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Accounting and Ethics in Good Corporate Governance: Agency Theory Perspective

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Abstract: Accounting can influence and be influenced by business environment. Accounting shaped in the perspective of agency theory presents profit as the main objective of companies. The first objective of this article is to provide an outlook on the role of accounting in Good Corporate Governance in the frame of agency theory perspective. The second objective is to criticize the view compared with the reality. This study finds that, in the perspective of agency theory, accounting is still far from neutral nature, full of managerial subjectivity to overstate the figure on the bottom line instead. It is because accounting is an exertion instrument of utilitarianism ethics, especially for the interest of shareholder.

Key words: Profit · Utilitarianism · Shareholder

INTRODUCTION

The developing study regarding Good Corporate Governance (GCG) discusses the relation between GCG and the success and failure of companies' existence. This article also sees GCG from a standpoint that success is the fruitfulness of a company in increasing its profit. On the contrary, the success is also the cause of financial scandal, as in Enron [1]. Starting from this paradox, this article presents itself to provide an analysis on GCG related to accounting and ethics. Accounting is needed to describe the practice of GCG in companies, but ethics deals with the moral attitude of management in carrying out GCG.

The elaboration of this article starts with an explanation about the concept of GCG, accounting, agency theory and ethics currently applicable in companies. Discussion about the relation among GCG, accounting and ethics in the frame of agency theory critical in tone is presented next.

MATERIALS AND METHODS

GCG and Accounting: The issue on GCG has raised various definitions. GCG is articulated as "a set of relationships between a company's management, its board, its shareholders and other stakeholders.Corporate governance also provides the structure through which the objectives and monitoring performance are determined" [2].This definition has not been able to explain the objective of GCG. In another paragraph, it is explicitly mentioned that:

> "The Principles are developed with an understanding that corporate governance policies have an important role to play in *achieving broader economic objectives* with respect to investor confidence, capital formation and allocation." [2]. (italicized by the author).
> "The corporate governance framework should *protect and facilitate* the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the *opportunity to obtain effective redress for violation of their rights*." [2]. (italicized by the author).

Based on the explanation above, the objective of GCG is to protect the interest of shareholder through profit increase. While accounting is more than merely a technical skill, it represents the trail of management in implementing GCG. It means that when the objective of GCG is profit increase, accounting is the only instrument for legitimating it [3].

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Table 1: Agency Problems and Solutions.

Agency Problems	Solutions of Agency Problem	Description
Hidden information and hidden action	Incentive compensation or reward systems	Systems give a share in the returns to agent. Principal-agents concerned in high returns. *It generates costs* to the principal and risks to the agent. Agent is required to provide high productivity
Hidden action	Monitoring or Information systems	It has to be complemented with other mechanisms, because perfect monitoring systems are often not effective. Budgeting sytems, layers of management, reporting procedures, board of directors, board of commisioners and auditors *generate costs to the principals*.
Hidden intention	Vertical systems	Itis expressed in a monetary way and predominant in labour contracts It surely *generates costs to the principal*. For example, promises regarding pensions and bonuses are established only after agent has dedicated to the principals for many years. *It represented principals' power to agent*.
Hidden intention	Game theoretical solutions	The relations are examined as combination between a cooperative and non-cooperative participant as games like in game theory. For example, the problem may be created as a prisoner's dilemma. A participant adjusts the situation to generate sustainablecooperation. Interaction frequency increased and *sanctions imposed on defective actions*.
Hidden characteristics and hidden information	Self-selection	Based on agent risk preference, an outcome-based or and a behaviour-based, which has vary on the risk and the return of the agent. It makes agent eagerness to work hard by his/her preference. It *generates costs to the principal*.
Hidden characteristics and hidden information	Signalling	This scheme in oppositions to others. *Agent provides the costs signalling*. For example, agent gets a high level education and has certifications are interpreted as signalling. Agent performs his willingness to work hard.
Hidden action	Bonding	Agent contracts himself to certain actions. For example, he produces performances and agrees to accept sanctions if he should not produce them. The rewards depend on his performance. It *generates costs to the principal* because efficient bonding has to be controlled.
Hidden characteristics and hidden information	Screening	This scheme is similar to signalling, but the specification of competence is determined by principal. Principal encourages agent to get selected procedures like tests or assessments centers, *which generates costs to him*.

