Contemporary Issues in Accounting 2014
Assignment 2

Due date: Tuesday 7 October 2014 at 1pm (Adelaide time)
Length: 2,500 words or equivalent
Weighting: 25%

This assignment may be completed in groups of up to 3 students. Groups are not compulsory and students are welcome to make individual submissions

Topic: Positive accounting theory – contracting theory

<u>Background</u>
Contracting theory characterises the firm as a legal nexus of contractual relationships organizing economic activity to reduce contracting costs. An agency relationship arises from a contract where one party (the principal) engages another party (the agent) on their behalf. One of the most significant agency relationships is that between managers and shareholders, whereby the separation of ownership and control means that managers, as agents of shareholders, can act in their own interests – many of which may not be in the interests of the shareholders.

There are a number of problems that can cause differences in shareholders' and managers' incentives regarding company policies, including the risk aversion problem and the horizon problem.

<u>The task</u>
The accounting firm for which you work has a number of clients who are interested in salary packaging options for their senior executives. A major component under consideration is bonuses – short-term cash bonuses and longer-term equity bonuses.

You are required to compile a report for management of your accounting firm, which addresses the issues outlined below. The report must offer practical information, but also outline the theoretical perspectives mentioned in the specific questions. You are not required to provide any recommendations in relation to salary packaging, as your report will be used by management to provide better-informed advice to clients.

The article below provides some useful discussion in relation to this issue – although it was published in 2007 it is no less relevant today.

The issues that your report must address are:

1. One of the problems in the shareholder/manager agency relationship that pay contracts are designed to overcome is the risk aversion problem. Outline what the problem is, and how the contract between managers and shareholders can be designed to reduce risk aversion.

2. How does equity as a pay component work to reduce the horizon problem? What role, if any, does accounting information play in specifying the contractual terms of bonus plans designed to reduce the horizon problem?

3. The article discusses a range of non-salary components that are contained within the

management compensation packages of top-100 companies. What is the purpose of including non-salary components in executive pay arrangements?

4. Why would managers prefer short-term cash over long-term equity bonuses? Why does this not align with shareholder interests?

5. Shareholders of Australian entities have the ability to vote to show either their support or dissatisfaction with companies' remuneration reports. While this is non- binding on the Board, they are obliged to take note of shareholders' views. Explain why shareholders might choose to vote against reports with too high a proportion of pay as short-term cash bonuses rather than long-term incentives.

Pay backlash prompts shift to bonuses

By Patrick Durkin

Boards of top-100 companies are paying their chief executives larger annual cash bonuses to avoid an embarrassing investor backlash over pay, experts say.

The fixed pay of CEOs at the top 100 listed companies has doubled over the past five years to an average of $1.8 million — increasing four times faster than pay for ordinary workers, according to a survey of executive pay by the Australian Council of Super Investors [ACSI], which advises 40 superannuation funds that manage more than $250 billion.

The increase compares to a rise of 26.8 per cent in average weekly earnings and a gain of 76.8 per cent in the benchmark S&P/ASX 100 Index over the same period.

ACSI said the more alarming trend was that CEOs were now much more likely to receive an annual bonus. Only four missed out in 2006, compared with one-quarter in 2002.

ACSI said annual bonuses had grown from an average of $769 000 in 2001 to $1.66 million, and more CEOs were receiving them.

'More and more boards seem to be placating executives unhappy at having to meet demanding performance hurdles to get their options by paying them more cash', said ACSI executive officer Phil Spathis.

'Where is the downside for these executives, when so much of their supposed 'at risk' pay is delivered much sooner than later?'

Telstra, AGL, MFS, Suncorp, Babcock & Brown Infrastructure, Leighton Holdings, Toll Holdings and Becton Property Group all faced shareholder protest votes against their remuneration reports this year.

Two of these top-100 companies, Telstra and AGL, faced majority votes against their remuneration reports, and two-thirds of Telstra shareholders, including the Future Fund, voted against Telstra's pay plan and the $11 million pay packet for CEO Sol Trujillo.

Shareholders were concerned his short-term performance pay nearly doubled and the hurdles for his long-term performance pay were less demanding than for other senior executives. But Geof Stapledon of Risk-Metrics, which conducted the survey, said shareholders typically voted only on long-term grants such as shares, options or equity schemes, rather than short-term annual cash bonuses. That was one factor driving an increase in the payment of short-term incentives, he said. 'Directors are paid to make tough decisions and it seems many cannot say no to their CEOs when it comes to pay increases,' he said. The top 10 highest paid CEOs all received a total pay packet of $8.41 million or more, up from $6.49 million the year before.

