

Busi 353
Section 921
Intermediate Financial Accounting I
Robert Bruce, CA

- Introduction....

Admin issues continued

Contact

- Email: Rob.Bruce@sauder.ubc.ca
- Office Hours: Before class, by appointment.
- Click on booking widget on connect site and book an appointment

Admin issues continued

- Required textbook: Intermediate Accounting, Volume 1, 2e. Lo and Fisher
 - Bring textbook to class!
 - Select solutions to textbook problems will be available on connect
- Optional textbook: Financial Accounting Theory 4^e. Scott
 - Select solutions to textbook problems will be available on connect

Admin issues continued

Online resources

- Connect: www.connect.ubc.ca
 - Class notes available for download
 - Assignments
 - Solutions to textbook problems
 - Other resource material
 - Practice exams
- My accounting Lab (info on connect)
- CICA HB
 - Available online from UBC Library.
 - Link to site on Vista

Admin issues continued

- Assignments
 - 10 % of final grade
 - Generally one per week
 - See course outline for due dates
 - File name: Lastname_firstname_assignment#.doc
 - Submitted to drop box on connect.
 - Not accepted after deadline
 - **Must be typed.** Handwritten will not be marked.
 - Email submissions will not be accepted

Assignments

- Electronic submissions are checked for plagiarism.
- Suspected plagiarism results in a mark of zero for first offence
- Second offence = fail course.

Course objectives

Theory

- Understand financial reporting environment
- Conceptual framework for financial reporting
- Understand the objectives of financial reporting
- Critically assess accounting standards and policies
 - Considering Management, investors, lenders and users

Course objectives continued

Technical

- Prepare statements of income (ASPE), comprehensive income (IFRS), balance sheet, statement of retained earnings.
 - Interpret the results of these statements
- Classification of assets
- Revenue recognition

Course objectives continued

- How to account for various asset accounts
 - Current assets
 - Long term
 - Tangible and intangible asset
 - Investments
- Impairment of assets

Course Structure

- Class 1, 2 & 3. Theory based.
- Class 4- 10- Technical topics
- Class 11 & 12- Theory revisited

A few ground rules...

- Please arrive on time.
- Mobile phone must be silent.
- We will have a break mid way through class
- Participation is greatly appreciated ☺

• Any questions?

The demand and supply of accounting information

- Accounting = the production and transmission of information
- Fundamental to accounting is communicating information
- Communicating from those who have it to those who need it

Branches in Accounting

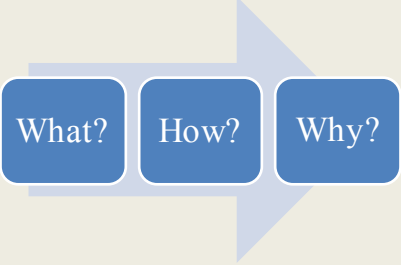
- Financial Reporting
 - Purpose is to report on company's financial results
 - Target: External users
- Managerial Accounting
 - Purpose is to analyze information for decision making
 - Target internal users
- Tax Accounting
 - Purpose: tax compliance
 - Target: tax agency

Generally Accepted Accounting Principles

- Broad principles and conventions of general application
 - Historical practice (ie. Definition of an asset)
- Rules and procedures that determine accepted accounting
 - Pronouncements (ie. Accounting for leased assets)

Financial accounting at the intermediate level

We need to consider these questions:



UNCERTAINTY AND INFORMATION ASYMMETRIES

- Information: Evidence that can potentially affect an individual's decisions.
- External parties' decision-making needs create demand
- Uncertainties exist

Information Asymmetry

- A condition in which some people have more information than others
- Two types:

adverse selection and moral hazard

Adverse Selection Example

- Example – buying a used car
 - 5 identical used cars for sale
- Seller has more information than you
- Seller uses **costly signalling** (or signalling)
 - information that is otherwise unverifiable (it runs beautifully!)
- Seller uses **cheap talk** – unverifiable disclosures (it's a bargain!)

Moral Hazard Example

- One party to a contract cannot observe some actions relating to the fulfillment of the contractual terms by the other
- Involves hidden actions in the future
- Example – buying insurance for the car
 - Insurer can not monitor the actions of the driver
- Moral hazard is costly

Adverse condition and moral hazard defined

- For adverse selection: one party to a contract has an information advantage over another party
 - “hidden information”
- For moral hazard: one party to a contract cannot observe some actions relating to the fulfilment of the contractual terms by the other party.
 - “hidden actions”

Application to accounting

Adverse selection:

- Selling shares and paying dividends
 - “there is money here, so everything is good”- MGMT

Moral hazard:

- Measuring performance and incentive pay
 - Incentive to add value
- Loan payments and covenants
 - To protect lenders interests

Agency /Principal-Agent Problem

- Separation of ownership and management
- The owners (principals) not able to monitor management (the agents) to ensure the agent(s) make(s) decisions in the best interest of the principal(s).

