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On: 01 October 2013, At: 01:24
Publisher: Routledge
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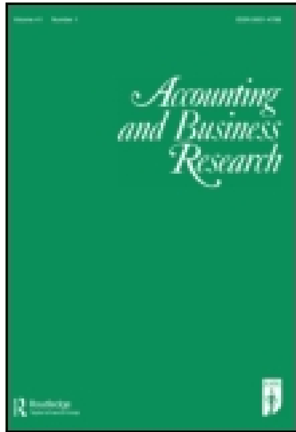

Accounting and Business Research
Publication details, including instructions for authors and subscription information:
http://www.tandfonline.com/loi/rabr20

Discussion of 'How does changing measurement change management behaviour? A review of the evidence'

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Published online: 28 Feb 2012.

To cite this article: Neil Chisman (2007) Discussion of 'How does changing measurement change management behaviour? A review of the evidence', Accounting and Business Research, 37:sup1, 73-74, DOI: 10.1080/00014788.2007.9730087

To link to this article: http://dx.doi.org/10.1080/00014788.2007.9730087

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Discussion of 'How does changing measurement change management behaviour? A review of the evidence'

Neil Chisman*

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I would like to thank Anne Beatty for an illuminating and thought-provoking address. I have a few brief observations and questions under these five headings:

1. Why do people complain? Aren't the behaviour changes always a good thing?
2. Are there differences between the UK and the US?
3. What are the non-economic motives for behaviour change?
4. What should we do about this?
5. What should standard setters do?

To take the first point: why do people complain; are not behaviour changes always a good thing? I know that Anne said more research was needed. I understand that – I used to be an academic myself. I was not very good at it because I found I had no trouble forming opinions in the complete absence of facts!

Doubtless accounting standards changes cause changes in behaviour. I've done it and I've changed behaviour as a result of an accounting standard change. I am not proud of it – I can only plead that I was very young at the time! I cannot think of a single case where such a behaviour change was a bad thing, or even an unintended consequence. For example, the standard dealing with off-balance sheet financing was overtly aimed at stamping out bad practice. Banks were openly marketing schemes to circumvent accounting standards. Prudent finance directors might not have liked them, but they could not refuse their pushy chief executives. Consequently, companies carried risks that they did not understand and that investors did not understand. The standard stopped all of that.

Or pensions accounting: I was a member of the Financial Reporting Council when the UK Accounting Standards Board introduced accounting standard FRS17 *Retirement Benefits*. A high-profile council member made an impassioned address saying that it would be the death of the British defined benefit pension scheme. A much lower-profile member responded that this would be a good thing because such schemes were widely misunderstood and mismanaged. It did indeed cause the decline of defined benefit schemes; I believe that was because managements and investors began better to understand the liability that they were carrying.

If a proposed accounting change is foreseen to cause a bad change in behaviour, then standard setters should respond to comment to that effect in the discussion phase, and I think they do. Perhaps the impassioned debate reflects differences of opinion on whether the foreseen behaviour change is a good or a bad thing.

There were some elements in Anne's presentation that made me ask if there were differences between the UK and the US. For example, do bonuses and remuneration really drive undesirable behaviour changes? I suppose it is not completely out of the question here in the UK. However, bonuses are normally awarded at the discretion of the remuneration committee, who would usually be expected to adjust for any engineered results, and the behaviour changes themselves are likely to be matters reserved for the full board.

Consequently, it is not really open to executive directors to tinker with the results without the agreement of non-executives merely to enhance bonus payments. Indeed, the whole area of window-dressing, involving such actions as making and releasing provisions to smooth the results, is much more constrained than it once was.

From this side of the Atlantic it can seem that the 'show me where it says I can't do this' mentality is quite rife in the US. It may indeed be less common over here now, but we must not forget that during the 1980s disciplines were disgraceful in the UK. It was perfectly normal to look for ways to circumvent accounting standards and there were some awful scandals. But there was a thorough clean-up in the 1990s, with David Tweedie at the ASB, with the Cadbury Committee on Corporate

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Governance, and with the Financial Reporting Review Panel scaring people to death. My perception is that it is now quite unusual to push the boundaries.

What, then, are the non-economic motives for behaviour change? Behaviour might change simply because management wants to do the right thing, both in the positive sense of wanting to earn one's place in Heaven, and in the negative sense of protecting one's back and not wanting one's face on the front page of a tabloid newspaper. Managements do care deeply about their reputations.

Anne mentioned that the debt:equity ratio, which we call gearing and which Anne calls leverage, is a poor proxy for tightness of debt covenants. I do not think it is any proxy at all; it is actually more stringent and more important. It is usually gearing that drives the behaviour change and not debt covenants. Debt:equity ratio is a guide to long-term financing stability, an indication that you are likely always to be able to borrow. I would expect a company's policy on gearing to be tighter than the debt covenants. It would be reasonable, for example, for a company to set a policy that the acceptable range is from 40% to 60%; any lower – as Anne's example quoted – would appear as unambitious, with the company needing to find good investments or return cash to shareholders. Any higher and the route back down must be clear. This is where the standard on off-balance sheet financing had its effect by demonstrating that companies' gearing had been pushed past acceptable upper gearing limits.

Perhaps the best and the most benign motive for behaviour change is simply increased understanding of the issues leading to better decisions. In my experience, this is the most common – and you might say that this is what accounting standards are actually for.

Behaviour change happens because people do not always act rationally in practice, and markets are far from perfect. In principle, all decisions within a company should be made by selecting the option which maximises the net present value of future cash flows, either directly by maximising the cash flows themselves or by lowering risk and the weighted average cost of capital.

If people consistently acted rationally in this way, then an accounting change would not induce a behavioural change. When it does, it implies that there was something wrong previously, that some area of irrational decision-making is being corrected. Hence the demise of the defined benefit pensions, as people understood the liability more completely, and the cessation of off-balance sheet financing as people understood better the risk of excessive gearing.

It is not only on the management side that better understanding is required. Ten years ago, there was an investor-driven move for hotel companies to sell big hotels and retain a management contract. It was argued that a revenue stream on 'no capital employed' had to be good business. Actually, this is usually value destroying because there are substantial extra costs, the revenue stream is no longer a perpetuity, and most of the benefit of improved trading performance passes to the new owner. Investors can and do bring irrational pressure to bear on managements. Indeed, investors are often cited as being more than willing participants in the strategy that brought down Marconi.

What, therefore, do we need to do? We must make a fundamental change in the way we account and report, in order to give both sides – management and investors – greater clarity and understanding that what matters is the net present value of future cash flows. If accounting standards can make the dialogue between investors and managements focus rationally and constructively on value creation rather than short-term profits, then there will be much beneficial behaviour change and we will all get richer.

What should standard setters do? Anne quoted Jim Leisenring as saying: 'Standard setters must continue to produce standards giving neutral decision-useful information,' and I agree with that. Decisions will then become more rational, and any changes in behaviour will be beneficial.

Let's not underestimate the task. Global standards are far from harmonised, and even the best are not yet very decision-useful. Progress is hampered by market participants' inability to agree, to reach a consensus, even on trivia like terminology. We have bickering; woolly thinking; partisan positions; poor to non-existent listening skills; arguments about the number of angels that can dance on a pinhead; and even political interference.

The standard setters are uniquely placed to rise above all this, to see the big picture, to show technical excellence, to lead opinion and to drive consensus about what needs to be done. The standard setters must not let themselves get bogged down in the trivia that we mere mortals indulge in; otherwise we will make no progress. The standard setters must lead – they must lead the world towards harmonised, high quality, decision-useful accounting standards, and it would be nice if that could be soon.