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BOOK REVIEWS

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DAVID ABOODY and RON KASZNIK*, Executive Compensation and Financial Accounting*, Foundations and Trends® in Accounting (Hanover, MA: now Publishers, Inc., 2009, ISBN: 978-1-60198-342-8, Vol. 4, No. 2, pp. xi, 88).

David Aboody and Ron Kasznik's monograph on the relation between executive compensation and financial reporting explores the interplay of regulation and pay. They organize their review around two themes: (1) compensation provides incentives to influence financial reporting (Chapters 2 and 3) and (2) financial reporting and regulation, more broadly, influence the compensation contracting process (Chapters 4 and 5). The authors do a nice job explaining important institutional details, summarizing much of the relevant literature, and offering potential explanations for conflicting evidence.

The literature in this area is vast and cuts across several disciplines; so no monograph could include all relevant research. And compensation practices and regulations are ever evolving; so new questions continue to arise. Besides highlighting the key features of Aboody and Kasznik's monograph, my aim in this review is to introduce the reader to work that provides different perspectives and highlight additional areas for future research.

I. EFFECTS OF COMPENSATION ON FINANCIAL REPORTING CHOICE

With apologies to the Rolling Stones, this section of the monograph could be subtitled "Maybe you can't always get what you want, but, with a rational economic agent, you just might find you get what you reward." In this section, the authors describe the literature, examining the incentive effects of compensation contracts on managers' financial reporting choices.

In Chapter 2, they summarize the literature on the influence of earnings-based contracts (i.e., bonuses) and stock option compensation on accounting choices. They provide a broad survey of the research in this area and highlight the limitations of studying discretionary accounting choices, including the inability to cleanly measure discretion.

The focus of Chapter 3 is the literature, examining the abnormal (v-shaped) stock price pattern around option grants and, in particular, the influence of stock option grants on voluntary disclosures. The authors primarily discuss their own work, Aboody and Kasznik (2000), which is appropriate, as they were the first researchers to try to disentangle whether managers were timing option grants around corporate disclosures, or vice versa.

The authors provide a survey of the key research in this area and leave the reader with directions for future research. One direction they do not mention is the incentives created by features of other types of equity grants. For example, in the U.K. and increasingly in the U.S., firms are granting stock and stock options with performance-vesting features. Performance requirements can create direct incentives to manipulate earnings or stock price, and reporting requirements make the performance targets more transparent to researchers. But other features of these contracts may alter those incentives (i.e., performance conditions measured over time or proportional vesting over a range of outcomes). Prior research has studied other aspects of these compensation

contracts, but exploring the incentive effects of these other types of equity may be a fruitful direction for future work.[1]

The literature in this section of the monograph demonstrates that compensation contracts can encourage self-serving behavior. Thus, the authors frequently pose the question, "Why would shareholders allow these contracts?" In Section 2.3, they present formally the idea that perhaps creating incentives to make choices is *exactly* in the shareholders' interest and not necessarily rent extraction. They then describe one of their studies, Aboody and Kasznik (2008), as an illustration of contracts motivating what appears to be self-serving behavior but actually serving shareholders' interests. The literature proposes other answers to their question, and thus a broader perspective here would have been helpful. For example, one such answer might be that shareholders are still better off with these contracts, even though they encourage self-serving decisions. Evans and Sridhar (1996) offer insights on this point. Their work considers the trade-off between reporting truthfully and managing earnings, and it recognizes that the firm has two levers at its disposal: the compensation contract that rewards effort, and the financial reporting system that may or may not constrain earnings management. In their model, it can be optimal to offer a compensation contract that may result in earnings management because it would be too costly to eliminate it. Said differently, executives' having skin in the game still provides a greater benefit to shareholders even if, on the margin, executives extract rents.

II. EFFECTS OF REGULATION ON THE DESIGN OF COMPENSATION

The second half of the monograph examines other forces that shape executive compensation—namely, accounting and tax regulation. The authors first take on the question of whether the favorable (i.e., non-expensing) treatment of options prior to SFAS 123R influenced their use. In summarizing that literature, they describe studies that examine the underlying assumption that non-expensing would benefit the firm, possibly through the perception of greater profitability. They then review studies that examine the influence of tax regulation on the design of compensation, focusing on Section 162(m) and various tax treatments of stock options.

