Lecture 1: PAT

Positive Accounting Theory (PAT): tries to explain or predict existing accounting practices

Assumptions:

- All persons maximize their own-self interest
- Rational behavior
- Efficient market
- Price protection-markets accurately adjust prices to reflect the actions of managers

Agency cost of equity: trade off between decline in value of firm due to manager's shirking and other conflicts with outsider AND monitoring and bonding coats incurred to reduce the manager's shirking behavior

Monitoring and bonding mechanism: financial reporting, management compensation(bonus plan), auditing

Agency cost of debt: trade off between decline in value of firm due to attempts by manager shift wealth from outsider to inside shareholders AND cost of monitoring on this kind of behavior

Monitoring and bonding mechanism: restrictive covenants, monitoring.....

Political cost: the possibility that the firm will have wealth transferred from it by governments or actions of special interest groups, not an agency cost but often considered alongside agency cost (loss of special concession, increased tax, government investigation, adverse publicity in the media)

Accounting policy choice predictions:

Bonus plan hypothesis: adopt income-increasing method if their compensation is linked to accounting profit

Debt covenant hypothesis: adopt income-increasing method if debt covenants limit borrowings via accounting number: max debt/asset ratio

Political cost hypothesis: large firm prefer income-decreasing method to minimize political cost

Economic consequences of accounting policy choice:

Managers have incentive to adopt particular accounting policies

Two perspectives:

Opportunistic perspective: managers are permitted to have some discretions in accounting choices, so opportunistic choice form part of the residual loss:

- Change depreciation method from reducing to straight line method
- Accelerating revenue recognition to increase profit
- Revaluing fixed assets to reduce leverage
- *Earning management---purposeful intervention in the financial reporting process, with the intent of obtaining some private gain* (income smoothing, discretionary accruals: capitalization)

Contracting efficiency perspective: method will be specified in contracts so not form part of the residual cost, manager choose accounting method that maximize firm value by minimizing agency costs