Agency and IFRS Implementation:

The Relationship between Primary Participants

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Abstract

This article helps to demonstrate the complex relationships between three of the primary actors involved in the implementation of International Financial Reporting Standards. The broad reaching effects of implementing a global set of accounting standards have yet to be clearly identified and analyzed. In more closely examining the macroeconomic impact that is likely to occur, it is essential to provide a framework in which to more easily view the environment and thus establish reasonable conjectures that will be beneficial in identifying various driving factors within these relationships. The existence of principal-agent relationships between investors and companies has been thoroughly established in academic publications. This paper examines a more complex multi-agent relationship that should be considered and explored; looking beyond the established agency relationship of investors and companies and expanding it to include the multi-faceted role fulfilled by government, more clearly demonstrates the complications involved in fully adopting IFRS. From the perspective of investors as principals, and both companies and governments acting as their agents, we identify a complex knot of possibilities whose deconstruction is far beyond the scope of this paper. It is essential to understand the basics behind this theory and embrace the existence of this proposed relationship between investors, companies, and government which will be assumed as my research progresses.

I Agency

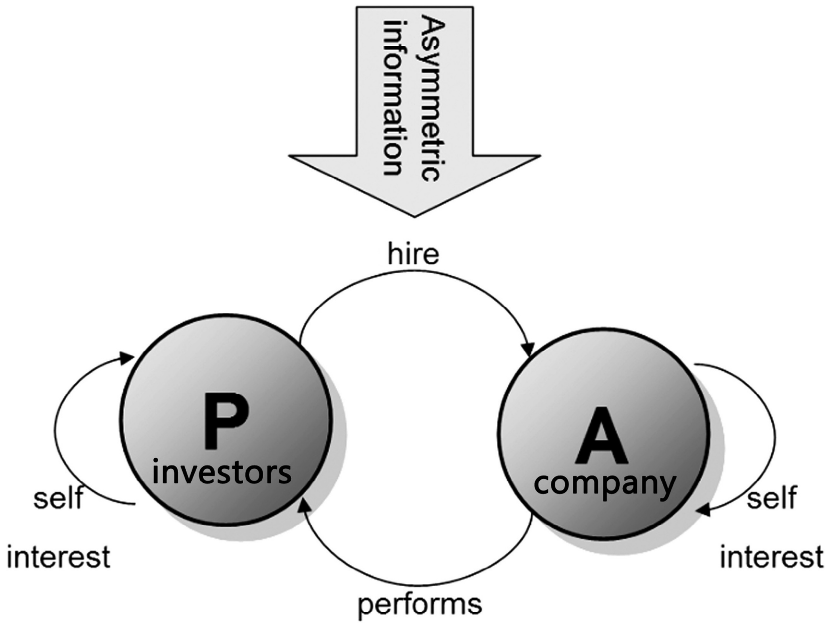
The theory of agency was developed independently by both Stephen Ross and Barry Mitnick in 1973. Ross is credited with originating the theory of agency in the area of economics. He clearly identified the agency problem as being generic to society. Ross's approach focused on the problems innate within agency relationships and identified significant existing problems and variables dealing with them as a decision based incentive problem, ignoring the components that wholly constituted the agency relationship. Mitnick concurrently developed the institutional theory of agency. His approach, while overlapping in areas, focused primarily on the relationships within institutions, specifically focusing upon the relationship between managers and employees. Their works are essentially parallels and both avenues of research stem from basic imperfections found in agency relationships[1]. To fully understand the theory of agency it is important to consider both economic and institutional theories.

The theory of agency is a supposition that explains the relationship between principals and agents in business. Agency theory is primarily concerned with resolving problems that exist in agency relationships; that is, between principals (such as shareholders) and agents of the principals (for example, company executives).

Agency theory addresses two concerns: "the problems that arise when the desires or goals of the principal and agent are in conflict and the principal is unable to verify the agent's actions.' and 'the variance in risk tolerance which may lead the principal and agent to take different actions[2]."

1 Mitnik, 2013, p. 2.
2 Caers *et al.*, 2013, p. 26.

Figure 1: Standard Principle-Agent Problem



The theory of agency derives its basis from the law of agency which is defined as a consensual relationship created by contract or by law where one party, the principal, grants authority for another party, the agent, to act on behalf of and under the control of the principal to deal with a third party. An agency relationship is fiduciary in nature and the actions and words of an agent exchanged with a third party bind the principal[3].

