

Management Incentive and Accounting Method Choice:
A Case of Inventory Valuation

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ABSTRACT

This research conducted an in-depth examination into whether the choice of an accounting method (LIFO vs. Non-LIFO) is affected by the management compensation structure (MC) and the degree of management ownership (OM). The evidence supported the bonus hypothesis: the more the management compensation (bonus) is linked to the firm value, rather than to the accounting earnings, the more likely the executives are to choose LIFO which in most cases increases the firm's cash flow through tax savings. Neither leverage ratio nor systematic risk of a firm (measured in terms of beta of the common stock) was found to have any significant effect on the management's choice of the inventory accounting method. However, the effect of management ownership of the firm on the method choice was found to be very perplexing. The result was that the higher the ownership percentage the executives have of their firm, the more likely they are to choose Non-LIFO. The author made several attempts to figure out why it happens but was unable to explain it. Leaving to the future studies the issue of why such a difference in effect between MC and OM occurs, the present study only concludes that the evidence supports the bonus hypothesis, and that MC and OM are among the most important variables affecting the inventory accounting method choice.