

## Chapter 1: Introduction

### 1.2 Historical Perspective

Reports began to be external once shares issued

Accounting was unregulated until the Great Depression of the 1930s

-Market crashed in 1929 causing Great Depression

-Regulation required since companies were overvaluing their assets

Results:

1. Creation of SEC

- Goal= insure investors provided with adequate & accurate info
- Power to establish accounting standards but delegates this power to profession

2. Strengthening in HC as many capital assets were overvalued before crash

Alternatives to HC developed over the years:

1. Current value

1) Value in use: PV of future CFs

2) FV (MV): amt to be received/paid if firm disposed of asset/liability

2. Mixed measurement

Market said to be working well when MV of assets/liabilities  $\approx$  true value

Conceptual Framework: basic concepts underlying financial reporting based on decision usefulness

### Collapse of Stock Market - Late 1990s

#### 1) Enron

- Expanded rapidly & needed large amounts of capital so attempted to raise capital without taking on debt
- Created SPEs to which sold their own shares in return for receivable  $\rightarrow$  overvalued assets since receivable from own company
- SPEs borrowed \$ (took on debt) with Enron's shares as collateral to pay Enron for shares
- When share P increased, Enron recorded investment income (since owned SPE)  $\rightarrow$  overstated income since recording investment income from own shares
- Enron should have consolidated but did not to mask debt (debt did not appear on Enron's books but on SPEs' books)
- When market found out, investor confidence decreased & share P plummeted
- Filed for bankruptcy in 2001

#### 2) WorldCom

- Overstated earnings by billions

- Capitalized costs that should have been expensed
- Decreased AFDA
- When market found out, investor confidence decreased & share P plummeted
- Filed for bankruptcy in 2002

In both cases, F/S were certified by auditors

Resulted in collapse of public confidence in markets, financial reporting & auditors

Could have been prevented by proper regulation & enforcement by auditors

-Too much regulation restricts market but must have some laws/rules

Result → Need to boost confidence by improving financial reporting

- Increased regulation & corporate governance (policies that align firm's activities with interest of investors/society by which company is directed)
- SOX Act (US 2002)
  - Tightened audit function – major provision = creation of PCAOB to
    - 1) Set auditing standards
    - 2) Inspect/discipline auditors of public companies
  - \*PCAOB similar to CPAB in Canada
  - Improved corporate governance
- Tightened rules regarding off-BS entities

### 1.3 2007-2008 Market Crash

Banks gave many mortgages to people with bad credit with house as collateral

-Knew they would sell so did not care quality of borrowers

-Used to increase D of ASBs

Created SPE (not consolidated) who sold ABSs/CDOs to investors made up of these “junk” mortgages

ABSs – on public markets

CDOs – on private markets (riskier)

People took on too many loans

-Many people buying houses so housing prices increasing creating housing bubble

ABSs began failing since they were bad debts

-Demand for houses decreased dramatically leading to housing market crash

-Credit default swaps had to be paid causing failure of insurance companies

Investors became suspicious about value of security so MV (share prices) decreased drastically leading to market collapse

#### Reasons for crash:

1. Inadequate regulation

- Lack of transparency of financial instruments (ABSs not transparent since investors did not know true riskiness)

2. Relaxed mortgage lending practices

### 3. Lack of ethics from banks

- Manipulated markets to sell bad loans (expected people to default)

#### **Accounting Implications:**

-Transparency for proper valuation

-FV may understate value-in-use when markets collapse due to liquidity pricing (when  $MV < \text{value in use}$ ) from loss of investor confidence

-Full disclosure of off-BS activities to avoid excessive risk-taking

-Improved regulation

→ Does not necessarily mean new standards since can still find loopholes in new standards

→ Extent of regulation not obvious since costly & risk of failure

-Ethical behavior

#### **1.4 Efficient Contracting**

Contracts create demand for accounting info (type of info required to assess firm depends on type of contracts)