But perhaps we might more specifically define agency as a situation wherein an agent acts on behalf of a principal within the scope of his authority which has been granted to him expressly or can be implied from the circumstances. The Agent's actions bind the principal and the third party unless it follows from the circumstances of the case that the agent undertakes to bind himself only[4].

3 DeMott, 2003, p. 291.
4 Roshni and Vimal, 2013, p. 51.

The theory of agency is plagued by the problem of information asymmetry; a situation in which one party in a transaction has more or superior information than another. This causes potentially harmful situations because one party can possibly take advantage of the other party's lack of knowledge[5].

Management and investors are constantly in need of vast amounts of high quality data thus enabling them to make well informed decisions that minimize risk and maximize return. Time and cost constraints often make perfect information impossible and the pursuit of it unrealistic. Information asymmetry is inevitable. Even if two parties are granted access to the same information, there is generally private information which will not be shared.

Even if both parties were to receive the private information, the interpretation and extraction of useful details from the information would be unlikely to yield equivalent results, ultimately leading to agency costs.

Ⅱ Agency or Stewardship

For the purposes of this paper, explanation is limited to the examination of information asymmetry between companies, financial markets, and government, focusing on information asymmetry and assuming 'There is goal conflict between the principal and the agent.' "Agents have more information than principals, which can be exploited for self-gain[6]".

At this point, it is important to mention another viable theory as well. A case for the application of stewardship theory could be argued as an alternative to a

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5 Akerlof, 1970, p. 488.
6 Van Slyke, 2007, p. 162.

standard principal-agency approach. Stewardship theory holds that managers, left on their own, will indeed act as responsible stewards of the assets they control. In American politics, an example of the stewardship theory might be a president governing based on their belief that their duty is to do whatever is necessary in national interest, as opposed to one group or body[7]. Though it could be argued that bureaucracy is better approached by way of stewardship theory, an evolved principal-agent relationship often develops, which mirrors some of the practices put forth under stewardship theory[8].

Both agency theory and stewardship theory deal largely with trust and a belief, one way or another, as to whether agents work for the benefit of the principal or whether they require more specific motivation.

Agency theory, in its assumption that agents' self-interest will interfere with a principal's agenda, deals largely with incentive programs for aligning interests. Stewardship is more often than not applicable in instances where financial remunerations are not possible and the currency of incentive is instead, replaced by the status of reputation. This is most readily seen in the relationship between politicians and constituents.

Failure to adhere to the agenda of constituents can lead to significant and immediate consequences, perhaps chief among them being the destruction of reputation which acts as a sanction. This same incentive "scheme" can be applied in instances of evolved agency relationships. Agents achieve reward in the form of enhanced reputation and sanction in the form of damaged credibility. In instances such as bureaucratic oversight, where market share may be devoid of competition,

7 Marguiles, 2014, p. 106.
8 Van Slyke, 2007, p. 170.

diminished reputation may have no adverse effect on a provider's opportunity for continued contracting in the way that agency theory suggests that it should[9].

Ⅲ Establishing the Principal-Agent Relationship

In a traditional principal-agent relationship, such as that observable between shareholders, *i.e.* investors, and the management of listed companies, shareholders act as the principal and invest in a company expecting an acceptable return on their investment in the form of dividends or similar remuneration. In contrast, managers are interested in maximizing their own gains which are most often achieved by maximizing the profit of the company. The contrasting interests are usually overcome by means of incentive plans. Examples include; the granting of stock, stock options, and bonuses to promote practices that align managers interests with that of the investors[10].

It can be argued that a similar situation exists between investors and government or bureaucrats. Investors desire to maintain all of the benefits and protections of government. Taxes are levied against them in order to fund these efforts. The investors, *i.e.* constituents, expect government and their elected bureaucrats to work in their best interest. Individuals or groups prefer optimizing their own gains to sacrificing for the benefit of another individual or collective. Therefore agents will often pursue actions that benefit them, regardless of the consequences inherent to the principals[11].

Although governments, or bureaucrats, act in the role of agents, history has

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9 Van Slyke, 2007, p. 176.
10 Zhang *et al.*, 2008, p. 248.
11 Meckling *et al.*, 1976, p. 5.

repeatedly demonstrated that in the political arena, self-interest tends to prevail over principal interest. Additionally with so many elected bodies being pressured from various angles, it is difficult to ensure that a principal's needs are met at all. Furthermore, the extent to which government works in the interest of principals often extends only as far as will secure the continued patronage of the principal while ensuring government interests are protected.