Source: [5], (italicized by the author).

Agency Theory as a Theoretical Frame (Method): Jensen and Meckling [4] defined agency relationship as a contract between principals and agent to perform some services on their behalf that involves delegation of some decision making to the agent. The relation between the agent and the principal causes several consequences [5], (1) the agent has more potential information about the quality than the principal does. Therefore, if the principal wants to know the information owned by the agent, some costs incur. (2) agent is assumed to have risk averse because he has lower income compared to the return expected by the principal. (3) each of principal and agent has the interest of maximizing his individual utility. While principal expects a high return, agent wants a high income. Agency theory assumes that a high result comes from the hard work of agent. It explains that principal expects the best effort from the agent for high return, but agent expects high income with minimum disutility. Separability between principal as corporate ownership and agent as corporate control causes considerable agency cost [1].

Mechanisms to reduce agency costs are presented on Table 1.

Table 1 shows thatprincipal concerns to the cost. Incentive compensation or reward systems, monitoring or information systems, vertical systems, self-selection and bonding describe it. While in signaling and screening, although the cost is generates to agent, however in long term, it will improve his competence. Higher his skill, higher costs to be generated by the principal. It can be concluded that, principal strives to get efficiency by expecting high productivity from agent to earn high return.

Ethics: GCG is a series of mechanism run by human beings, as a subject that produces corporate cultural changes [6]. Thus, the success of GCG cannot be separated from ethics built by the management in carrying out his duties for the shareholder.

Ethics is perceived as a set of moral codes implemented in the structure of the company that becomes the best guidelines in working [7, 8]. If observed deeper, it is parallel to the objective of GCG; that is economic surplus. Therefore, the embedded ethics should also represent the economic motif. This is described in the operationalization of the company, where its decision-making is based on the rationalization of economic measures that provides material profit. It means that employee and customer as one side of stakeholders will be seen as something valuable if they give material profit during their transactions with the company [9]. Every decision to be made should consider the interest of shareholder.

DISCUSSION

Agency theory roots from the problem of principal, who wants the information owned by the agent is obtained transparently. The effort to get the information incurs agency cost. To minimize the cost, effective mechanisms for the principal to control the agent is needed. This can be achieved through the implementation of GCG. Meanwhile, the objective of GCG is to increase profit. Gosh, *et al* [8] stated that, "When the ownership is sliced up under the strait jacket of corporate structure, profit maximization turn into value maximization of shareholders. Shareholders are the real owners of the corporations…" therefore, it is obvious that maximum attainment of profit as the objective of GCG is a form of the implementation of agency theory that protects the interest of shareholder. Meanwhile, accounting works to reduce the agency cost between shareholder as principal and management as agent [10]. Figure 1 describes the analysis of this article.

Ethics as the Basis of Actions: The exposition above states that corporate and profit have an intimate connection. What is ethics? Ethics, according to Heath [7] "is usually associated with behavior that is 'altruistic', in some sense of term." Therefore, in his opinion, ethics does not reflect self-interest at all. Pushing profit increase is not an order of maximizing it. He gave an example by analogizing the profession of a medical doctor. A doctor should have advised health to his patients. It is similar to corporation. The increase of shareholders' welfare can only be achieved by caring other stakeholders. Gosh *et al*. [8] supports the idea by asserting that ethics should make peace with profit. It means that both should not conflict each other. They must meet at a point of seeking the possibility of respective optimum value.