**Efficient contract:** best tradeoff between costs & benefits; generates trust @ lowest cost

-Role of accounting info = maximize contract efficiency

-Required for good corporate governance

-Emphasizes mgmt. stewardship (alignment of mgmt. & SH interests)

Required:

- Reliable financial reporting – to generate trust that mgmt.
  - Conservatism – prevents mgmt. from overstating performance & provides early signs of distress
- \*Ideal = give correct # but understating is safer than overstating

#### **1.5 Ethical Behavior of Accountants/Auditors**

Behaving ethically has LT advantages

-Important to keep public's confidence to keep profession alive since performing a public service

To restore/maintain public confidence in financial reporting:

1. Improved/increased regulation
2. Ethical behavior

#### **1.6 Rules-Based vs. Principles-Based Standards**

Rules = Detailed instructions

Principles = General guidelines; reliance on professional judgment in application

IFRS – more principles-based  
US GAAP – more rules-based  
World moving towards principles-based

Which is better?

- Balance of best of both worlds
- Depends on environment/culture
- More room for leeway with principles-based but usually professionals know what they are doing if acting wrongly
- Even if rules-based is more “strict”, can still be bent

### **1.7 Complexity of Accounting Information**

Reason for complexity:

- Individuals react differently to same info – therefore can't have perfect accounting standards
- Affects decisions therefore affects working of market

### **1.8 Role of Accounting Research**

Research into:

- Market response to certain financial info – to ID useful info
- Managerial behavior & compensation – to improve contracts with managers to better align their interests with investors/creditors

### **1.9 Information Asymmetry**

Info asymmetry: when 1 party knows more than another

- 1) Adverse selection: 1 party has information that other party does not (info advantage)  
→ Insiders have better/more info than outsiders that they may use at expense of outsiders, which raises concern among investors so markets do not work as well
- 2) Moral hazard: 1 party can observe actions in fulfillment of contract that other can not (effort observation advantage)  
→ Shareholders can't observe mgmt's work, providing opportunity for mgmt. to shirk on effort

**Roles of accounting information:**

1. Control adverse selection – by communicating useful info from inside to outside firm (best controlled by current value)
2. Control moral hazard (best controlled by FV)

DUAL ROLE → Inform investors & measure/motivate mgmt. stewardship

## 1.10 Fundamental Problem

No perfect accounting concept → most useful measure of NI to inform investors not necessarily best measure to measure stewardship & motivate manager performance

**Fundamental Problem** = How to design/implement standards that combine investor informing & manager performance-evaluating roles of accounting info?

Part of solution = extent of regulation

## 1.12 Standard Setting

IASB: developed IFRS

-Canada adopted IFRS, US considering adoption

FASB: standard setting body in US

-Been working with IASB to converge standards

AcSB: standard setting body in Canada

-Issued CICA Handbook (authoritative source of GAAP in Canada)

-Adopted IFRS in 2011

Securities Commissions: enforce accounting standards (ensure adherence to GAAP & discipline when necessary)

Canada – provincial not national (OSC)

US – SEC

## Chapter 2: Accounting Under Ideal Conditions

Relevant info: info about firm's future economic prospects (div, CFs, profitability)

Reliable info: faithfully represents what it is intended to

## 2.2 Ideal Conditions of CERTAINTY

→ All info is public/known

-Know future CFs

-Given interest rate

- Basis of accounting = PV
  - Under certainty:  $PV = MV / \text{value-in-use} = FV$  (no price discrepancies)
- Income recognition: as changes in PV occur
  - Calculated accurately
  - $NI = \text{interest on opening asset value}$
  - $\text{Expected NI} = \text{Realized NI}$
  - NI has no info content, all relevant info in BS
- No need for accounting – Accountant's job is to provide info to market but all info is already known under such conditions

- Not realistic

### 2.3 Ideal Conditions of Uncertainty

1. Set of possible states publicly known & complete
2. State probabilities are objective & publicly known
3. State realization is publicly observable
4. Given, fixed interest rate

→ **Future CFs known conditionally on state but don't know which state will occur**

