Lecture 1 – Objective of Financial Reports

Financial accounting – an information reporting system **designed to relieve information asymmetry** in economies

Demand for accounting information:

- 1. For **valuation** to address **adverse selection** problems and ensure **capital market efficiency**
- 2. For **stewardship** and **efficient contracting** to address contracting and **moral hazard** problems

Information Asymmetry

Occurs when one party to a transaction is at an informational disadvantage to the other

- A unifying theme that formally recognises that some parties to business transactions may have an information advantage over others

Two main types:

- **Adverse selection (valuation)**
  - A party to a transaction has an informational advantage over other parties
  - There is adverse selection between shareholders and management and between shareholders themselves
- **Moral hazard (stewardship/efficient contracting)**
  - A party to a transaction can observe their actions in fulfilment of the transaction but the other cannot
  - Management potentially suffers from moral hazard since they can undertake actions that are in their own self-interest at the detriment of shareholders

Role of financial reporting

- Role of information in a market economy
  - To **reduce adverse selection** and thus improve operation of capital markets (the **valuation** objective)
    - i.e. by providing useful information for decision making
  - To **reduce moral hazard** problem and thus improve operation of managerial labour markets and efficiency of contracts (the **stewardship** objective)
    - i.e. use net income as a managerial performance measure

The fundamental problem of FA measurement

- The best measure of net income to control adverse selection is not the same as the best measure to motivate manager performance
  - Implies the interests of investors & managers conflict
    - Investors – may prefer **current value** accounting
    - Managers – prefers **HCA**, conservatism better reflects managerial efforts
  - **Standard setting** viewed as the means of mediating these conflicting interests

Valuation objective of Financial reporting

- Also referred to as **decision usefulness view**
- Basic characteristics of the information demands for valuation objective
- Ideal accounting for valuation:
  - The **PV** (value-in-use) of **future CFs** of all the firm's assets and liabilities
- This is relevant but what about its reliability?
  - Current values (relevant but less reliable)
  - Historical costs (reliable but less relevant)
- Condition necessary for ideal accounting (jointly perfectly relevant and completely reliable) using PV:
  - Need to know with perfect certainty future CFs
  - Need to know discount rate

Stewardship/Contracting Objective of Financial Reporting

- Also referred to as the **efficient contracting view**
- Basic characteristics of information demand for efficient contracting
  - Emphasis on contracts. A firm can be defined by the contracts it enters into
    - E.g. debt contracts, compensation contracts…
  - Need information that facilitates efficient contracting
    - Current values or historical costs?

Key Contract (Principal-Agent) Relationships in a Firm

Shareholder and Manager

- Separation of ownership and control
- Partial or non-ownership of firm by managers provides incentives for managers to act contrary to shareholders' interests because they do not bear the full cost of dysfunctional behaviour

Moral Hazard Costs of Equity

- **Dividend retention**
  - Empire building (for greater compensation/reputation)
  - Excess consumption of perquisites
- **Risk aversion** (company executives exposed to greater firm-specific risks, i.e. reject +ve NPV projects due to volatility)
- **Horizon problem** (may reject +ve NPV projects due to -ve short term CFs)

Shareholder and Debt-holder

- Assumption that interests of managers and shareholders are aligned
- The debtholder is the principal, and the manager acting on behalf of shareholders is the agent

Moral Hazard Costs of Debt

- Debt contracts provide managers with incentives for:
  - **Excessive dividend** payments (may be borrowing to pay out dividends)

- **Asset substitution** (i.e. low-risk to high-risk after the loan is made)
- **Claim dilution**
- **Under-investment** (i.e. due to order of repayment, may not invest in +ve NPV projects)

Reduction of Moral hazard costs

- Shareholders contract with managers to **link pay** to reported firm **performance**
  - Benefits **lower moral hazard costs**
- Debtholders contract with firm to incorporate a **covenant** into a borrowing contract. Covenants are a **cost of contracting**
  - Benefits **lower interest rates** (i.e. debtholders more willing to lend due to covenants)

The Role of Accounting

- Management compensation contracts and debt contracts are based on **accounting numbers**
- Accounting numbers are the basis of assessment of the success or failure of the contracts written by managers

Efficient Contracting Theory

Focus is on role of financial accounting information in **moderating information asymmetry** between contracting parties