Source: Extracts from Patrick Durkin, 'Pay backlash prompts shift to bonuses', The Australian Financial Review 21 November 2011

Source: Rankin, Michaela. *Contemporary Issues in Accounting*. John Wiley & Sons Australia,, 03/2012. VitalBook file.

Format/expectations

This assignment must be presented as a formal report. If students are not familiar with the requirements of such a report please refer to the report writing guidelines for assistance.

Your assignment must be prepared in 1½ line or double spacing with 3cm left and right margins.

The word limit for this assignment is 2,500 words. When taking into consideration an allowance of 10% above that amount, your submission should be no more than 2,750 words in length. Penalties for assignments exceeding the maximum word limit will be imposed at **10% per 100 words or part thereof in excess of 2,750 words**. There is no minimum number of words, but you need to consider that 2,500 – 2,750 words provides a guide as to the depth and or breadth of coverage you should be seeking to achieve. If your report is significantly less than 2,500 words you should not seek to increase your word count simply by padding out what you have already written – rather you should consider the depth and breadth of what you have prepared.

<u>Your assignment must have a title page. The word count must be printed on the title page. Markers cannot be expected to look for the word count on cover sheets, in headers or footers or elsewhere. Marks will be deducted if the word count is not on the title page. (Note: the title page must include your name and ID or network username, course code and name, title of the paper and the word count.) Students do not need to attach an assignment cover sheet as these are attached automatically when the assignment is submitted on Learnonline.</u>

Note regarding penalties: 10 marks will be deducted if you do not provide a title page. 5 marks will be deducted if you do not include a word count on the title page. If neither a title page nor word count is included 15 marks will be deducted in total.

A high standard of presentation is expected. This is a capstone course in a professional qualification and it is expected that students are able to present a paper of professional quality. At the very least, check spelling and grammar. Ensure that all aspects of the requirements have been addressed.

Ensure that you comply with **Harvard** referencing conventions in preparing this assignment and that plagiarism is not an issue. You are expected to adhere to high standards of academic integrity and all assignments submitted in this course may be checked for plagiarism.

You need to ensure you comply with these requirements – failure to do so will result in penalties being applied.

Group work

This assignment may be completed in groups of up to 3 students. Groups are not compulsory and there are no restrictions on membership of groups – internal and external students can work together, as can internal students from different tutorial classes.

As much as benefits from group work are valuable, disagreements and difficulties can occur between group members. Group work is not compulsory in this course and students should think carefully before committing themselves to working in groups. Ensure that all group members are clear about expectations of each other and the way in which the work will be tackled. Be clear about deadlines and ensure that you communicate often and well with each other as you prepare the assignment for submission. Remember, the assignment is everyone's responsibility and you must all be happy with it before it is submitted. The one thing you should never do with a group assignment is allocate separate parts to different members of the group, then submit them all to one person just before the deadline to pull it all together and submit. Any group assignment needs careful editing and should be read and approved by all group members. All group members must take responsibility for the final submission.

Marking criteria and feedback sheet

Assignment Mark and Grade		**Mark**	**Comment**
Executive summary (10%) Clear and concise summary of the content and conclusions of the report	**Excellent Fair Poor**		
Introduction (5%)	**Excellent Fair Poor**		
Content (55%) Clear and effective explanations in response to the issues raised (see below)	**Excellent Fair Poor**		
Conclusion (5%)	**Excellent Fair Poor**		
Effective communication (15%) Fluent piece of writing (2)	**Excellent Fair Poor**		
Succinct writing (2)	**Excellent Fair Poor**		
Grammatically correct (2)	**Excellent Fair Poor**		
Correct spelling throughout (2)	**Excellent Fair Poor**		
Overall standard of presentation - appropriateness for purpose (7)	**Excellent Fair Poor**		
Information literacy (10%) Appropriate references used	**Excellent Fair Poor**		
Correct citation of references and adequate acknowledgement of sources	**Excellent Fair Poor**		
Less penalties			
Total mark	**/100**		

Comments

Individual weightings are not provided for the individual issues raised in the question. Students need to determine the most appropriate way to present this information to the managers of the accounting firm. You do not need to answer the questions in order and you may choose to combine questions if you think that is appropriate.