State of nature: uncertain future events that affect firm performance (CFs)

Ex: State of economy (good/bad), weather, govt policies

- Basis of accounting = expected PV (based on probability of states)
  - Not as accurate as certainty but still accurate since know possible states & probabilities (can accurately calculate PV)
- Income recognition: at end of period, after state observed
  - IS needed to see how estimate changed
  - Expected NI may not = Realized NI  
Abnormal/unexpected earnings = expected – actual  
NI = Expected NI +/- Abnormal earnings
- Accountants can help at beg of period, less at end
- Not realistic – people do not assess future outcomes same way  
More realistic – subjective probabilities rather than objective since individuals differ in knowledge & forecasting ability
  - IS important since want to analyze past performance
  - Subjective probabilities based on available info & experience
  - Subject to error so investors are alert for info to revise probabilities
- Lack of certainty creates volatility (higher risk for investor)

**\*\*\*IDEAL CONDITIONS DO NOT EXIST IN REAL WORLD \*\*\***

Ideal conditions of certainty = most reliable

Ideal conditions of uncertainty = less reliable

Non-ideal conditions = least reliable

### 2.4 Examples of PV Accounting

**1) Embedded Value:** partial application of PV accounting used for insurance companies

Value of business = discounted PV of policy amounts to be collected net of costs

- Not complete application since does not include PV of all expected future CFs
- Highly relevant but reliability issues since requires actuarial assumptions

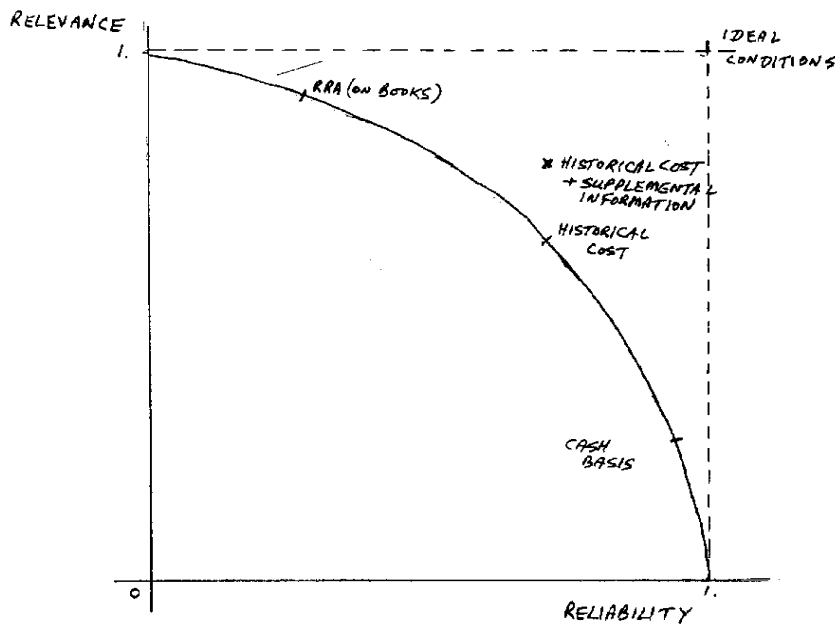
- Reporting it more useful than not reporting

**2) Reserve Recognition Accounting (RRA):** supplemental disclosure of PV of PROVED oil & gas reserves and explanation of change in measure  
Discounted at mandated rate of 10%, uses average prices for period

- Prices fluctuate a lot so average is best solution although not as accurate as would like
- More relevant than HC (using current rather than past values)
- Less reliable than HC
  - Cost easily verifiable
  - Not completely representative since only applied to proved reserves
  - Need estimations, which are subject to error & bias
    - Ex: timing of extraction, quantities, prices, state probabilities not objective, classification as “proved” (requires judgment)
- Reported as supplementary info since info is not perfect but still helpful

### Relevance vs. Reliability

- Traded off against each other (can't have 100% relevance & reliability due to lack of ideal conditions)
- To increase relevance, need more estimates which decreases reliability



