FAT NOTES - TOC

Week 1

Objective of financial accounting – information reporting system designed to relieve information asymmetry in economies.

- 1.Valuation – Adverse Selection problem : Ensure capital market efficient(PV of FCF)

Adverse selection (PRE-TRANSACTION)
-information asymmetry where a party to a transaction has an informational advantage over other parties; adverse selection between SH & Mgmt between SH themselves.
eg : second hand car manager/stocks/

? – Provide decision useful info
Financial reporting- decision usefulness view – info D - FCF

- 2.Stewardship/Contracting – Contracting & Moral Hazard problems

Improve managerial labour markets and efficiency of contracts
Moral hazard/Incentive (POST-TRANSACTION)
-information asymmetry whereby a party to a transaction can observe their actions in fulfilment of the transaction but the other cannot
-mgmt potentially suffers from moral hazard; undertake actions in their own self-interest at detriment of SH.

?- Net income as managerial performance measure
Eg: manager everyday, mechanic – gear box
End of year – past performance; full of contracts with different agents.
Contract : SH with manager & DH

Manager&SH contracts- no bear cost of full dysfunctional behaviour
Dividend retention – empire building(compensation & reputation) and excess consumption of perks(private corporate jet) ; Risk aversion, Horizon Problem

Manager & DH- DH Is the principal and the manager acting on behalf of SH.

Moral Hazard Costs of Debt

- Excess Dividend Payment (borrow $$ - declare dividend- wealth lender to SH)
- Asset Substitution (fixed income stream, face downside risk) Equity sh- benefit; lender – low risk to high risk assets)
- Claim dilution (more loans, give newer loaners – first claim)
- Under-investment (+NPV sufficient for DH)

Reduction of Moral Hazard Costs

-SH contract with managers to link pay to performance(↓ moral hazard cost)

-DH incorporate covenants(↓ IR)

EG of IA: Job application : grads info asymmetry ; once employed – moral hazard. Business– manager knows more about current condition than outside investors

Investors – current value ; Managers – historical

Standard setting – means of mediating conflicting interests.

Current Value **(relevant not reliable)** /Historical Costs**(reliable not relevant)**

Efficient Contracting Theory-moderating IA between parties

- Debt contracts & managerial compensation contracts
- Lender & manager interests- conflict with interest of SH
- Trust, lower cost of firm

Conservative Accounting – higher standard of verification required for gains vs losses

-Timely recognition of losses as opposed to gains

Conditional Conservatism : **Internally generated intangible assets**
Impairment tests (RA<CA; written down)
LCNRV/Market value inventory

Sources of Contracting Demand

-Lenders payoff symmetry, lose heavily if firm does poorly, demand for early warning of financial distress.

-SH- managers assumed rational, responsible manager effort and limit opportunistic actions

Efficient Contracting

a) Reliability – estimates; opportunity for managers upwards: hide losses & record unrealized gains
b) Conservatism: i) Lenders D – help predict financial distress, limit dividend: conditional, reporting unrealized losses help protect financial distress
ii) SH- stewardship; constraint on managerial opportunism, timely recognition of losses (timely recognition of –NPV)

Efficient Contracting : reliable, conservative, flexibility ; conflict with current value

Conflicts with conceptual framework :

Framework- future-orientated for investors (relevant but not reliable)

Flexibility : contracting costs- moral hazards; contracts rigid-costly for firm; lowest contracting cost. DH – covenant on acct no. Mgmt- pay to income (LT contract)
Acct standards – Δ– cost : rigid contracts
-Efficient solution – manager flexibility in acct policy choice ~ opportunistic behaviour
Contract theory : opportunism(manager max. utility) or efficient(contracting)?

Opportunistic	Contracting
-Hope & Thomas – multinational firms no disclose earnings by geo. – foreign sales increase, earinings did not -Dechow & Shakespeare – aggressive fair value for securitisation	-Mian & Smith – consolidated f/s -Dechow- net income highly assoc. with CF than share returns -Dichev &Skinner – debt covenants -Wittenberg-Moerman – conservatism & IA: negatively associated; no assoc. unrealised gains.

Week 2 – Recognition

Recognized : probable(more likely than not>50%) that future eco. benefit will flow to/from entity, cost measured reliably.

i) Contracts with Customers – probable collect consideration. Recognise revenue – performance obligation – entity transfer promised good, accrual. Revenue-control passes.
ii) PPE- probable FEB & cost reliably.
iii) Provision- probable, reliable, no recognise contingent liability

Issues :

a) Portfolio Theory & CAPM - β- info unreliable(not value in firm), info reliability – liquidity ~adverse selection : disagreement FCF numerator – lack of trade; no market.
b) Objective(certainty:coin) vs subjective(s.e- estimate-R&D) pr. – pr ≠ reliability
c) Recognition vs disclosure : market efficient -may not matter :
Not efficient – not read notes. Investors react differently – info diff form (recognised more highly than disclosure)
d) Reliable- recognition more info than disclosure- auditor verify b/s, reveal precision (user- items more precise- disclosed)

Report level of reliability rather than not recognise – can measure precision and report it.

$$SE = \frac{st\ dev}{\sqrt{n}}$$

CI = X ±1.96 SE

Skewness of asset payoffs- +ve skewed, Low Pr. High Payoff(Not recognised)

iv) Intangibles – diff financial position(book value) vs market capitalisation (stock market) e.g: HR,brand names, customer ☺

$$Price\ to\ book = \frac{Price\ per\ share}{Book\ per\ share(Net\ assets)}$$ (Ideal :1)

Intangible asset – identifiable, non-monetary without physical substance , probable & measured reliably.X - goodwill, brands, mastheads, publishing titles, customer lists,research. √ : Business combination
Intangibles acquired acquisition,bs. Combination,gov grant, exchange, internally generated.

Intangible- cost. Business combination : FV

<u>Subsequent to initial recognition-Cost/FV</u>
Amortisation i) Finite life – same for PPE, SL, residual = 0, over life
ii) Indefinite life- no amortisation, sub to impairment.

Transactions with third party
Not reporting intangibles

i) Mismatching of P& L – valuation of firm. Early years- expense (loss); low value- misvalued, later years- overvalued

Capitalised in b/s – manager –account

ii) Earnings management – change expenditure ; r&d expenditure – capitalise

Costs – increase adverse selection, underpriced securities, underinvestment
- misallocation of resources- misprice
Benefits- conservative f/s opportunistic behaviour
Conservatism – cannot be consistently applied over the firm's life; in later years no more profit- shift of earnings from one period to the next.

Week 3- Measurement
Measurement – attribute no. to f/s

a) Historic Cost
b) Current value
   - Fair value (Exit) /Current (Entry) / Value In Use

Depends on : objective of f/s, profit and thus capital maintenance, reliability of measurement info. required. PPE- cost/fv / Valuation of debt & equity + Stewardship
Measure A & L – influenced by income(change of wealth between two points of time), wealth – influence what report as income.
Capital Maintenance

a) Financial (Historical Cost)

HC- $ Profit = End- Beginning

b) Purchasing power (Historical Cost- adjusted for inflation)

Adjusted for purchasing power (inflation) – maintain basket

c) Physical operating (Entry prices)

Produce End period – Beginning period

d) Current Cash Equivalent (OC) (Exit prices)

Cash to sell the firm for