Objective of Financial Reports

Recognition and measurement: How are economic assets and liabilities recognised and measured?
Two objectives of financial reports: valuation and stewardship/contracting
Financial accounting is an information reporting system designed to relieve information asymmetry in economies and societies and to facilitate in efficient allocation of world's scarce resources.
End game is to improve efficient allocation of resources. Information is most fundamental ingredient to facilitate efficient allocation of resources. Financial reports are crucial
Two distinct types of information asymmetry give rise to two distinct objective of financial reports

Information asymmetry: When one party in a transaction has an information advantage or disadvantage relative to other party.

- **Adverse selection**: Arises in relation to **potential** transaction between two parties when one party is at an information advantage. Adverse selection exists between shareholders and management because corporate managers have an information advantage compared to shareholders. Shareholders trading between each other gives rise to adverse selection because certain shareholders have information advantage compared to others. In job applications managers want to hire the best but are at an information disadvantage to know who are the best candidates to hire. Investors want to buy and sell shares as close as possible to true underlying fundamental value but counterparty may have more information than investors. This results in increase in demand for information i.e. financial reports to minimise information risk so that investor can conduct own valuation of firm. Lower adverse selection results in lower information risk in share market and investors are prepared to invest more in capital markets and thus provide more efficient capital markets. Reason why less developed countries are less developed because they don't have resources to pool resources to provide high quality accounting standards or auditors or analysts. Information is of low quality and investors are not prepared to invest. Corporate entities cannot raise capital. Quality information reverts capital from low performing companies to high performing companies i.e. **cross sectional application of capital**. Information produced will then more reflect the true underlying fundamental value of company.
- **Moral hazard**: Arises in relation to **post** transaction, where transaction has occurred. Counterparty engaged to fulfil an action on one's behalf but one cannot observe agent's actions in fulfilment of transaction. Management may suffer from moral hazard because actions undertaken in own self-interest to detriment of shareholders. Shareholders cannot observe actions of CEO or CFO in fulfilment of contract. Once applicant is hired, managers have moral hazard of inability to observe actions of employee, whether they are truly acting in best interest of firm. Shareholders investing in firm engage in corporate manager to manage corporation on their behalf but cannot observe actions of managers. In order to minimise moral hazard problem, they will demand information, i.e. financial reports, information to make managers accountable, stewardship objective (corporate manager acting in best interest of shareholder). If moral hazard is reduced, less corporate resources wasted, giving rise to efficient use of world's resources.

Valuation objective of financial report: **Helps solve adverse selection**. Desirable information attributes (decision usefulness) include information that can forecast future cash flows. Ideal accounting for valuation is present value of future cash flows of all firm's assets and liabilities. Present Value of asset and liabilities is expected future cash flows discounted for time value of money and risk associated. Condition necessary for this attribute is the need to know with perfect certainty future cash flows and discount rate which requires estimation. Perfect information to **satisfy valuation objective** is to have **all firm's assets and liabilities** (on balance sheet) **measured at present value** (value in use). **Current value accounting may facilitate in valuation objective** but though relevant, may not necessarily be reliable and thus conflict with requirements for efficient contracting objective.

Stewardship/efficient contracting objective of financial reports: Helps solve moral hazard. Firm is a collection of contracts. In order to maximise firm value, need to minimise transaction costs of all contracts. **Primary/direct contracting costs refers to wages**. **Indirect contracting costs refer to moral hazard costs, monitoring costs**, renegotiation or contract violation costs. Indirect costs are costs that financial accounting aim to reduce to maximise firm value. Moral hazard states that firm cannot fully observe actions of counterparties in contracts. So if **contracting costs minimised, firm value maximised**.

- Contract between firm management and **shareholders** for management to act in best interest of shareholders gives rise to need of quality financial accounting information to hold management accountable and minimise contracting costs. Two distinct limitations when equity holders contribute funding: **separation of ownership and control** and **shareholders' limited skills and expertise to run firm**. Therefore, manager is employed to maximise wealth. This gives rise to agency relationship. Three significant moral hazard costs associated with separation of ownership:
    - **Dividend retention**: Whenever firm has excess cash that cannot be utilised in positive NPV investments should be returned to shareholders. But instead in presence of information asymmetry, may not be done due to **Empire building** (retention of dividends causing false perception of larger firm in hopes of higher compensation for manager. Managers of larger firms enjoy greater reputation) and **excess consumption of perquisites** (CEOs retain cash in order to invest in personal projects not necessarily Positive NPV.