PV provides most relevant info to users

PV accounting between RRA & HC

## 2.5 HC vs. Current Value

### 1) Relevance/Reliability

Most to least relevant: PV – FV – HC

Most to least reliable: HC – FV – PV

HC: Reasonably reliable since cost usually verifiable (less subject to estimation error) but low in relevance since does not take changes in current value over time into consideration

CV: Faces volatility & reliability issues

### 2) Revenue Recognition

HC: Rev recognized as inventory sold, greater recognition lag

CV: Rev recognized as changes in CV occur, little recognition lag

### 3) Matching of Costs & Revenues

HC: through accruals; reasonably reliable (loses reliability through estimates of useful life & amortization)

CV: little matching; NI = explanation of how CVs of assets/liabilities changed during period

Disagreement over which is more useful

## 2.6 Non-Existence of True NI

Due to:

- Lack of objective probabilities of states
- Incomplete markets – MV don't exist for all assets/liabilities
  - Thin market (ex: oil & gas reserves)
  - Info asymmetry (too much = fail to develop)

Under ideal conditions (do not exist in reality):

- True NI exists
- Accounting info completely relevant & reliable

### Meaning for Accounting:

- If true NI exists, accountants not needed
- Lack of well-defined concept of NI means judgment must go into asset valuation & income measurement
  - Professional judgment = basis of accounting profession
- Goal = get most accurate estimate with least amount of assumptions

Value relevance: how relevant & reliable info is

Higher value relevance = more relevant while maintaining acceptable level of reliability

## Chapter 3: Decision Usefulness Approach to Financial Reporting

Decision usefulness: ability of financial accounting info to help users make good decisions (impact their decision)

### 3.2 Decision Usefulness Approach

Idea = if can't prepare theoretically correct (perfect) F/S, can provide useful F/S info  
2 roles of financial reporting = decision usefulness & stewardship

2 Questions:

- 1) Who are the users (constituencies) of F/S?
  - Many users: current/future investors, current/future creditors, banks, mgmt, employees, unions, standard setters, govts
- 2) What are the decision problems of F/S users? What are the information needs of users?
  - Tailoring F/S info to needs of users will increase usefulness

### 3.3 Rational Decision Theory

-Individuals make decisions in different ways (interaction of individual decisions form market price); theory gives decision process of **AVG** investor  
-Decision model on average basis therefore does not necessarily always work (works on average)

**Theory:**

- Investor decisions are rational **ON AVG**
- Rational investors make decisions to maximize expected utility (satisfaction)

Reasonable – if individuals do not make decisions in some predictable way, difficult for accounts to know what info they find useful

**Bayes' Theorem:** device to revise state probabilities upon receipt of new info

$$P(\theta/m) = \frac{P(\theta)P(m/\theta)}{\sum_{\theta} P(m/\theta)P(\theta)}$$

$\theta$  - state of nature

$m$  - message received before F/S (earnings announcement, MD&A, analyst report, market, trends)

$P(\theta)$  - expected probability of  $\theta$  (subjective)

**Information System:** all the conditional probabilities taken together

	F/S INFO	
	GN	BN
High	P(GN,H)	P(BN,H)
Low	P(GN,L)	P(BN,L)

STATE

Main diagonal probabilities

Off-main diagonal probabilities – exist since ideal conditions do not exist (error P)

F/S informativeness affects accuracy of probabilities

- Highly informative = transparent, precise, high quality
- Info system = informative/useful if helps decision maker predict future returns by changing his subjective state probabilities (thereby potentially affecting decision)
- Informative info = relevant & reliable
  - Can only increase informativeness if increase in relevance > decrease in reliability
  - Increase in informativeness = main diagonal Ps increase
  - Decrease in informativeness = off-main diagonal Ps increase
  - To maximize informativeness, must find most useful relevance/reliability trade-off (consider enhancing characteristics)
- The higher the main diagonal Ps relative to off-main diagonal Ps, the more informative/useful the system (lower estimation risk)

