

Table of contents

Lecture	Topic
1	Objectives of Financial Accounting
2	The Decision Usefulness Approach to Financial Reporting
3	The Measurement Approach to Decision Usefulness
4	Application of Fair Value Measurement
5	Accounting Analysis
6	Ratio Analysis
7	Forecasting and Valuation
8	Application of Valuation
9	Debt Contract
10	(Non) Recognition of Intangibles
11	Managerial Compensation Contract
12	Economics of Voluntary Disclosure

Few points to note:

- I've done this subject, my advice to you:
 - UNDERSTAND this subject, memorising will gain you nothing because exam questions will be made in a way to test your understanding instead of your memorising skills
 - This is NOT IFA1 or 2 where you can memorize the debit and credit transactions to get some scores
 - This subject content has altered/changed (sequence is different, lecturer adds new content, etc.), BE mindful when buying outdated notes (my notes are revised based on 2020 sem 2 content)
- These notes contain **colour coding**:
 - **GREEN highlight**- separates every lecture
 - **YELLOW highlight**- separates each lecture into parts
 - **LIGHT BLUE highlight**- separates each part into points
 - **Red word font** - elaboration, skip them if you already understand the black sentences
- Important words/concepts are underlined or bolded
- I wish you all the best for your assessments! :)

Lecture 1: Objectives of Financial Accounting

- Information asymmetry

Adverse selection (“hidden information”)	Moral Hazard (“hidden action”)
<p>is a type of information asymmetry whereby one or more parties to a potential transaction have an information advantage over other parties</p>	<p>Moral Hazard is a type of information asymmetry whereby one or more parties to a contract can observe their actions in fulfillment of the contract but other parties cannot</p> <p>the management wants to earn as much as possible by putting in the least effort.</p>
<p>you see adverse selection between shareholders and management; shareholders and shareholders</p>	<p>Moral hazard occurs due to separation of ownership and control</p> <p>After receiving capital from investors, managers act in their own best interest rather than the interests of investors</p> <p>It is effectively impossible for capital providers to observe managers effort</p> <ul style="list-style-type: none"> ● Managers may be tempted to shirk ● Pay/perks unrelated to firm performance <ul style="list-style-type: none"> ○ Manager pay themselves for something that they don’t deserve getting ● Safe projects only <ul style="list-style-type: none"> ○ Manager do not invest in the projects (higher risk) that generate higher return
<p>Consequences of adverse selection:</p> <ul style="list-style-type: none"> -Extreme adverse selection leads to a collapse of financial markets -Investors stay away from markets -Firms find it harder to raise capital -Need to access capital from other more expensive sources -Cost of capital increases -Overall the whole economy suffers <ul style="list-style-type: none"> ● suffer in different ways: 	<p>Consequences of moral hazard</p> <ul style="list-style-type: none"> -Extreme adverse selection leads to a collapse of financial markets -Investors stay away from markets -Firms find it harder to raise capital -Need to access capital from other more expensive sources -Cost of capital increases -Overall the whole economy suffers <ul style="list-style-type: none"> ● suffer in different ways:

<ul style="list-style-type: none"> ● 1. good companies do not have funds to expand their products/services, the society don't get to consume these. ● 2. the existing shareholders will experience a fall in share price. <p>Formula of share price : $P = C / (1+r)^n$.</p> <ul style="list-style-type: none"> ○ r is cost of capital. As the cost of capital (denominator) increases, P reduces → fall in share price 	<ul style="list-style-type: none"> ● 1. good companies do not have funds to expand their products/services, the society don't get to consume these. ● 2. the existing shareholders will experience a fall in share price. <p>Formula of share price : $P = C / (1+r)^n$.</p> <ul style="list-style-type: none"> ○ r is cost of capital. As the cost of capital (denominator) increases, P reduces → fall in share price <ul style="list-style-type: none"> ● Both types of information asymmetry lead to a worse outcome in the society (for consumers, business and existing shareholder)
<p>How to mitigate adverse selection in capital markets</p> <ul style="list-style-type: none"> ● Make information less asymmetric <ul style="list-style-type: none"> ○ Provide accounting information for investors before they make investment decisions. So, informed investors have better understanding of a firm's underlying economics and future prospects ● Ways to make information less asymmetric <ul style="list-style-type: none"> ○ Reliable financial reporting ○ Auditing/assurance ○ Financial analysts ○ Credit rating agencies ○ Signaling 	<p>How to mitigate moral hazard in capital markets</p> <ul style="list-style-type: none"> ● Change the incentive <ul style="list-style-type: none"> ○ Design a managerial compensation contract that can better monitor and reward (punish) managers <ul style="list-style-type: none"> ■ learn this towards the end of the semester. We also learn this in EPM (rewards system) ● Accounting information provides a basis for contracting between investors and managers to reduce their conflicts of interests