> "The very acceptance of the government in our lives and the 'social contract' amongst the members of the society indicate that individual interest is subordinate to social welfare. A macroeconomic structure with its full interactive feedback mechanism and mutual mutandis provisions should more strongly justify profits with ethics than without." [8]

Both opinions are coercive. How can profit as the bottom line in any financial reporting, which is the result of deduction of revenue by profit, remains an altruistic ethics? The ethics of social interest will only add cost and reduce profit for shareholder. Therefore, to shareholder, management that uses this ethics is considered fail in making the priority of its interest.

Let us take a closer look. Rodgers and Gago [11] assessed the development of corporate ethics of the last 75 years. They found six kinds of ethical position that can help understand corporate behavior. Every company has a life cycle stage, which at the same time is different from one company to the other. The six ethical positions are egoism, deontology, utilitarianism, relativist, virtue ethics and ethics of care.

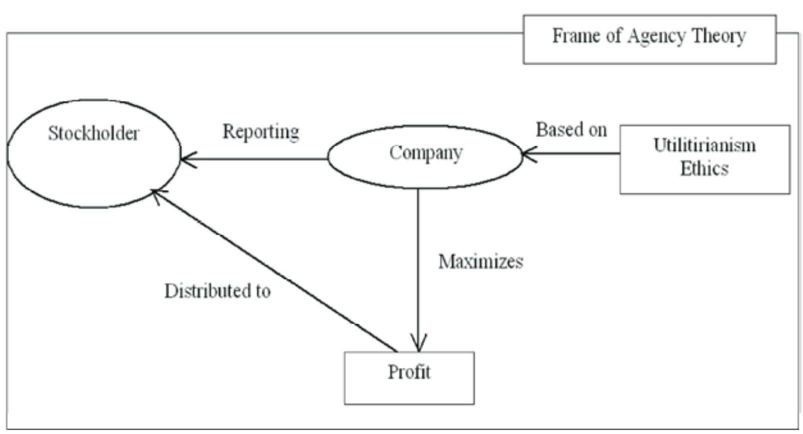

Fig 1: GCG in the Frame of Agency Theory Frame (reflection of the author)

Table 2: Position of ethics in corporate life cycle

Ethics	Definition	Description
Psychological egoism	Based on individuals and firms existing solely to serve their own ends.	The selfish nature of human is driven by self-interest. Corporate is run efficiently for the maximum welfare of the shareholder.
Deontology viewpoint	Emphasizes the rights of individuals and the judgments associated with a particular decision process rather than on its choices.	Every human has rights and obligations in the society and each decision he makes is based on the perception of circumstance.
Utilitarian position	Based on collective “economic egoism”.	This calculus was extended to value judgments by the principle of maximizing happiness and minimizing pain. New version of utilitarianism is rule-utilitarianism, which is adapted to legal provision. Therefore, companies are allowed to maximize profit as long as they do not commit fraud.
Relativist perspective	Assumes that decision makers use themselves or the people around them as their basis for defining ethical standards.	This ethics is mostly applicable to multinational or global companies with headquarters located in a country. The rule in one country differs to other countries, so it is relative in nature.
Virtue ethics outlook	The classical Hellenistic tradition represented by Plato and Aristotle, whereby the cultivation of virtuous traits of character is viewed as morality’s primary function.	This ethics relates to individual interest to live harmoniously with social environment. Decision will be made based on the consideration of social environment’s improvement.
Ethics of care philosophy	Focuses on a willingness to listen to distinct and previously unacknowledged perspectives.	Companies must build solidarity among employees, suppliers, customers, shareholders and communities. The operation of the companies must not harm any parties as stakeholders.

Source: [11]

Based on Table 2, it can be concluded that the level of company’s concern to stakeholders also varies. Selfish psychological egoism does not regard stakeholder at all. Companies with this ethics are past-time companies. While deontology and utilitarianism have low degree of corporate’s dependence on stakeholders, relativist perspective has medium degree of corporate’s dependence on stakeholders and virtue ethics outlook and ethics of care has high degree of corporate’s dependence on stakeholders.