Conditional probabilities = link between current F/S info & future firm performance

Care about all sources of info (not just F/S) since more info = more useful

Ex: Supplementary information

Conservative accounting increases P(BN,L) relative to P(GN,H)

Ex: Recognition of unrealized losses but not gains

**Information:** evidence that has the potential to affect an individual's decision

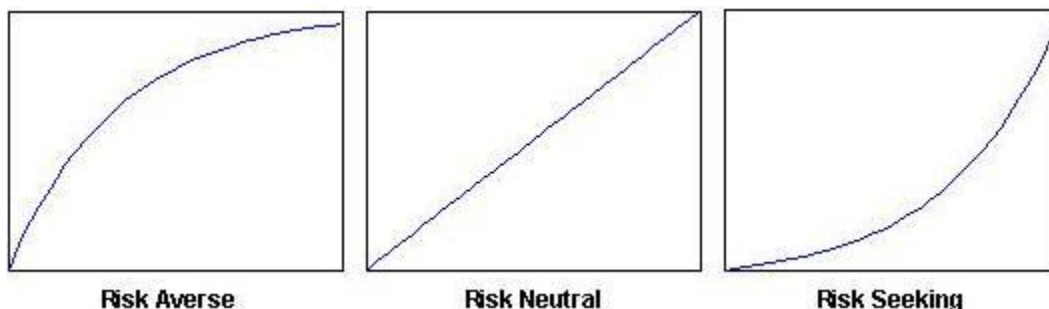
- Decision & individual specific
  - Info needed differs depending on user
  - Individuals make different decisions even when provided with same evidence (decision affected by personal characteristics & judgment)
- Benefits > Costs
  - If Costs > Benefits, won't use therefore not info
  - Costs: production, loss of competitive advantage, time & effort, lawsuits (more info released = more chance of error)

- F/S = info but many other info sources exist (analyst forecasts, media, web, speeches, announcements) so accountants face competition
  - Must supply useful, timely & cost-effective info to continue being important source

### 3.4 Rational, Risk-Averse Investor

Investors usually assumed to be risk-averse

- Trades off risk & return – demands higher return for higher risk
- Need info about risk & expected return



As payoff increases, utility increases @ decreasing rate (concave)

As payoff increases, utility increases (linear)

As payoff increases, utility increases @ increasing rate (convex)

Risk-neutral = reasonable assumption when payoffs = small

- Decision made based on expected payoff, risk does not matter per se

### 3.5 Portfolio Diversification

Total risk = Firm-specific risk (diversifiable) + Market risk (undiversifiable)

As diversification increases, firm-specific factors tend to cancel out

- Fully diversified portfolio (market portfolio):
  - Firm-specific risk cancels out completely
  - Only market risk left

### 3.6 MD&A

→ Management's outline & explanation of firm's operations/performance/condition to assist investors to interpret F/S

- Provides indication of future performance

- Discussion of trends, risks, uncertainties, future prospects – consistent with info system concept since provides connection between current & future performance
- Consistent with rational decision making – more info = better future predictions

Firm has choice on how much info to release

+ve:

- Builds investor confidence through reduced info asymmetry & full-disclosure reputation
  - Lower cost of capital
  - Higher demand for company shares (share P increases)

-ve:

- Potential lawsuits if forward-looking disclosures not met

Relevance – forward-looking therefore relevant compared to F/S (past-oriented)

Reliability – less than F/S since some estimates hard to verify

Major step by securities commission to increase decision usefulness

-Study shows +ve relationship between tone & next quarter earnings (persists for 3 quarters but becomes weaker)

+ve tone → expect good future performance

-ve tone → expect poor future performance

-Results show MD&A helps predict future performance therefore it's useful

-More info = more helpful in decision-making

### 3.7 Conceptual Framework

-F/S oriented to primary users' decisions

- Primary users = present & potential investors, lenders & other creditors

-States these users need info about “amount, timing and uncertainty” of future CFs

- Reference to uncertainty implies assumption of risk-aversion
- Decision usefulness implied