It is here that we are forced to diverge from a standard principle-agent problem and advance to a multi-agent problem. Often you see government or companies mentioned as the principal in an agency problem. In contrast this multi-agent problem displays both as agents of investors. It clearly demonstrates where agency's primary problems, information asymmetry, agency cost, and conflicting interests; assert their presence in the equation.

Ⅳ Multiple-Agency

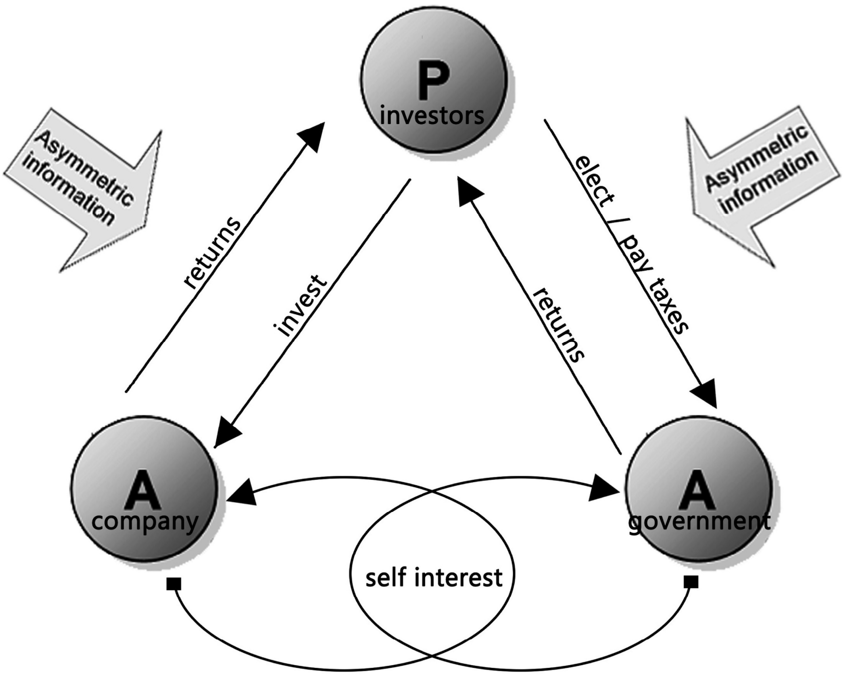
Agency relationships often have significant information asymmetry. Such relationships are at their most asymmetric point when basic agency theory breaks down. Preferences are unknown or go unsatisfied, contracts are not formulated, incentives are not fashioned, monitoring goes un-mobilized, and sanctions are not levied[12]. In regards to a regulating body, investors are often left with the SEC or other similar agencies, to ensure their protection and uphold their expectations. However, the investors do have some control of the legislators that govern the SEC and can thereby influence matters in that way. As far as the selection of their other agent in this scenario, investors always have their choice of which company to

12 Shapiro, 2005, p. 277.

entrust their investment to. Ultimately a successful principal-agent relationship should decrease uncertainty and Agency Cost and adhere to the interests of the principal.

The difficulty that arises in a multiple-agent problem, especially in this example, is that agents often have competing interests. Companies are not necessarily eager, but are often willing to undertake actions, such as the adoption of IFRS. The potential increase in foreign investment is a significant incentive for them to do so. Companies do face the risk of increased taxation in the future; however the benefits can potentially outweigh the drawbacks of open disclosure.

Figure 2: Multi-agent model.



V Agency Costs

We can at this point, readily identify a clear example of the potential costs involved. The adoption of IFRS would require governments to give up considerable control of their sovereign taxation rights, potentially reducing their income tax receipts. This is a strong disincentive for the official adoption of IFRS over a country's established GAAP. All agency relationships are encumbered by agency costs. *Agency costs are defined as a type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal.* Agency costs arise because of core problems such as conflicts of interest between shareholders and management.

Shareholders wish for management to run the company in a way that increases shareholder value. But management may wish to grow the company in ways that increase their personal power and wealth and are not necessarily in the best interests of shareholders[13]. It is important to realize that there will always be divergence between an agent's decisions and those decisions which might benefit the welfare of the principal. This residual loss should always be expected and cannot be completely eliminated outside of a theoretical perfect principal-agent relationship.

