LECTURE 1 INTRODUCTION & OVERVIEW

Information Asymmetry

Adverse Selection *(pre-transaction):* A type of information asymmetry where a party to a transaction has an informational advantage over *other parties*. *AS example*:

1) *job application* (hiring process), the employer is at a huge information is advantage with prospective applications. To mitigates AS risk, they review resume, and conduct interviews to test to reduce IA;
2) *buying a product on ebay*, the buyer is at an information disadvantage as limited information is offered. Ebay mediates this by forcing sellers to post up pictures and include descriptions, also has a feedback rating system.
3) *invest in a company*, managers know more about the current conditions and future prospects than outside investors. The managers may delay or selectively release information thereby reducing the ability of investors to make good investment decision. To mitigate, the company produces FS (which are audited), meet disclosure requirements. The CEO must make announcements about significant changes and there are heavy penalties for not doing so.

Moral Hazard *(post-transaction):* A type of information asymmetry whereby a party to a transaction can observe their actions in fulfilment of the transaction but the other cannot (management act in their own self-interest at the detriment of *SHs*). *MH example:*

1) *new CEO is hired*, it's impossible for SH to observe directly the extent and quality of new CEO. CEO may decide to shirk on effort, blaming any deterioration of firm performance on factors beyond his control or based reported earnings to cover up. To mitigate this risk, it could be a condition of the contract that CEO have shares in the company, or is remunerated with a combination of cash and shares so that he has an incentive to act in the best interests of the company.
2) *salesperson is paid a flat salary with no commissions.* To mitigate, the manager should decide to pay a wage comprised of both salary and commissions.
3) *employee who was hired but might decide to shirk.* To mitigate, the employee could be placed on a probationary period and monitored closely, and evaluated on KPIs and other internal measures which assess whether they're working hard consistently.

Objective of Financial Reports

Valuation Objective (b/w Managers and Investors)

Provide *decision useful information* to *predict future cash flows*

To address *"Adverse Selection"* problems and ensure capital market efficiency

- Ideal: know the PV (present value / value-in-use) of future CF of all the firm's A and L. (know the time-value of money). e.g. $PV_0 = (500/1.06) + (500/1.06)^2 + (500/1.06)^3 = 1336.50$
- Condition for ideal accounting (jointly perfectly relevant and completely reliable): know perfect certainty future cash flows and discount rate (cost of capital)

Stewardship/Contracting

Use *NI as a managerial performance measure*

To address contracting and *"Moral Hazard"* problems

1) Debt contracts (b/w Managers and debt-holders)
   - Assume interests of managers and shareholders are aligned (the debtholder is the principle and the manager acting on behalf of shareholders is the agent)
   - *Moral hazard costs of debts:*
     - *Excessive dividend payments* (the company may not have the sufficient cash to pay the loan, but still decide to pay excessive dividend. Lenders will not get paid if bankrupt)
     - *Asset substitution* (there is an asset incentive, the lenders can lend to the company at a low risk, the company may re-invest that loan on the riskier assets, it benefits SH)
     - *Claim dilution* (if 2 claims for 4 assets, need more loans, arranging the new loans to get first claim, the original lender has been diluted & becomes worse off, because the company has made the additional loans)
     - *Under-investment* (assume the company is close to bankrupt, the new debts are only sufficient to repay the lenders)
   - *Solution: debt covenants* – debtholders contract with firm to incorporate a covenant into a borrowing contract. Covenants are a cost of contracting (benefits lower interest rates)

2) Managerial compensation contracts (b/w Managers and SHs)

- *Moral hazard costs of equity*
  [recall mid-term test: what's the moral hazard cost for equity-holders?]
  - *dividend retention* (e.g. *empire building;* or excess consumption of perquisites) – not distribute dividend in order to build up the size of the firm, greater reputation, purely self-interest, not in best interest of SH
  - *risk aversion* SH = risk natural, manager = risk adverse (rational SH are not expose to firm-specific risk, they hold portfolio to gain diversification benefits; However, the corporate managers are exposed to the firm-specific risk, there is the possibility of bad payoff if accepting the projects with positive PV but high firm risk, so the mangers rejects these projects, only for self-interest)
  - *horizon problem* SH = long-term, managers = short-term (not accepting all projects with positive PV, the manager will also consider the short-run labour market reputation, as the short-term PV might be negative)
- *Solution: manager's compensation is based on NI* (benefits lower moral hazard costs)