-Info system implied since suggests investors use current performance to revise probabilities of future firm performance

-Overall: Adoption of decision usefulness approach

Useful info = helps predict future performance (makes difference in decision-making)

Fundamental Characteristics:

1) Relevance

2) Reliability – faithfully representational

- Complete
- Free from material error

- Neutral (free from bias)

Enhancing Characteristics:

- 1) Timeliness
- 2) Comparability
- 3) Verifiability
- 4) Understandability

Conservatism:

- Increases relevance → recording write-downs anticipates lower FCFs
- Decreases reliability → write-downs subject to error & mgmt bias

## Chapter 4: Efficient Markets

Theory → Security prices fully reflect collective knowledge & information-processing ability of investors

Implications for Accounting:

- Full disclosure
- Reporting on firm risk

Markets not fully efficient but close enough for accountants to be guided by efficiency so question = what is the degree of efficiency?

As extent of inefficiency increases, importance of financial reporting increases

### 4.2 Efficient Securities Markets

Non-ideal conditions – info not free so investors must decide how much info & expertise to acquire (cost/benefit tradeoff)

Rational investors continuously revising subjective probabilities as they receive new info

#### General Definition (Semi-Strong Form):

An efficient securities market is one where the prices of securities at all times fully reflect all publicly known information about the securities

-Important points on efficiency:

1. Market prices = efficient with respect to publicly known info
2. Relative concept
  - Incomplete/wrong info causes wrong prices
3. Fair game – can't achieve abnormal return above expected return
4. Prices fluctuate randomly over time (random walk)
  - Only reason P changes = unexpected info & unexpected events, by def'n, occur randomly

-Once new info becomes publicly available, market P quickly adjusts

- Investors quick to revise beliefs & make investment decisions upon receipt of new info
- Rational investors may not react same way to same info
- Different prior beliefs & expertise cause different reactions
  - Market price = consensus forecast (average of decisions) – assume individual decisions = independent & unbiased so individual differences cancel out to reflect publicly available info
  - Market P has superior quality than individual estimates
- Does not guarantee prices fully reflect real firm value

### **Forms of Efficiency**

- 1) Weak: All past prices are reflected in current P
- 2) Semi-strong: Prices reflect all publicly available info
- 3) Strong: Prices reflect all info (public & private)
  - Unlikely due to high cost of eliminating inside info

## **4.3 Financial Reporting Implications**

### **1) Accounting Policies**

Accounting policies do not affect their security prices as long as:

- 1- No direct CF effects
- 2- Policies disclosed
- 3- Sufficient info given so reader can convert across different policies

Ex of policy choice: SL vs. DB amortization

- Efficient market should be able to see through the CF & div implications
- Policies affect NI but does not directly affect future CFs & div which are what investors are concerned with

### **2) Disclosure**

Management should disclose all relevant info (full disclosure)

- As long as it is cost-effective
- Investors use all available info to improve predictions so additional info not wasted
- Greater investor confidence

### **3) Naïve Investors**

Firms should not be concerned with naïve investors (no need to oversimplify F/S)

- If enough investors understand, market P will be the same as if everyone did
- Can hire experts or mimic decisions of informed investors

### **4) Role of Accountants**

In competition with other info providers

Must recognize importance of their role in reporting to society

## **4.4 Informativeness of Price**

Under efficiency, share price = fully informative

→ Inconsistency exists

- Investors have no motivation to acquire info since all info already reflected in market P (won't pay for extra info) so prices will no longer reflect available info

- From accounting perspective, what is the point of incurring costs of producing F/S if market already reflects all available info?