The authors provide a nice description of the institutional details of the related accounting and tax issues and draw from a variety of studies in accounting, finance, economics, and management. They also provide critical context for considering the mixed results of the early literature and for assessing the validity of the conclusions of the early literature when compared with later work.

Scholars interested in this area might also consider some additional work. Hodder et al. (2006), for example, provide evidence that discretion allowed in determining option valuation inputs does not necessarily result in Black-Scholes assumptions that are value-decreasing. This study provides an interesting contrast to the studies described in the monograph that suggest that managers use this discretion to lower option expense. Similarly, researchers doing experimental work provide additional evidence that might shape studies examining how the market values stock option expense. For example, Frederickson et al. (2006) provide evidence that financial statement users accord greater reliability to reported over-disclosed expense, while Libby et al. (2006) argue that auditors may require greater accuracy in recognized over-disclosed expense. These findings suggest that the market valuation of stock option compensation may differ under the new accounting treatment. Finally, many studies, too numerous to list, have questioned whether the market values stock options as an expense or as a net benefit. Though diverse in their conclusions, likely from the variety of research designs, these studies may help researchers drill deeper into that question.

As in the prior section of their monograph, the authors lay out many directions for future research, but they may undersell the potential for future work on the relation between tax regulation and pay. While the Tax Code Section 162(m) provides fodder for a stream of research in this area, other tax regulations related to compensation, such as Section 83(b) and Section 409A, may provide interesting additional "frictions." And, unlike the challenges in examining accounting discretion, these studies are able to exploit more "exogenous" events like tax rate changes.

III. GENERAL COMMENTS

The monograph underscores an important message in this line of research, namely, that compensation contracts are shaped by many forces: desire to align incentives, tax rules, financial reporting consequences, resource (cash) constraints, and political costs, among others. All of these forces occur in a labor market where talented executives may demand specific contractual features. This real-world complexity makes research challenging, but

[1] See for example Gerakos et al. (2007), Bettis et al. (2008), and Carter et al. (2009).

we, as scholars, should not be dissuaded by less-than-perfect research designs. A messy world will, at times, yield messy conclusions, but there still might be something we can learn.

I fear that the authors sometimes overlook this reality. In this vein, they are, perhaps, too critical of the backdating research. They note (on page 51) that "inferring backdating in large samples using only publicly available data is challenging. Specifically, it is nearly impossible for researchers … to disentangle backdating from other opportunistic timing of option awards … or opportunistic timing of corporate announcements." This criticism could be leveled at much of the research in this area. And, while undoubtedly imperfect, the results in Lie (2005) were convincing enough to have a hefty impact on regulators and practice.

Similarly, Aboody and Kasznik interpret the mixed results of studies that attempt to document a link between pay and performance as suggesting (on page 2) "weakness in the premise of incentive alignment as a principal determinant of executive compensation." Indeed, this is one of the most fundamental questions of this field, as one solution to the moral hazard problem is the "carrot": deliver better performance, and you shall be rewarded. I would offer, instead, that the mixed results reflect the difficulty of doing work in this area. As researchers, it is rare for us to observe the underlying contract; we only see the payoffs from the contracts. Those payoffs reflect both short-term and long-term objectives of the firm and may rely on performance measures different from accounting or stock price performance often used in these studies. Researchers often must make assumptions about the *ex ante* contract and, to the extent they are wrong, those assumptions weaken the power of their tests.

IV. WHAT NEXT?

At the end of Chapter 5, the authors highlight recent developments, including the Troubled Asset Relief Program, which potentially created frictions in contracting by constraining compensation for participating banks. They also mention the recently enacted "say on pay" legislation, which will increase the visibility of executive compensation. But there are other developments that dovetail with the theme of their monograph. The financial crisis, for example, has engendered real debate about the role that compensation played. Did performance-based pay encourage excessive risk-taking by some firms? Another development is changes to required proxy statement disclosure effective in 2006 and 2010. These new disclosures provide data that allow greater insight into the *ex ante* features of contracts, putting researchers in a better position to examine previously difficult-to-address questions with potentially stronger research designs.