The fundamental problem of FA measurement

The best measure of NI to control adverse selection (valuation objective) is not the same as the best measure to motive managers' performance (Stewardship objective)

Valuation Objective:

Problem? The interests conflict b/w investors and managers:
- Investors: prefer current/fair value accounting
- Managers: does HC accounting, conservatism better reflect manager effort

Solution? Standard setting (FASB is the standard-setting body)
- *conceptual framework:* FV accounting (measurement approach) – relevant (scarify reliability) – decision usefulness for *investors* rather than *stewardship* (problem is that best information for investor decision making and stewardship evaluation may not be the same)

Stewardship/Contracting objective:

Efficient contracting approach – moderate *information asymmetry*, generate *trusts* b/w conflict contracts, for both debt and managerial compensation contracts, at a *lowest contracting cost.*

- Debt contracts (for *lenders*) usually contain accounting-based *debt covenants:*
  (1) a specified level of working capital (= CA – CL, ensure the firm has the cash needed to pay interest and principal, since the firm is constrained fro)
  (2) not exceeding a specified debt-equity ratio
  (3) an agreed times interest earned ratio
  - Increase *lenders* trust in *loan security* (e.g. debt covenant may state that the borrowing firm will not pay dividends if its working capital falls below a specific level)
- Management compensation contracts (for *SHs*) typically depend on *NI*
  - Manager compensation is based on NI (here NI act as a measure of manager performance)
  - Increase investor trust by helping to align manager and shareholder interests. The alignment of interests is the *stewardships* role financial reports

Contracting costs include costs during the term of the contract, 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

Accounting policies for efficient contracting
- *Reliability*
  - Increase *lenders* trust in loan security since the manger will not harm their interests;
  - Benefits compensation contracting by increasing *shareholder's* trust that managers cannot cover up poor performance by opportunistically manipulating reported net income.
- *Conservatism*
  Lenders demand conditional conservative information
  - To predict *financial distress* (by reporting unrealised losses but not gain)
  - To increase *debtholder security* (by limiting dividends pay out)

Shareholders demand conditional conservative information for stewardship purposes

- To constrain opportunism (not allow gains to be recognised until realized, thus limiting discretion)
- To timely recognise loss (allows timely recognition of negative NPV projects that managers may have engaged in)

Sources of efficient contracting demand

Lenders

- IA: the management may choose accounting policies to hide performance threats leader interests
- *Payoff asymmetry*: loss if the firm performs poorly, limited gain if performs well.

Shareholders

- *Conflicted interests*: managers assumed rational and will act in their own interest, which may conflict with SHs' interests
- SHs demand information to encourage responsible manager effort and limit opportunistic actions

Conservative accounting

Higher standard of verification required for recognition of gains/assets versus losses/liabilities

- *Unconditional conservatism:* (1) non-recognition of assets with uncertain payoffs (e.g. internally generated intangible assets)
- *Conditional conservatism:* recognition of unrealized losses but non-recognition of unrealised gain (more timely recognition of losses relative to gains)
  - (2) impairment test: cannot impair upwards
  - (3) lower-of-cost or market valuation of inventory

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* (manager compensation may be affected) and *debt covenants* (probability of debt covenant violation may increase)
- Since contracts are hard to change (rigid), *unlikely* that contracts can be *renegotiated* to allow for changes in GAAP

Implications of contract rigidity

- change accounting standard => hard to change contract (rigid) => real cash flow effects

Solutions of contract rigidity

- 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

- Managers' accounting policy choices are driven by
  - Opportunism (opportunistic view): max manager's own expected utility at expense of investors
  - Efficiency (efficient contracting view): manager chooses accounting policies to max contract efficiency (i.e. good corporate governance)
- But in real world, we are difficult to distinguish the manager's driven.