The implementation of GCG in agency theory has not reached virtue ethics outlook and ethics of care because, as explained before, GCG aims for maximizing profit and protecting the interest of shareholders. It is not, also, in psychological egoism because its financial reporting still includes environmental and social account as cost. Deontology viewpoint does not also reflect the ethics of GCG since it still considers a perception of a circumstance, as in relativist perspective. Thus, the ethics of GCG fits utilitarianism better because it is based on collective “economic egoism”, in which shareholders play ownership role and management acts as the agent. Furthermore, decision will be made if it can maximize happiness and minimize pain during the existence of the company.

Accounting as a Tool: The ethics embraced by corporations is reflected in their disclosure in financial performance [6]. The viewpoint on accounting that does not stand only for profit is articulated in sustainability accounting, which assumes that accounting is also necessary in balancing the interests of environment, social and economic performance [12], summarized in the triple bottom line. However, remaining around the frame of agency theory, it is not logically accepted because placing environment and social account as cost contradicts the profit maximization purpose, which is carried out by reducing cost to the lowest point. Milne, *et al* [13] stated:

> “That growing the business, making increased profits and securing the financial viability of the business might come at the expense of the environment or social equity *avoided* in the developments we have examined”(italicized by the author).

If environmental and social account are classified into cost account, “for the sake of efficiency and effectiveness”, they, as expenses, will be reduced to increase profit. It implies that, at this point, the interest of shareholders is contested with environmental and social interest. Therefore, the existence of environmental and social cost is in question [13]. They were only used as adornment for financial report since they oppose utilitarianism ethics, which is based on collective “economic egoism” and purely filled with human greed [14]. Therefore, accounting is clearly plays roles in generating profit for shareholder [15].

In addition, various offers of accounting policy scheme in account measurement accommodate management to take policies beneficial for its company. Creative accounting and earning management are two forms of managerial rescue effort for the sustainability of profit. It is based on the reason mentioned by Charoenwong, *et al*. [16], that the mechanism of GCG tends to make the management worry about his position and increase the value of the company by increasing profit. It indicates that, as long as management obeys accounting standard, the use of policy intended for profit is acceptable. Therefore, accounting is vulnerable for misappropriation. Pay attention to the statement of Ms. McLean, who made corporate financial reports in investment banking division of Goldman, Sachs. She also reviewed the accounting of companies prepared to be sold.

> "I learned," she said, "that numbers can lie."… In accounting, "There is no reason why. There is no fundamental truth underlying it. It's just based on rules." "These rules create an incentive to get around rules," she said. "This means getting away from any accounting portraying the fundamental economic reality of a company." [17].

Therefore, accounting that focuses on profit cannot reflect the reality of the corporation. This is also stated by Abdel-khalik [1]:

> "When professors teach agency theory, it is *assumed* that (1) reported performance measurements reflect actual rather than wishful results and (2) there is a system of reporting and accountability in place, which assures that such is the case." (italicized by the author).

Both assumptions contradict the statement of Ms. McLean in Barringer [17] that actually accounting has yet able to reflect the real economic reality. Therefore, accounting is still far from neutral nature [3], full of managerial subjectivity to overstate the figure on the bottom line instead.

CONCLUSION

Profit has a status quo to be achieved in agency theory perspective. Accounting helps corporation by measuring the success of GCG through maximization of material value on the bottom line. The development of accounting with the characteristic of utilitarianism is one form of its existence in business. On the other side, discourses of green accounting, environmental accounting, social accounting, religious accounting and spiritual accounting keep trying to find suitable form to create harmony with the interest of human, universe and God, so human can move normally as human as a whole realizing his existence that always interacts with other human, nature and God. Therefore, the various accounting discourses must be clearly beyond the frame of agency theory.

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