmrose, 'Litigation and Independent Auditors: The Role of Business Failure and Management Fraud' (1987) 6 *Auditing: A Journal of Practice and Theory* 90. On the policy that may be adopted by ASIC with respect to prosecutions, see Alan Cameron, 'The Perspective of the Australian Securities Commission On the Enforcement of Directors' Duties and the Role of the Courts: A Comment' in Ian Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 205.

¹⁹⁹ In the text accompanying nn 167–192, above.

²⁰⁰ 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.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.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 role²⁰³ that Ramsay and others appear to have overlooked.²⁰⁴ Ingleby and Johnstone point out that lawyers perform a 'gatekeeper' function in relation to the legal system,²⁰⁵ and Yablon has alluded to the potential influence that legal advice may have in terms of shaping the making of corporate decisions.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.

Perspectives On the History, Philosophy and Sociology of Law (1995) 61, 66–7, 70; Ronald Coase, 'The Problem of Social Costs' (1960) 3 *Journal of Law and Economics* 1; and David Wood, Rosemary Hunter and Richard Ingleby, 'Themes In Liberal Legal and Constitutional Theory' in Rosemary Hunter, Richard Ingleby and Richard Johnstone (eds), *Thinking About Law: Perspectives On the History, Philosophy and Sociology of Law* (1995) 41, 43–4.

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.

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.**

²⁰³ Cf Charles Yablon, 'Overcompensating: The Corporate Lawyer and Executive Pay' (1992) 92 *Columbia Law Review* 1867, 1870 on the potential role of lawyers in terms of corporate governance.

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.

²⁰⁵ Richard Ingleby and Richard Johnstone, 'Invocation and Enforcement of Legal Rules' in Rosemary Hunter, Richard Ingleby and Richard Johnstone (eds), *Thinking About Law: Perspectives On the History, Philosophy and Sociology of Law* (1995) 157, 169.

²⁰⁶ Yablon, 'Overcompensating', above n 203, 1867, 1870.