- **Dual Role of Financial Reporting**
 - Adverse Selection (inside information) (**VALUATION ROLE**)
 - Asymmetric information about a **firm's fundamental value**
 - Capital Markets Perspective** - Role of accounting reports to **value the firm**
 - Valuation--reduce adverse selection by supplying value relevant accounting information to capital markets
 - Moral Hazard (manager effort)(**STEWARDSHIP ROLE - Efficient Contracting**)
 - Asymmetric information about a manager's effort
 - Contracting Perspective** - Role of accounting reports to evaluate the manager
 - Efficient contracting --reduce moral hazard by motivating and evaluating managers
- Now we know that financial reporting has two objectives, but are the two objectives always aligned? Can we achieve both objectives using the same set of accounting information?
 - No, there is a dilemma (**RELEVANCE VS RELIABILITY**)
 - Valuation Role (Value **relevance**)
 - to value the firm, we want fair value, a land bought 10 years ago worth 1 mil, now it worths 10 mil. If we only record 1 mil , it will be understated
 - Stewardship Role (**Reliable** measurement)
 - want to be awarded based on what the manager has done/performed, not something out of their control (i.e. market wide factors)
 - Therefore, it is one thing to know how much a company earns this year and a different thing to know if the earning is attributable to the manager
 - a company can earn if the market is good, but this does not mean that the management has performed well
 - The best measure of net income to control adverse selection is not the same as the best measure to motivate manager performance
 - Might use **fair value accounting for valuation** role and **historical cost accounting for stewardship** role
- A side question for your knowledge: would you expect equal levels of adverse selection for debt and equity holders?
 - Large financial institutions participating in direct lending arrangements with firms may have the ability to access private information from the firm that is unavailable to the market. This would minimize information asymmetry for them.

Lecture 2: The Decision Usefulness Approach to Financial Reporting

- This lecture's focus is on adverse selection. About company providing new information and how that will change share price

Learning Objectives:

- To understand the **efficient market hypothesis** and its implications for financial reporting
 - The basic efficient market hypothesis posits that the market cannot be beaten because it incorporates all important determining information into current share prices. Therefore, stocks trade at the fairest value, meaning that they can't be purchased undervalued or sold overvalued.
 - **all information will be incorporated into stock price**, we will see this today → As company announces new news (earnings), share price will change to incorporate the new information
- To appreciate **full disclosure** as a mechanism for dealing with **information asymmetry**
 - To be specific, it is adverse selection we are talking about, valuation problem
- To examine empirical research evidence that examines associations between **earnings** and **share prices** to understand investor decision making using financial accounting information
 - **earnings** is what the firm announces (it is from accounting perspective)
 - **share price** is not what the firm can control (it is from market perspective)
- Quantify decision usefulness of earnings (**earnings response coefficients**)
 - Firm characteristics
 - Earnings quality

Efficient market

- 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 those securities
 - However, market is not always fully informed and efficient
- Two points to note:
 - **Information instantly impounded into prices** (no delay)
 - Prices capture information in **an unbiased manner** (no over-or under-reaction)
- therefore, in an efficient market, no one can get advantage. you can only get advantage if you know that the share price is undervalued, then you buy it and sell when it goes high (buy low sell high)
 - but since an efficient market captures all information and the price will not be over/undervalued, you don't get the chance to buy low (cause you cannot buy undervalued shares) and you cannot sell high (because you are uncertain as to when it will be high)
- In an **efficient market**, no one can exploit mispriced stocks consistently (including the experts) because price movements are mostly **random** and driven by unforeseen events.
 - **Random walk**- assumes the past movement or trend of a stock price or market **cannot be used to predict** its future movement. In short, random walk theory proclaims that stocks take a **random and unpredictable path** that makes all methods of predicting stock prices futile in the long run.
 - Therefore, both **technical analysis** and **fundamental analysis** will not work in an efficient market

- **Technical analysis** is a trading discipline employed to evaluate investments and identify trading opportunities by **analyzing statistical trends** gathered from trading activity, such as **price movement** and volume.
 - **Fundamental analysis**, which attempts to evaluate a security's value based on **business results such as sales and earnings, technical analysis focuses on the study of price and volume.**
 - Fundamental analysis (FA) is a method of measuring a security's intrinsic value by **examining related economic and financial factors.** Fundamental analysts **study anything that can affect the security's value**, from macroeconomic factors such as the state of the economy and industry conditions to microeconomic factors like the effectiveness of the company's management.
- Are there any biases from individual investors?
 - The answer is: YES, of course
 - Sources of biases:
 - Liquidity trades (i.e., sale of securities by investors to meet sudden needs for cash)
 - Trade on noise("Monday is my lucky day!")
 - these will cause market to be inefficient, BUT, market will overall and averagely still be efficient because in a liquid market, positive biases and negative biases are assumed to cancel out
 - As such, on average the market prices are unbiased
 - The naïve investor is price protected by an efficient market