Overall, Aboody and Kasznik offer a coherent and thought-provoking summary of the literature in this area and point to many possibilities for future research. With the continual evolution of compensation practices and related regulation, this is a literature with growth opportunities. To quote Mick Jagger, who, after all, attended the London School of Economics, "A good thing never ends."

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JAN PFISTER, *Managing Organizational Culture for Effective Internal Control: From Practice to Theory* (Berlin, Germany: Physica-Verlag, 2009, ISBN 978-3-7908-2339-2340-0, pp. xx, 245).

This book presents the design and outcomes of a field study that aims to develop and validate a new framework for internal control in organizations. It starts with a quick motivation of the importance of such an exercise, which points to the recent (near) collapses of financial institutions across the Western world. Arguing that such failures "can be linked to internal control and organizational culture" (p. 1), the author claims the need to understand the combination of effects of internal control and organizational culture on managerial behavior and organizational outcomes. As, these days, probably few would oppose such a need, the study appears to be a timely academic response to contemporary concerns about the effectiveness of organizational control systems, and potential detrimental effects of organizational culture.

The author's analysis aims to unravel how internal control and organizational culture interact to produce organizational outcomes, guided by an overarching research question that is formulated as follows: "How do management principles and practices affect organizational culture in a way so that organizational culture positively impacts internal control effectiveness?" (p. 6). Whereas the research question proposes a unidirectional model from "management principles and practices," via "organizational culture" to "internal control effectiveness," the author points out elsewhere that the two main challenges of the study lie in capturing "the influence of organizational culture on internal control effectiveness" (p. 3) and "how control mechanisms influence organizational culture" (p. 3), arguing that "not only does culture influence control, but control also influences culture" (p. 3). Disregarding the apparent ambiguity in terminology, the word "challenge" itself seems aptly chosen, because an analysis of the relationships between culture and control is no trivial exercise for theoretical and empirical as well as for conceptual reasons. Chapter 1 therefore starts by presenting definitions of internal control and organizational culture with the aim to delineate them for analytical purposes (pp. 1–2) and continues by pointing out five "broad issues" (p. 5) that the study aims to address. These "broad issues" are problems distilled from the extant literature in management accounting and control, and are presented as "open questions" on the relationship between control and culture that guide the analysis (pp. 5–6).

I find these different layers of proposing the study's structure to be confusing, as it takes some guessing to understand where the author wants our thoughts to go. For example, the first of the "broad issues" relates to the ambiguous nature of culture in causal models of accounting and control practices. The author means that, in extant accounting studies, culture usually acts as an independent variable, even if studies from outside the accounting and control literature conceive culture as a dependent variable. This is quite a straightforward issue, but the author then formulates the open question in rather indirect terms: "how can culture be captured as a construct that is being influenced by control?" (p. 5) A second "broad issue" relates to the distinction between control and culture, as management control typologies sometimes include culture as a type of control. The related "open question" is, "how can culture be captured as a transcendental concept in the context of control?" (p. 6) Three remaining questions point to similar and other ambiguities in the extant literature about the relationship between control and culture and lead to three other open questions. It remains somewhat unclear whether these questions aim to provide the reader with a roadmap to the analysis, or are in fact just illustrations of the logical and semantic complexities of the control and culture debate. In sum, therefore, the brief introduction of "challenges," "broad issues," and a "research question" leaves the reader somewhat confused as to the nature of the theoretical model that will be developed and validated.

The remainder of the introductory chapter is concerned with mapping out the objectives of the study, the

outline of the empirical research design, and an overview of the chapter structure of the book. As regards the objectives, the author emphasizes the aim to contribute to theory as well as practice, pointing out "research gaps" in academic studies and the need for a "deeper knowledge" in practical situations. The research design proposes a qualitative field study that aims to result in an empirically founded framework for the relationship between control and culture. This is why the book is subtitled "from practice to theory."