    - **Risk aversion**: From shareholder's viewpoint, **fundamental determinant of firm's risk is firm's beta i.e. systematic risk**. Shareholders do not care about firm specific risk because their portfolios can be diversified. So they demand expected return greater than required return determined by beta in order to maximise firm value. Manager comes across positive NPV project relative to firm's required risk, but may choose to reject due to project specific volatility. Manager thinks about own portfolio wealth and own human capital determined by success of firm. If manager chooses project with high volatility, there is risk that firm will lose value affecting their reputation. Shareholders do not care about firm-specific risk and encourage positive NPV high volatility projects. **CEO is risk averse in relation to firm-specific risk. Shareholders are not risk averse in relation to firm-specific risk.**
    - **Horizon problem**: Shareholders want to maximise wealth, and wish to accept all projects that maximise expected future **cash flows into perpetuity**. However, some projects may have large investment outlay with early negative future cash flows. Managers may reject project simply due to labour market reputation and short term performance of project. **Shareholders have long horizon whilst CEOs have short horizon.**
- Most of funding in corporations come from **debt** as opposed to equity. Moral hazard costs of raising debt arise because lenders cannot observe actions of firm using money lent i.e. firm may not use funds in best interest of lender.
    - **Excessive dividend payment**: Lender lends money to firm, firm can simply declare lent money as dividends to shareholders. Lenders have no recourse i.e. cannot get money back. Potential moral hazard problem.
    - **Asset substation**: safe assets substituted for risky assets. Lender lends money to firm perceived to possess safe asset i.e. strong capacity to service debt. However, when loan lent, firm may substitute safe assets with risky assets. **Firm benefits but lenders are worse off**.
    - **Claim dilution**: After loan made, firm may obtain loans from other lenders and give greater priority to claim of firm's assets thus resulting in claim dilution.
    - **Under-investment**: If there is positive NPV project that presents itself, may allow firm to use expected future cash flows to bring themselves out of financial distress i.e. service lenders but provide no further benefit to shareholders. Managers therefore may reject positive NPV project.

As an economy, goal is to minimise moral hazard costs. Contracts need to be written that take into consideration moral hazards. Contracts need to be written using financial accounting numbers e.g. link manager's compensation with reported financial accounting numbers to align incentives of manager with incentives of shareholder. Manager less inclined to retain dividends, or invest in pet projects. Debtholders can write contracts with firm using reported numbers i.e. debt covenants, terms and conditions, penalise borrowers for breaches in contract. Three distinct attributes that financial accounting information should possess to facilitate efficient contracting:

- **Conservatism** (**higher standard of verification required for recognition of assets and gains** as opposed to standard of verification required for recognition of liabilities and unrealised losses).
    - **Unconditional conservatism**: non-recognition of assets with uncertain payoffs. Standards do not allow internally generated intangible assets (i.e. goodwill) to be recognised. **Intangible asset shall be recognised** only **if probable (greater than 50%)** that expected future **economic benefits** attributable to asset will **flow to entity** and cost of asset can be **measured reliably**. Corporations deals with large amount of intangible assets.
    - **Conditional conservatism**: **Recognition of unrealised losses** but **non-recognition of unrealised gains** for recorded assets. Impairment test (if recoverable amount of asset lower than carrying amount, asset revalued downwards. However, if recoverable amount greater than carrying amount, nothing done) and lower-of-cost or market valuation of inventory (if net realisable value of stock lower than cost, unrealised loss needs to be recorded but if net realisable value of stock higher than cost, no gains recorded).
- Lenders have clear **asymmetric pay-off function**. Lenders derive no incremental benefit if firm performs well, but if firm performs poorly, lender incurs cost of poor performance as loan not repaid. Lender care more about losses than gains. Shareholders demand information that prevents manager's engagement in pet projects or withholding of dividends. Lenders demand **reliable** information (verifiable by realised transaction) **as opposed to relevant.** Relevant information gives managers opportunity to use discretion in making estimates of valuation of unrealised transactions and to opportunistically biased estimates upwards to hide losses. Lenders demand **conservative information** because more concerned about "economic loss" than "economic gain''. Conservative accounting policies limits opportunities to declare and payoff dividends and limits moral hazard of excessive dividend payments. If project's future cash flows negative, conservative accounting forces managers to report losses, information a lender wants.
- **Flexibility/Contract rigidity**: Change in accounting standard can result in **technical breach** of contract and result in unforeseen costs. If debt contract includes debt covenant with limit leverage ratio and if accounting standards changes definition resulting in reclassification of preference shares from equity to debt, there will be higher leverage ratio, debt covenant breached. Solution is to give corporate managers flexibility in accounting policy choice to guard against technical breaches of contract. If managers use discretion to increase profit to boost equity, they could have maintained leverage ratio to avoid breach. In substance, firm's fundamental credit risk has not changed. Accounting policy flexibility can result in efficient contracting. Contracting costs lower because firm does not incur extra costs in technical breaches of contracts.

But if firms have flexibility, managers may use opportunity to act in self-interest. If pay linked to numbers, corporate manager may bias numbers upwards to obtain higher pay.
Evidence exists to show firms that encountered technical breaches in debt covenants made accounting policy choices to avoid these technical breaches. Conservatism and information asymmetry linked, conservative firms found to have lower information risk with lenders and more efficient contracting with lower debt cost. Given opportunity to have accounting flexibility, managers will take advantage to act in self-interest at cost of shareholders. Managers' remuneration linked to numbers, will act opportunistically to obtain bonuses. **Heterogeneous firms with homogenous accounting policies, result in firms reported earnings miss-measuring underlying fundamental value of firm. Heterogeneous firms should not have homogeneous accounting policies. But trade-off is heterogeneous accounting policies give rise to opportunistic behaviour of managers.**