RECOGNITION AND MEASUREMENT THEORY	
Financial Accounting	is 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	- One party to a transaction is at an **informational disadvantage** to the other. e.g. Mgmt knows more about company than S/H. **Adverse selection (valuation)** - A party has informational advantage over other parties - Adverse selection between S/H and MGMT and between S/H themselves i.e. Managers know more about the current condition and future prospects of the firm than outside investors. Investors face adverse selection as managers (i) may behave opportunistically, (ii) may delay or selectively release information RESULT: reducing the ability of investors to make good decisions **Moral hazard (stewardship/efficient contracting)** e.g. S/H cannot observe mgmt's actions - A party to a transaction can observe their actions in fulfilment of the transaction but the others cannot (doing things **without transparency**) - Management potentially suffers form moral hazard because they can undertake actions that are **in their own self-interest** at the detriment of S/H Moral hazard occurs due to the separation of ownership and control : effectively impossible for S/H and creditors to observe directly the event and quality of manager effort - Managers may claim that fall in profit due to economic climate or managing earnings to cover up.
Role of Financial Reporting	**VALUATION OBJECTIVE**- reduce adverse selection : improve operation of capital markets **STEWARDSHIP OBJECTIVE** - reduce moral hazard problem : improve operation of management and efficiency of contracts
Valuation Objective of Financial Reporting	**Ideal Accounting for Valuation :** - The present value (VIU) of future cash flows of all the firms assets and liabilities **Current Values** : Relevant (but not reliable) **Historical Cost** : Reliable (but not relevant) Ideal accounting : Need to know with certainty the **FUTURE CASH FLOWS & DISCOUNT RATE.**

Stewardship / Contracting Objective of Financial Reporting	Also known as the **Efficient Contracting View.** Basic characteristics for efficient contracting : - **Emphasis on contracts.** A firm can be defined by the contracts it enters into. - Need information that facilitates efficient contracting **(CV or HC?)** **Manager-Shareholder Contracts** **i)** Separation of ownership & control ——Partial or non-ownership of firm by **managers** provides **incentives** for managers **to act contrary to S/H interest** because they **do not bear the full cost of dysfunctional behaviour** e.g. (Moral Hazards Cost of Equity) i) **Dividend retention** - Empire building : retaining too much earnings in company/ - Excess consumption of perquisite : risk mgmt spending on expensive things like luxury flights ii) **Risk Aversion** - choose not to enter projects that increase firm specific risk iii) **Horizon Problem** **-** Mgmt forgo projects w LR returns but SR losses - Chooses projects w SR return. - S/H sees performance in SR, but may not be happy if co makes losses in the LR. **Shareholder-Debtholder Contracts** -assumes that the interests of managers and S/H are aligned (want to borrow money) - The D/H is the principal, manager (agent) acting on behalf of the S/H e.g. (Moral Hazards Cost of Debt) i) Excessive dividend payments ii) Asset substitution (D/H at risk) iii) Claim dilution (S/H claims least priority) iv) Under-investment (S/H no profits)
Reduction of Moral Hazard Costs	<u>**Management compensation contract**</u> S/H - Manager contract : **to link bonuses to firm performance** i.e. align manager's incentives to S/H — Benefits **lower moral hazard costs** <u>**Debt contract**</u> D/H contract with firm to incorporate a **covenant** into a borrowing contract; **Covenants =** cost of contracting i.e. required to maintain a certain **D/A ratio** **—Benefits lower interest rates**
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 S/H - **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 form continuing business relationships — Implicit contracts can be modelled as non-cooperative games.

Conservative accounting **:** recognising expenses & liabilities as soon as possible when there is uncertainty about the outcome but to only recognise revenue & assets the they are assured of being received.	**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.** Intangible assets : shall be recognised if an only if - probable that future economic benefits will flow to the entity - cost of asset can be measured reliably. **Conditional Conservatism :** **Recognition of unrealised losses** but **non-recognition of unrealised gains** for recorded assets **—** impairment test : losses : immediately recognised gains recognised in OCI, but transferred to P&L when sold **—** LCNRV (lower of cost / net realisable value)
Demand for Contracting *(relating back to efficient contracting)*	Lenders : Payoff asymmetry **—**may lose heavily if firm does poorly, but does not directly share in gains if firm does well **—** demands early warning of financial distress Shareholders : Managers assumed rational and will act in their own interest , which may conflict with S/H interest **—**S/H 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 debt holder security **——** Conditional conservatism (non-recognition of unrealised gains) **——**Reporting unrealised losses to help predict financial distress Shareholder demand conservative information for efficient contracting purposes. - Act as a constraint on managerial opportunism by **not allowing gains to be recognised until realised.** -Timely recognition of losses, even if unrealised, **allows timely recognition of negative NPV projects** that managers may have engaged in.
	Contracting Costs include costs arising from moral hazard 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 … contracts with the lowest contracting costs

	Efficient contracting demand for **reliable** and **conservative** information conflicts with the **Conceptual Framework** **A) Framework** more future oriented (relevant) information **fair value accounting** — **reliability downgraded** to an enhancing characteristic **B) 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 *-how much choice should we give corporate managers?* *i.e. depreciation methods??*	- Many contracts depend on accounting variables —Debt contracts contain accounting based **covenants** —**Managers compensation contracts (bonuses)** 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** — **Manger compensation may be affected** Since contracts are hard to change (rigid), unlikely that contracts can be renegotiated to allow for changes in GAAP. As a result, changes in accounting standards can have real cash flow effects due to contracts. How address : — An efficient solution is to **allow manager more flexibility** in accounting policy choice — However, by doing so, it **opens up possibility of opportunistic behaviour**
Distinguishing Efficiency and Opportunism Contracting	Are manager's accounting policy choice driven by **Opportunism** : manager benefits at expense of investor (maximise earnings upwards effortlessly by changing accounting policies (shirking)) **Efficiency** : managers chooses accounting policies to maximise contract efficiency