Desirable characteristics of accounting information

- Investors demand relevant information
- Investors demand reliable information
 - Verifiable
 - Not prone to manipulation
- Trade-offs must be made

The role of accountants

- Role of accounting information to control adverse selection
 - Convert inside information into outside
 - Supply useful information to investors
- Role of accounting information to control moral hazard
 - Control manager shirking
 - Improve corporate governance

Accounting policy choice and earnings management

- Standards allow for choices in accounting polices and estimates
- Why do these choices exist?
 - One size does not fit all
 - Accrual accounting requires estimates
- What can happen?
 - Earnings management

Defining “Positive Accounting Theory”

- “A theory for understanding managers’ motivations, accounting choices, and reactions to accounting standards.”

Motivations for Managing Earnings Upward

- Share price
- Provide more funds or charge a lower interest rate.
- Meet its contractual obligations such as debt covenants.
- Meet regulatory requirements, such as capital requirements for banks.
- Provide a stronger bargaining position in merger negotiations.
- Obtain higher compensation

Motivations for Managing Earnings Downward

- Reduce additional taxes or regulations
- Increase the likelihood of receiving government subsidies and trade protection
- Take a “big bath” in a bad year resulting in:
 - Higher future compensation
 - Higher stock price
- Improve the firm’s bargaining position relative to employee unions

Accounting and the securities market

- Referring to a market for securities
 - Public stock exchanges
 - Private exchange
- Security markets take accounting information to for pricing
- Security markets provide information for accounting

Accounting information in securities markets

- Many estimates are used and provide opportunities for earnings management
- Valid and acceptable estimates exist
- Management's ethical responsibility is to choose the best approach
- Underestimating costs increases current profit

Using information from securities markets in accounting

- Firms hold investments that trade in the securities market
- Markets provide information for valuing investments recorded in financial statements

Collapse of the Stock Market Boom of Late 1990s

- Enron
- WorldCom
- Collapse of public confidence in capital markets
- Effects on financial reporting
 - Sarbanes-Oxley Act
 - More conservative accounting?

Market Meltdowns, 2007-2008

- Terminology
 - Securitization
 - Financial instruments
 - Asset-backed securities
 - Collateralized debt obligations
 - Asset-backed commercial paper
 - Credit default swaps
 - Expected loss notes
 - Liquidity risk
 - Liquidity pricing
 - Counterparty risk

>> Continued

Market Meltdowns, 2007-2008

(continued)

- Financial accounting issues leading up to the market meltdowns
 - Fair value accounting for financial instruments
 - Complicated by liquidity pricing
 - High leverage of financial institutions
 - Off-balance sheet financing liabilities
 - Use of expected loss notes to avoid consolidation of structured investment vehicles
 - Was disclosure of off-balance sheet liabilities adequate?

>> Continued

Market Meltdowns, 2007-2008

(continued)

- Response of standard setters
 - Stopgap measures in response to government pressure
 - Fair value accounting guidance during liquidity pricing
 - Increased use of internal estimates (value-in-use)
 - Increased use of cost-based valuation
 - New accounting standards
 - Consolidation
 - Derecognition
 - Increased disclosure

Market Meltdowns, 2007-2008

(continued)

- Response of other regulators
 - Increased disclosure of managerial compensation
 - Move transactions to security exchanges from shadow banking system
 - Increased capital reserves for financial institutions

>> Continued

Market Meltdowns, 2007-2008

(continued)

- Implications for accountants
 - Need for transparency
 - Value-in-use v. fair value accounting
 - Full disclosure of off-balance sheet activities
 - New accounting standards to prevent future abuses?

Conservative Accounting

- Write down but do not write up
 - A partial application of current value accounting
 - Lower of cost or market
 - Ceiling tests
- Current value accounting
 - Current value accounting writes up and down
- Increased conservatism in recent years
 - A response to the volatile and fleeting nature of current values?

Rules-Based v. Principles-Based Accounting Standards

- Do rules-based accounting standards work?
 - Enron, WorldCom
 - Expected loss notes
- Will more rules in new accounting standards work to prevent abuse?
- Principles-based standards
 - Important role of Conceptual Framework
 - Relies on ethical accounting/auditing profession

Regulation as a Reaction to the Fundamental Problem of Standard Setting

- Standard setting is a form of regulation
- Is standard setting needed?
 - Market forces motivate firms to produce information
 - But market forces subject to failure
 - Adverse selection
 - Moral hazard
 - Regulation steps in to try to correct market failures
 - Regulation is costly

Regulation as a Reaction to the Fundamental Problem of Standard Setting (continued)

- Standard setting mediates between conflicting interests of investors and managers
 - Investors want lots of useful information
 - Managers may object to releasing all the information that investors desire
 - Due process in standard setting
 - Representation of diverse constituencies
 - Super-majority voting
 - Exposure drafts

Theories Relevant to Financial Accounting

- The rational investor
 - A model of how an investor may use new information to revise beliefs about future firm performance
 - Rationality holds *on average*, not necessarily for each individual
- Efficient securities markets
 - Share prices fully reflect all publicly available information
 - Efficiency is relative to a stock of information
 - Role of financial reporting in improving/expanding the stock of information

» Continued

Theories Relevant to Financial Accounting (continued)

- Behavioural theories
 - Investors do not use all the information in financial statements → securities markets not fully efficient
- Agency theory
 - Efficient contracts to motivate manager performance and achieve good corporate governance

Discussion problems

- Problem P1-4 (page 17)
- Problem P1-13 (page 19)

- Problem P1-16 (page 20)