Various agency costs exist, however, for the purpose of this article we will limit our mention to adverse selection and moral hazard, both of which deal with market failure. Adverse Selection may be defined as: A phenomenon wherein the one party is confronted with the probability of loss due to unknown risk which were not factored in at the time of sale[14]. Moral Hazard may be defined as: The risk that a party to a transaction has not entered into the contract in good faith, has provided

13 Meckling *et al.*, 1976, p. 316.
14 Jagannathan *et al.*, 2011, p. 69.

misleading information about its assets, liabilities or credit capacity, or has an incentive to take unusual risks in a desperate attempt to earn a profit before the contract settles[15].

For our purposes we can say that adverse selection occurs when a party, most commonly the agent, has better information than the other party, generally the principal, prior to the establishment of an agency relationship.

This allows the party with the better information, in this case the agent, to act opportunistically prior to the establishment of any binding obligation. In an instance of moral hazard the party would act opportunistically after the establishment of a binding obligation.

A simple example which demonstrates adverse selection would be investors receiving information procured by the SEC. Such information would have been procured through independent audit demonstrating that a firm was adhering to GAAP and disclosing accurate details related to sales, assets, and earnings. Bad firms sometimes slant their information to improve the outlook to investors which in turn causes adverse selection for investors. That money could have been invested in a better firm if the investors possessed more accurate information.

An example of moral hazard on the other hand, can be shown in the form of a firm selling stock under the guise of investing in valuable assets but instead using those funds to pay off retirement debt. Without strong safeguards in place for both parties to enforce obligations, there is the strong possibility for deceit and misappropriation.

Figure 2 demonstrates the complexity of introducing a second agent to a relationship. The areas in-between principals and agents are where asymmetric information lies. The lower half of the figure demonstrates overlapping or competing

15 Investopedia, 2014.

interests between agents. Some examples of asymmetric information utilized in a multi-agent problem might be controversial legislation, or the leaking of information between agent and principal in regards to other agents [16].

Ⅵ Aligning Interests and Agent Remuneration

Where government involvement is concerned we are forced to consider the impact of International Financial Reporting Standards on tax revenues. Beyond tax revenue, governments do not have profits or monetary gains to distribute among public agencies or politicians for adhering to the interests of a principal. There are many metaphors which clearly demonstrate this fact. Politicians seek to obtain votes, bureaucrats need big budgets.

Policy commitments often undermine the expectation of goal conflict resolution between principals and agents [17]. When dealing with political entities, remunerations are usually conferred in the form of reputation or sanction. Proof of the government interest in lost revenue can easily be seen in the current case being made against Caterpillar Inc. The US government is alleging that Caterpillar has deferred or avoided billions of dollars in tax liability over the past decade. This was accomplished by shifting profits from overseas replacement-part sales to a Swiss subsidiary [18].

Additionally the US government is currently scrutinizing Swiss banks participating in the U.S. Justice Department program and others outside of the program which have allegedly been hosting undeclared U.S. assets to help

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16 Shapiro, 2005, p. 267.
17 Shapiro, 2005, p. 268.
18 Hagerty, 2014.

circumvent tax payments[19]. Subsequently of interest is the fact that Switzerland began IFRS convergence in 2002 and full adoption in 2005, which includes IAS tax regulations for listed companies[20].

Ⅶ Conflicting Interests: Simple Scenario

Recalling from our earlier mention that agents working for a principal often have varying or competing interests allows us to look more closely at Figure 2 and acknowledge the potential for agency problems. The overlapping region at the bottom of Figure 2 representing mutual interests between government and companies, the two primary agents mentioned in this article. These interests rarely align in a convenient manner. It is in the resolution of these competing interests that the strongest evidence of and most significant source of agency costs may be found.

It is perhaps in the form of bureaucratic corruption that we can most clearly define this issue. Bureaucratic corruption can be defined as bureaucratic behavior that consciously deviates from the formal duties and accepted norms for private advantage[21]. These actions may be found among both politicians and managers, however, for our purposes a simple example should suffice to see in what manner it applies.

A simple yet effective scenario may be crafted in relation to the adoption of International Financial Reporting Standards. Investors desire the use of International Standards to ensure that they are investing their funds in, what they

19 Morse and Barrett, 2014.
20 Larson and Street, 2004, p. 90.
21 Gillespie, 2001, p. 4.

believe to be, the best option, thus potentially alleviating agency costs and promoting a strong return on their investment.