The remainder of the book is clearly and logically organized into parts and chapters. Part I deals with the "groundwork" of the study and consists of the Chapters 2 and 3. Chapter 2 ("Basics") discusses the various extant definitions and connotations of the concepts of internal control and organizational culture. Since the study is placed in the context of failures of the financial industry (p. 1), it follows that much attention is paid to the effectiveness of internal control (p. 26). Here the author "broadly" (p. 27) defines internal control effectiveness by the extent of legal compliance, reliability of financial statements, and management's assurance that operational effectiveness and efficiency are achieved. It is not entirely clear how this definition supports the analysis. Indeed, while argued to be broad, the definition in fact narrows down internal control to *ex post* assessments via formal systems. While the author seems to suggest on the one hand that management control and internal control are essentially the same, as he refers to typical management control frameworks (e.g., Ouchi 1979; Merchant 1985; Simons 1995), on the other hand he seems to deemphasize the primary focus of management control on good decision making *ex ante*, as well as the fact that these frameworks all include organizational culture. Overall, this left me somewhat confused about the exact definition of internal control that will appear in the final framework. Why does the similarity of internal control and management control receive so much emphasis, after they have been demarcated sharply in Chapter 1 (p. 4)? Why, instead, is no attention paid to the obvious connection between internal control and accounting information systems? Can internal control indeed be seen as including management control, even if it excludes organizational culture? The author continues by arguing that internal control systems, even if "well designed" (p. 30), may not be immune to fraud and errors, and should be defined with a cost-benefit trade-off in mind. It does not become clear, however, how these two characteristics can or should be part of any foundational definition of internal control. The remainder of the second chapter discusses the concept of organizational culture. It leads the reader along various descriptions of organizational culture, resulting in the definition of culture as the ways in which groups of people adapt to the external environment and achieve internal integration (pp. 38–39). Although the definition is intended to exclude formal control arrangements, it does not do so explicitly.

Chapter 3 ("Literature Review") presents a well-structured overview of the conceptual and typological literature on internal control and management accounting and control. After a short section on academic research on internal control, it continues by evaluating the presence or absence of culture in the various internal control frameworks (i.e., COSO, CoCo, Turnbull, etc.). It also assesses the role of culture in management control typologies (e.g., Ouchi 1979; Merchant 1985; Simons 1995) and in a limited number of academic studies on the culture-control relationship. Overall, the findings illustrate the contention expressed earlier that culture is sometimes seen as a "part of" control, and sometimes as an external contingency that affects or interacts with control. The chapter closes with the (correct) conclusion that research on internal control and culture has not yet developed beyond its infancy. In response to this research gap, five "theses" are developed that provide another five guidelines to theory development about the culture-control relationship. An example is the first thesis that "[c]ause and effect between culture and control go in both directions" (p. 65). Taken by themselves, these five theses are a logical conclusion to the chapter. However, in combination with the earlier "research question," the two "challenges," and the five "open questions," a rather complex roadmap emerges that guides the analysis.

Part II, which consists of Chapter 4 ("Field Study"), presents interview feedback from 31 semi-structured interviews the author had with senior officials in 21 companies in Switzerland and in the U.S. (pp. 74–84). Interviews were conducted in two rounds and form the single source of empirical data. A first round of nine interviews in Switzerland aimed at obtaining a "practical understanding of internal control matters in companies" (p. 83). The second round of 22 interviews conducted in the U.S. focused on two questions. First, interviewees from various functions in management, finance, and auditing were asked to identify the principles and practices that they perceive as drivers for control effectiveness. The second question asked the interviewees to identify the roots of control failures. Following a Grounded Theory methodology for content analysis, the author describes the process through which interview transcripts were made, analyzed, grouped, and summarized. This results in the identification of five categories of control failures (related to "commitment," "competence," "communication," "complexity," and "change") and, within each of those categories, five drivers for control effectiveness. These latter drivers describe managerial practices that enhance internal control and mitigate the control problem. For example, practices that mitigate "commitment" failures include "lead by example," "deal with reality," and "ensure accountability." While this framework appears to be plausible, at first sight, the author seems to acknowledge its diversity and lack of clear dimensionality. Therefore, he proposes to interpret the framework as a supportive tool for classification of principles and practices, rather than as the outcome of strict classification. For example, he notes that "the drivers interrelate with each other and often influence several [control failure] areas" (p. 88). The chapter concludes by presenting an overview of illustrative interview quotations for each of the

categories identified, which mention the management practices used to address these failures. Overall, this chapter provides a rich but relatively unstructured overview of internal control challenges and solutions from a selected set of companies and senior officials.