- Once share P stops being fully informative, investors would seek info to make prices informative again (process repeats itself)

- This is NOT actually what happens

→ Theory still holds

1. Noise traders: irrational investors with a personal purpose; might over or under value a security

- Incentive to gather more info since share may not be properly valued
- Share prices PARTIALLY informative

2. Risk

3. Voluntary disclosure: beyond min requirement of standards; 1<sup>st</sup> movers on this info can gain an advantage

- Mgmt won't want to disclose info that would result in loss of competitive advantage
- Can have credibility since potential legal liability & reputation damage impose discipline
- Can be used for signaling inside info

**Conclusion:** "fully reflect" should be interpreted with care

- Does not mean prices are fully informative in which case F/S would not be useful

- Prices are **partially informative**

## 4.5 CAPM

2 Types of Risk:

- 1) Market/systematic → Undiversifiable
- 2) Firm-specific/unsystematic → Diversifiable

CAPM:

- Investors should not be compensated for bearing firm-specific risk since can diversify away

- Implies that market risk (reflected by  $\beta$ ) is appropriate measure to determine return required by investors for holding a security

Ex post return – actual realized return (at end of period looking back)

Ex ante return – expected return (at beg of period looking forward)

$E(r)$  can be viewed as firm's cost of equity capital (what market demands)

## Uses

- 1) Dependency of share prices on expectations of future P & div
- 2) Separates realized returns into expected & unexpected components
- 3) Helps estimate stock's  $\beta$

## Limitations

- 1) Rational expectations – investors assumed to know  $\beta$ 
  - Beats may not be accurately known
- 2) Common knowledge
  - Better-informed investors will take advantage of share mispricing resulting from less informed investors rather than making diversified investment decisions that underlie CAPM
- 3) Transaction costs – assumed to be 0
  - Markets not perfectly liquid
  - Liquid market: investors can quickly & at a reasonable cost buy/sell securities
- 4) Investor rationality

\*This model is not realistic enough

## **4.6 Information Asymmetry**

**1) Adverse selection:** unknown parameter = honesty of insider

**2) Moral hazard:** unknown parameter = mgmt shirking

Investors' reaction = bid down prices of securities to protect themselves against estimation risk (or withdraw)

- Cost of capital increases
- CAPM understates cost of capital
- Prices bided down by expected amt of losses at hands of insiders

## Result

-Market incompleteness

-Markets do not work as well

-Regulation & voluntary disclosure used to reduce effects of info asymmetry & resulting estimation risk

-Extreme cases → market crash or fails to develop

**Fundamental value** of a share = value it would have in an efficient market if there is no inside info (all existing info = publicly available)

- Theoretical (can't completely eliminate inside info)

Financial reporting = convert inside info into outside info

- Goal = Bring efficient market P closer to fundamental value
- Difference between Fund value & EMP = inside info

- Can't fully eliminate inside info since cost too large but can reduce it through higher quality reporting:
  - Full & timely disclosure
  - Regulation
  - Voluntary disclosure

<b>Ideal Conditions</b>	<b>Non-Ideal Conditions</b>
MV reflects all info (no estimation risk) so $MV = \text{Fund V}$	MV reflects all public info (inside info exists) so $MV \neq \text{Fund V}$

## Chapter 5: Value Relevance of Accounting Information

Value relevance: when security prices respond to accounting information, accounting info has **value relevance**

Value Relevance Approach:

- Investors want to make own prediction of future returns (under non-ideal conditions) & are able to take in all useful info to do so
- Empirical research can help accountants to increase usefulness by letting market reaction guide them as to which info is/is not valued by investors

Investors & accountants may benefit from useful info but society may not

Reasons: cost, info affects people differently (cost-benefit)

→ Must be careful when equating usefulness with extent of volume/price change after release of new info

→ Value relevance still valid

- Markets work better if security prices provide good indicators of future performance
- Accountants can still try to provide most useful info
- Accountants can't claim best accounting policy = one that provides biggest market response

### 5.2 Research Problem

#### Reasons for Market Response

(To F/S info; specifically NI)

Predictions about Investor Behavior:

- Have prior beliefs about future firm performance based on available info up to release of earnings (differ across investors due to differing knowledge & ability)
  - Upon receipt of info → investors quickly revise beliefs
    - > Expected = GN (upward revision) → BUY
    - < Expected = BN (downward revision) → SELL
- Volume of shares traded increases (greater unexpected = greater volume)  
If more investors interpret GN than BN → P increases (& vice versa)

