Lecture 1: Financial reporting

Financial reporting
- An economic goods - determined by demand (E.g. lenders & investors) and supply (E.g. auditors)
- **Purpose**: To relieve information asymmetry (One party to a transaction has informational disadvantage to others)

Sources of demand

Valuation
- To reduce adverse selection & improve market capital efficiency
- **Adverse selection:** Party to a potential transaction has informational disadvantage (Hidden **information before** transaction)

Stewardship & Efficient Contracting
- To address moral hazard & contracting problems and improve the operation of managerial labour market & efficiency of contracts
- **Moral hazard:** One party can observe actions in the fulfilment of contract while others cannot (Hidden **action after** transaction)

Btw management & investors

- Management knows more about the current conditions & future prospect of the firm.
- Investors face adverse selection since management may act opportunistically, delay or select information to be relased - reduce the ability of investors to make good decisions.
- The investors face information risk - do not know the true price & think management inflate share price to increase their wealth. They reduce the share price they are willing to pay.

Btw investors

- Some investors (E.g. institutional investors) may know more than other investors (E.g. retail investors).
- Buyers face information risk & reduce the price they are willing to pay.
- Sellers face information risk & increase the price they are willing to sell.
- Greater bid-ask spread. They cannot agree on a price. No stocks are trading.
- Illiquid market. Investors value liquidity due to unforseen needs.
- Therefore, they require risk premium

Btw shareholders (Principals) & managers (Agents)

Separation of ownership & control

- Managers may act in their own best interest rather than shareholders .
- (i) Pay/ perks: The manager buys things that are not related to the firm's return. E.g. Plane
- (ii) Shirk : The manager invests in projects that are easier to be managed but have lower return.
- (iii) Empire building: The manager retains the cash flow and does not distribute it to investors.
- (iv) Risk aversion: The manager invests in safe projects that have lower return.

Btw debtholders (Principal) & manager (Agents)

- Assume the interest of managers & shareholders are aligned.
- (i) Claim dilution: The firm may borrow from other lenders, increasing the credit risk & dilute the asset can be claimed if the firm bankrupts.
- (ii) Asset substitution: After receiving the loan, the manager invests in more risky project. This does not increase the lenders' return but increase thier risk.
- (iii) Excessive dividend payment: The manager distributes excessive dividend to them, leaving no fund to pay debt.

Consequences

- Higher cost of capital, reducing proceeds to the firm.
- Reduce informativeness of price when allocating resources.

Solutions

- Increase quality & quantity of information through mandatory financial reporting, voluntary information reporting and other information intermediaries.
- **Decision useful view**: Provide information about the future cash flow & discount rate.

Solutions to address both problems

Reliability
- Guard mangerial opportunistic actions.
- Reduce moral hazard problems by reflecting managerial effort.
- Reduce adverse selection by reflecting economic value added

Accrual accounting
- Recognise transactions when they incur & can be measured reliably. Reduce timing & matching problems. Increase the relevance & More presice measure of both managerial effort & economic value added.
- **However,** this may give rise to biases (e.g. net asset is biased downward) & reduce reliability. Increase info asymmetry....(refer to consevatism)
- Revenue recognition: Recognise revenue when they incur & reliazable
- Expense recognition: Recognise expense in period where the revenue occurs.
- Accurals = Net profit - Cash flow from operation

Solutions

Efficiency contracting view
- Write contracts based on performance (accounting numbers). Accounting numbers are the assessment of seccess or failure of the contract.
- (i) **Debtholders**: Write debtholders contracts which include covenants. Covenants are cost of contracting, thus lowering the interest rates.
- (ii) **Shareholders**: Write shareholders contracts which link manager pay to performance. Lower moral hazard costs.

Conservatism
- Definition: Higher standard verfication for recognition of gain/ assets vs loss/ liabilities
- **Lenders:** Face payoff asymmetry. Lose heavily if the firm does poorly but do not share in gains if the firm perform well. Limit dividend & give early signal of financial distress
- **Shareholders:** Timely recognition of losses & Improve responsible managers effort.
- Reduce managers opportunistic actions & results in more neutral reports.
- **However,** this may give rise to biases (e.g. net asset is biased downward) & reduce reliability. Increase info asymmetry.
- Increase adverse selection by impacting determination of firm value.
- Increase moral hazard by having less precise measure of managerial efforts.

Are these two objectives always aligned & use same set of information?
- To reduce adverse selection, the investors prefer current value accounting while to reduce moral hazard problems, managers prefer historical cost accounting and conservatism.
- There is a conflict between investors and managers.
- Standard setting viewed as the means of mediating this conflicting interest.