Part III aims to present "theoretical explanations" for the empirical findings from the earlier part. Chapter 5 ("Capturing Culture") sets the scene by presenting culture as a "black-box" that needs to be opened (p. 120). It postulates that we could conceive of culture both as a variable and as a metaphor, and proposes to investigate how culture mediates the relationship between management principles and practices and internal control effectiveness (pp. 120–122). This provides a setup for the analyses in the two subsequent chapters. These analyses distinguish between "the organizational level" (Chapter 6) and "the individual level" (Chapter 7). Chapter 6 relies on social system theory to present culture as an organizational phenomenon, which provides a buffer between the external environment and the internal environment. Via a series of graphical illustrations, the chapter introduces the concepts of "boundaries" between the organization's external environment and its culture, and between its culture and its internal environment. The concept of "transfer" between these three spheres is introduced to explain how behaviors and values are adopted and copied from one sphere to another. It concludes by suggesting that these boundaries may be "open" or "closed," thus enabling or hindering the transfer of behaviors and values between environments and culture. Chapter 7 reiterates this analysis at the individual level, loosely guided by the question of how people's individual interests and values affect the individual's inclination to engage in dysfunctional behavior. It stresses the importance of alignment between individual and organizational values and interests, which is an important, if not a rather undisputed claim.

Part IV ("Synthesis") combines the various steps in the theoretical and empirical analyses into an overall framework. In fact, a surprisingly simple "control-and-culture framework for effective control" is introduced and graphically illustrated (p. 163), which relies on three types of "drivers" that are defined as including "formal and informal control mechanisms, but … also include other factors influencing behavior" (p. 161). The main thrust of this model is that managerial principles and practices provide drivers that may "open" or "close" the "boundaries" between individuals, the culture of the organization they work in, and the external environment in which the organization operates. Closing drivers are those that define how controls need to be performed and how organizational members should act (p. 162). They define acceptable behavior within the culture and provide consistency throughout the culture (p. 165). Opening drivers give those members some freedom to act and adapt (p. 162). They encourage interaction, debate, and accountability (p. 167). A third category of "reinforcing drivers" refers to those that support and communicate the opening and closing drivers that are present (p. 169). On first consideration, this threefold typology is elegant and plausible, as it seems solidly based on the author's account of practice. On second consideration, however, I became a bit concerned with the descriptive and predictive validity of these three kinds of drivers. Can all managerial practices and principles be so neatly ordered to be either of the "opening," "closing," or "reinforcing" type? Are these categories of mechanisms and other factors influencing behavior solid and precise enough to inform theory and practice? Is the difference between "opening," "closing," and "reinforcing" drivers the same at the organizational level as at the individual level, as Chapters 6 and 7 suggest? The remainder of the chapter seems to address these validity concerns by pointing out applications of the new framework. In particular, it gives some examples of how the framework may inform theory and practice. Regarding the former, it shows how the new framework compares to the Merchant and Simons typologies. This is an interesting exercise, even if both extant frameworks are not primarily theory-based or even research-based frameworks. Regarding practice, the author gives some examples of how "opening," "closing," or "reinforcing" drivers (should) reflect in managerial and auditor behavior. The chapter closes by a short review of how the five theses, which were formulated in Chapter 3, can be interpreted in the control-and-culture framework. The chapter furthermore sketches strengths and limitations of the research design. Chapter 9 ("Conclusion"), finally, provides a short overview of the study's questions, design, and outcomes, and concludes with an overview of further research opportunities.

Overall, this study provides a much-needed next step in academic research aimed at understanding the relationships between such complex phenomena as "internal control" and "organizational culture." The choices made in this study regarding theory and method, however, will provide quite a tough read to those expecting an unproblematic analysis in the tradition of contemporary management control studies. Neither contingency theory (dominating behavioral control studies) nor economic theory (dominating agency-based control studies) is explicitly addressed, such that the theoretical foundation of this study appears to be a bit more opaque than in extant research, and to be based on implicit rather than explicit theoretical considerations. Given that the study is empirically founded on only a limited number of observations, especially the author's first suggestion, which is to find generalization of the proposed claims in future studies, deserves support. Indeed, the study provides more than enough theory, empirics, and concepts to make it a starting point for such further enquiries, even if its relative complexity and lack of conceptual, theoretical, and empirical precision does not point to any clear, particular way forward.

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