IFRS can be described as essentially “investor focused”. The rationale underlying this investor focus is that if the financial information produced satisfies the needs of investors, it should also, by definition, meet most of the needs of other users of the financial statements[22].

In the current environment, companies are often happy to comply because by providing these statements they help promote foreign investment into the company, thereby increasing capital. In instances where IFRS have been fully implemented there are various examples of government passed legislation guaranteeing there will be no increase in taxation. This is significant because some studies have revealed that the use of IFRS for a tax base in Italy would increase the base tax rate by as much as 20%[23]. Regardless of whether IFRS increases the tax base it is still likely that companies would adhere to investor interests to ensure access to investor capital.

Governments on the other hand are rarely as responsive to the acceptance of international standards due to beliefs that IFRS principles are too ‘investor focused’ to meet the requirements of taxpayers and tax authorities. It has been acknowledged that IFRS might be an appropriate place to design a common tax base[24]. The adoption of IFRS would require governments to waive considerable control of their sovereign taxation rights which is a considerable disincentive.

Research performed in Australia has demonstrated that the application of IFRS in government reporting has shown a positive increase in both assets and

22 Price Waterhouse Coopers, 2006, p. 3.
23 Gavana *et al*, 2013, pp. 58-59.
24 Price Waterhouse Coopers, 2006, p. 11.

liabilities[25].

It provides some evidence that suggests IFRS adoption would increase taxable assets for companies as well and thereby potentially increases tax revenues for the government. This same idea is reflected in the fore mentioned Italian study. If proven true, it would provide strong incentive for governments to adopt IFRS for various reasons. However, until it is proven, it is considered prudent to tote the status quo.

Ⅷ Agency and Bureaucracy

The scenario mentioned above provides a simplistic view of one agent working cohesively with the interests of the investor while the other does not. This scenario can become much more complex when one takes into consideration the method in which government legislation and politicians are influenced. It can be argued that government and bureaucrats cannot be considered as agents because they are not elected by any one individual and are not working for the interests of any select person, generally speaking. Though true it is also an erroneous view.

Politicians are usually elected en masse by a collective of people to serve that single collective's various interests. Therefore it is vital to consider that though investors are the majority in electing officials to represent them, companies are also comprised of individuals with the same rights and privilege. Even companies themselves are now empowered with the ability to elect officials to represent their interests.

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25 Kamran and Manzurul, 2012, p. 118.

Ⅸ Corporate Political Influence

Prior to 2010 the Taft-Hartley Act of 1947 prohibited labor unions and corporations from spending money to influence federal elections and prohibited unions from contributing to campaigns. However, the Citizens United V. Federal Election Commission ruling, in 2010, brought to power a new political action committee known as a Super PAC[26]. These committees may not make contributions directly to political campaigns or candidates however so long as they remain independent they may engage in unlimited political spending, can raise funds from individuals, corporations, unions, and other groups without any legal limit.

These Super PACs have continued to gain traction and receive large cash flows in which to help support candidates of their choice. Companies are slowly becoming strong contributors[27].

In the 2012 US primary elections Super PACs spent nearly 40 million supporting Mitt Romney[28]. Nearly 16 million was used to support Newt Gingrich[29]. Companies are able to use their inflows of investor capital to help fund their support of candidates. This is an important consideration since the candidate selection may not be in alignment with the investors own personal wishes and would not have been considered an acceptable use of funds by the investors.

Additionally the development of the Super PACs gives significant power to foreign companies who through localized subsidiaries are able to engage in the sovereign political election process of a nation, which under other circumstances would be

26 United States District Court for the District of Columbia, 2009.
27 The Wall Street Journal, 2014.
28 Blake and Cillizza, 2012.
29 Gold and Masso, 2012.

illegal.

X Conclusion

Despite the various topics this article was forced to address, the existence of complex multi-agent relationships, between government entities, companies, and investors has been demonstrated. Though this relationship is not tangible and could not easily be demonstrated through calculus, it suggests a viable relationship that must be taken into consideration. Accounting standards are not solely based on the laws of a country but on the society as well. The essential background information provided the theories involved and clarified their application in real world examples so that a plausible stance for assuming these agency relationships could be established and defended, thereby enabling future research to continue unimpeded. Though it must be acknowledged that the accounting systems in various countries differ, it should be sufficient to say that if such relationships can be identified in highly structured law and rule based societies such as the US, similar relationships exist in other law bound nations, and most certainly exist is less restrictive governments, thus permitting a base assumption that investors have an agency relationship with both companies and government.

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