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Lecture1 Introduction: objectives of financial accounting

Objectives of financial accounting

Financial Accounting in an information reporting system designed to relieve information asymmetry (adverse selection and moral hazard) in economies or society and in turn to facilitate an efficient allocation of scarce resources

Demand for accounting information

Two distinct types of information asymmetry (adverse selection and moral hazard) give rise to two distinct objectives (valuation and efficient contracting) of financial reporting

- ⇒ **Valuation objective**: address adverse selection problem & ensure capital market efficiency
- ⇒ **Efficient contracting objective**: address moral hazard problem & improve operation of managerial labour markets and efficiency of contracts

Information Asymmetry

Information Asymmetry occurs when one party to a transaction is at an informational disadvantage to the other

Adverse selection

Adverse selection is a type of information asymmetry whereby one or more parties to a potential transaction (before transaction) have an information advantage over other parties

- ⇒ What is the adverse selection problem/'the lemon problem': the **'death spiral'**
  1. Some business ideas are 'good', others are 'bad'
  2. Given that investors cannot distinguish between the 'good' from the 'bad' due to hidden information
  3. Rational investors value all ideas equally at the average value
  4. 'Good' ideas are undervalued
  5. Entrepreneurs with 'good' ideas leave the market
  6. Proportion of 'bad' ideas in the market increases, average price decreases
  7. Over time, 'bad' ideas crowd out the 'good' ideas
  8. No investor participates in the market

9. Market eventually collapses

⇒ 3 key problems pointed out by ‘the lemon problem’
  - Managers are better informed about the value of their business ideas than investors
  - Managers have an incentive to overstate the value of their business ideas
  - Investors lack the financial sophistication to differentiate among various business plans

⇒ Consequences of adverse selection in capital market
  - Collapse of financial market (in extreme cases)
  - Investors stay away from markets as they know good shares leave the market and bad shares stay
  - Firms find it harder to raise capital
  - Firms need to access capital from other more expensive sources
  - Cost of capital increases
  - Overall the whole economy suffers

⇒ How to mitigate adverse selection problem – make information less asymmetric
  - Reliable financial reporting; signalling – expensive actions to reveal the quality of information: e.g. hire auditors to show the quality of financial statement
  - Informational intermediaries: Auditing/assurance, credit rating agencies
  - Financial intermediaries: e.g financial analysts

Moral Hazard

Moral Hazard is a type of information asymmetry whereby one or more parties to a contract (after transaction) can observe their actions in fulfillment of the contract (by exploiting the other party/ act in their own self interest) but other parties cannot

⇒ Moral hazard in capital markets
  - occurs due to separation of ownership and control → effectively impossible for shareholders and creditors to observe managers effort → managers may act in their own best interest rather than the interests of shareholders and creditors
  - managers are incentivised to exploit shareholders and creditors
    - tempted to shirk/slack off
    - pay/perks unrelated to firm performance
    - invest in safe projects only

⇒ How to mitigate moral hazard problem – make information less asymmetric
  - Change the incentive: design contracts that can better motivate and evaluate managers e.g. tie management compensation to performance, give managers stock options to encourage more risk-taking

Adverse Selection vs. Moral Hazard

Adverse Selection	Moral Hazard

Both result from information asymmetry	
Hidden information (e.g. firm's future cash flow)	Hidden action (e.g. how hard the manager is working)
Before transaction	After transaction
May occur between • Management and investors • investors and investors	May occur between • management and shareholders • management and creditors

Objectives of financial reporting – to relieve information asymmetry

⇒ **Valuation – to reduce adverse selection**

- Supply value relevant accounting information to capital markets → investors better able to forecast future cash flows and firm value
- Increase decision usefulness

⇒ **Efficient contracting – to reduce moral hazard**

- Minimise contracting costs (moral hazard costs) → aligning the interests between two parties (i.e. the owners and the managers)
  - Managerial contracts: between management and shareholders
  - Debtors contract: entered into when they borrow, between the firm and the lenders, the lenders are interested in the financial health of the company; use covenants to reduce the moral hazard problems
- in turn monitor the performance of the counterparty

⇒ **Fundamental problem of FA measurement**: different objectives require different measurement

- e.g. Account for unrealised foreign currency gains and financial asset gains in other comprehensive income
  - can be used to achieve valuation objective: give investors better idea of the fundamental value of the firm
  - not normally used to achieve efficient contracting objective: these matrix normally outside of management control

Lecture2 Efficient capital markets and implications for financial reporting

Efficient Securities Markets

An **efficient securities market** is one where the prices of securities traded on that market at all times fully reflect all information that is publicly known about these securities (semi-strong form of EMH)

(in simple words, share prices fully reflect all public information)

Eugene Fama proposed the Efficient Market Hypothesis

- ⇒ Past price changes cannot predict future price changes (random walk → implies that technical analysis doesn't work)
- ⇒ New information is quickly incorporated in prices (instantaneously)
- ⇒ Demonstration examples: a dividend announcement and a share split announcement are quickly reflected in a rise in stock price, and the price remains stable afterwards

Two features of an efficient market

- ⇒ Information instantly impounded into prices (no delay)
  - ∗ As soon as new or corrected information becomes publicly available → rational investors will scramble to revise their beliefs about future performance → realise that the expected returns and risks of their portfolios will change → they will enter the market to restore their optimal risk-return trade-offs → the market price will quickly change to fully reflect the new information

- ⇒ Prices capture information in an unbiased manner (no over- or under-reaction)
  - ∗ Bias can exist in each individual investor
    - Each individual may have different prior beliefs and/or may interpret/react to the same information differently (even though they are all rational)
    - Liquidity trades: investors sell securities to meet sudden needs for cash, not based on the fundamental value of the shares
    - Trade on noise: investors trade on gut feelings, or plain luck
  - ∗ The market can still be efficient and share price is unbiased after an averaging process → market price fully reflects all publicly available information
    - Assume individual decisions are independent → even though one individual may not be correct, individual differences (the positive biases and negative biases) are assumed to cancel out
    - Note, if investors display collective bias (e.g. expect future earnings growth simply because of growth in the past) → share price would be biased (e.g. share price momentum, a high share price being driven by past price increases rather than by rational evaluation of information by independent investors)

Implications of efficient market

- ⇒ Investors can't beat the market / cannot earn abnormal returns above the normal expected return on that security / portfolio – you get what you pay for
  - ∗ CAPM theory: return generated from purchasing the stock should only be compensation for systematic risk, and any unsystematic risk can be diversified or hedged away