- Debt contracts and managerial compensation contracts
- Lenders' interests and managers' interests may conflict with interests of shareholders
- An efficient contract generates **trust** between these conflicting interests at lowest cost to firm
- Contracts may be formal written documents or implicit
  - Implicit contracts arise from continuing business relationships
  - Implicit contracts can be modelled as non-cooperative games

Conservative accounting

- Higher standard of verification required for recognition of gains/assets versus losses/liabilities
- ~~Unconditional conservatism~~: non-recognition of assets with uncertain payoffs
  - Internally generated **intangible** assets
- ~~Conditional conservatism~~: recognition of unrealized losses but non-recognition of unrealized gains for recorded assets (more **timely recognition** of **losses relative to gains**)
  - Impairment test (AASB 136)
  - Lower of cost or market valuation of inventory (LCNRV)

Recall AASB 138 Intangible assets

Intangible assets only recognised if probable FEB attributable to asset, and cost can be RM:

- Internally generated **goodwill** shall **not be recognised** as an asset
- No intangibles arising from research shall be recognised (but expenditure on research shall be recognised as an expense once incurred)

- Internally generates brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets

Sources of Contracting Demand for Financial Accounting Information

- **Lenders**
  - Face **payoff asymmetry**
    - Can lose heavily if firm performs poorly, but do not directly share in gains if firm does well
    - As a result, they demand early warning of financial distress
- **Shareholders**
  - Managers assumed rational and will act in their own interest, which may conflict with shareholders' interests
    - As a result, shareholders demand information to encourage responsible manager effort and limit opportunistic actions

Accounting Policies for Efficient Contracting

- **Reliability**
  - Lenders demand reliable information to help protect against **opportunistic manager policies** that hide losses and record unrealised gains
- **Conservatism**
  - Lenders demand conservative information
    - To help **predict financial distress**
    - **Limits dividends** increasing debtholder security
      - Conditional conservatism
      - Reporting unrealized losses helps predict financial distress
  - Shareholders demand conservative information for **stewardship purposes**
    - Acting as a constraint on managerial opportunism by not allowing gains to be recognised until realized (thus **limiting discretion**)
    - **Timely recognition of losses**, even if unrealised, allows timely recognition of negative NPV projects that managers may have engaged in

Efficient contracting

- For efficient contracting, financial reporting should be reliable and conservative
- These policies often conflict with current value accounting
  - Current value accounting sacrifices reliability for relevance

Efficient Contracts

- **Contracting costs** include costs arising from **moral hazard** (i.e. residual loss) and **monitoring** of contract performance and costs of **possible renegotiation** or contract **violation** should unanticipated events arise during the term of the contract
- **Efficient contracts** are contracts with the **lowest contracting costs** (one that generates trust between the conflicting interests with the lowest contracting costs)

Accounting Policies for Efficient Contracting

- Efficient contracting demand for **reliable** and **conservative** information conflicts with Conceptual Framework
  - Framework more future-oriented (i.e. relevant information) – fair value accounting
    - Reliability downgraded to an enhancing characteristic
  - Framework more orientated to information needs of investors than stewardship
    - Framework does state that investors need information about manager stewardship but ignores problem that best information for investor decision making and stewardship evaluation may not be the same

Contract Rigidity

- Many contracts depend on accounting variables
  - Debt contracts contain accounting-based covenants
  - Manager compensation contracts depend on net income
- Both types of contracts tend to be long term
  - Accounting standards change during contract term, affecting net income and debt covenants
    - Probability of debt covenant violation may increase
    - Manager compensation may be affected
- Since contracts are **hard to change**, unlikely that contracts can be renegotiated to allow for changes in GAAP

Contract Rigidity: Implications

- Changes in accounting standards can have real CF effects due to contracts
- To address this:
  - An efficient solution is to allow manager some **flexibility** in accounting **policy choice**
  - However, giving management discretion opens up the possibility of **opportunistic behaviour**

Distinguishing Efficiency and Opportunism in Contracting

A basic question in contract theory:

- Are managers' accounting policy choices driven by:
  - **Opportunism** (manager benefits at the expense of investors, policies chosen to maximize their own expected utility)
  - **Efficiency** (manager chooses accounting policies to maximize contract efficiency → good corporate governance)
  - But this question is difficult to answer
- Conclusion from empirical evidence: significant evidence for efficiency version, but also some for opportunistic version