FAT REVISION NOTES

Objectives of financial reporting and information asymmetry

Objectives of financial reports:

- valuation [adverse selection problems]
- stewardship/contracting objective [moral hazard problems]

Information asymmetry: occurs when one party to a transaction is at an information disadvantage to the other
Types:
Adverse selection: where a party to a potential transaction has an information advantage over other parties
Moral hazard: party to transaction can observe their actions in fulfilment but other cannot. Undertake actions that are in their own self-interest and at the detriment of shareholders

Adverse selection (valuation)	Moral hazard (stewardship/efficient contracting)
- involves hidden information about a firm's future cash flow before transaction - involves a selection problem	- involves hidden action after transaction - involves an incentive problem

Adverse selection

Sources
- shareholders and managers
- between shareholders

Consequences
- increased information risk thus higher cost of capital
→ only want to issue new shares at price either equal or greater than fundamental value
- lower liquidity
- decreased informativeness of prices to guide resource allocation
→ greater information asymmetry, less likely prices reflect true value leading to misallocation of resources

- Don't know true price, buyers and sellers can't converge on price, stocks don't trade, aren't liquid
- Price reflects value of firm therefore resources allocated better as prices are used as signal for underlying economy; allocate resources to high performing stocks and away from low performing stocks

Mitigation
Make less asymmetric via:

- Mandatory financial reporting
- Voluntary information reporting
- Other information intermediaries (financial analysts, the media)

Bid-ask spread
→ buyer thinks seller has better information and lowers their bid price (to protect against paying too much)
→ seller thinks buyer has better information and increases their asking price (to protect against selling too low price)
→ greater information asymmetry, greater information risk = greater bid-ask spread
→ greater the spread = no trading in a stock as investors cannot agree on price

eg. Buyer (biding) willing to pay 9.5, seller (asking) willing to sell for 10
Spread = 10 – 9.5 = 0.5
Bid ask spread %= (10-9.5)/(10+9.5)/2) x 100 = 5.1%

- Can lead to market failure= fewer trades thus decrease in liquidity, leading to discounted prices therefore higher cost of capital, investors walk away from markets

Debt and equity
Hierarchy of financing:

1. Internal funds
2. Debt issuance
3. Equity issuance

→ prefer debt rather than equity as its cheaper
→ adverse selection costs lower for debt than equity (debtholders know amount of interest and principal receive comparable to equity financing where investors believe stock may be overvalued)

Moral hazard

Sources
- shareholder and manager
- shareholder and debt-holder

→ occurs due to separation of ownership and control
→ impossible to observe managers efforts (eg. pay/perks, unrelated to firm performance, dividend retention and empire building)

Consequences
Debt contracts provide managers with incentives for:

- Excessive dividend payments
- Asset substitution (get loan, invest in risky asset, debt holder incur all risk of downside and no upside)
- Claim dilution (firm may get more debt after initial debt)

Mitigation
- emphasis on contracts
eg. compensation contracts with managers, lending contracts with creditor
- need information that facilitates efficient contracting
eg. past performance of managers, reliable information, conservative information)

Role of financial reporting

- reduce adverse selection and improve operation of capital markets
→ done via providing decision useful information
- reduce moral hazard problem and improve operation of managerial labour markets and efficiency of contracts
→ done via using net income as managerial performance measure

- Accrual accounting and conservatism both created to achieve valuation and stewardship

Accrual accounting	Conservatism
- effects of transaction are recognised when they occur and can be reliably measured	- higher standard of verification required for recognition of gains/assets versus losses/liabilities

Sources of demand for conservatism and reliability
Lenders
- face payoff asymmetry
→ lose if firm does poor, no direct share in gains if do well
→ demand reliable information to protect against opportunistic manager policies
→ demand conservative information to help predict financial distress

Shareholders
- managers assumed rational and will act in their own interests that may conflict with shareholders' interests
→ demand conservative information to act as a constraint on managerial opportunism by not allowing gains to be recognised until realised

Recognition and intangible assets