-Market will only react to earnings it did not expect

Market P reaction is a better measure of usefulness than volume reaction (noisier)

### **Finding Market Response**

(Difficult)

-EMT implies market reacts quickly to new info (in narrow window)

→ Must know when NI becomes publicly known

-GN/BN evaluated relative to expectation

→ Must obtain proxy for investors' expectation

Ex: previous earnings, analyst forecasts

-Difficult to find since there are many events that affect share P

→ Should separate market & firm-specific factors

Can use CAPM to estimate variables → Use past data on stock & market return

Difference between actual & expected return = abnormal/firm-specific return

+ve abnormal return – investors (on avg) reacted favorably to unexpected NI

-ve abnormal return – investors (on avg) reacted unfavorably to unexpected NI

→ Examine abnormal returns on either side of Day 0 (earnings announcement)

-Investors may learn news early

-Abnormal returns may continue for a few days before/after

→ Market response (abnormal returns) observed if investors found NI useful

Complications:

1. Firm-specific info comes around time of earnings announcement therefore difficult to tell if response is to earnings
2. Estimation of beta – regression using past data but may change over time
3. Which market portfolio to use?

### **5.3 B&B Study**

1<sup>st</sup> study to provide convincing evidence that share returns response to info content of F/S (aka F/S have value relevance)

#### **Study:**

-Examined returns over narrow window around earnings announcement date

-Proxy for expectation = prior year earnings

GN → earnings > last year

BN → earnings < last year

#### **Result:**

+ve avg abnormal market return in month of GN earnings announcements

-ve avg abnormal market return in month of BN earnings announcements

Conclusion → Market did respond to news regarding earnings

### **Causation vs. Association:**

Study repeated for wide window & showed market began to anticipate GN/BN as much as a year earlier

- 1) If reaction observed during narrow window → accounting info = cause
  - Relatively few firm-specific events other than NI in narrow window
  - NI CAUSES returns
- 2) If reaction observed during wide window → accounting info maybe not cause
  - There may be multiple other events affecting share P
  - Price leads earnings due to recognition lag (effects on P anticipated)
  - NI & returns ASSOCIATED

BCW Study: Greater the change in unexpected earnings = greater market response

### **5.4 Earnings Response Coefficients**

BB study – abnormal returns were averages

- Some firms' abnormal returns were above or below average
- Market response is greater for some firms than for others

ERC: measures extent of security's abnormal market return in response to the unexpected component of reported earnings of firm issuing that security

$$ERC = \frac{\text{Abnormal Share Return}}{\text{Unexpected Earnings}}$$

→ Gives abnormal return per dollar of abnormal earnings

### **Reasons for Differential Market Response**

#### **1) Beta – Higher $\beta$ = Lower ERC**

- Assume risk-averse investors
- Higher beta = riskier returns
- Investors use current earnings as indicator of future performance so the riskier the future returns are, the lower the investor reaction to abnormal earnings, leading to higher cost of capital

#### **2) Capital Structure – Higher leverage = Lower ERC**

- High leverage: increase in earnings adds safety to debt so most of GN goes to debt holders rather than shareholders

#### **3) Earnings Quality – Higher quality = Higher ERC**

- More informative = better predictions = higher reaction
- Measurements of earnings quality
  1. Earnings persistence - Higher persistence = Higher ERC
    - More persistent = better indication of future performance
    - Different components of NI have different persistence – separate them

- 1- Permanent: persist indefinitely
  - 2- Transitory: affects earnings in current yr but not future yrs
  - 3- Price-irrelevant: zero persistence
2. Accruals quality – Higher quality = Higher ERC
- NI = CF from operations +/- Net accruals
  - CF from operations less subject to error/bias so earnings quality depends mainly on quality of accruals
  - If manager uses control over actuals to influence reported NI, accruals said to be discretionary
  - Higher discretionary accruals are compared to CFs = lower quality
- 4) Growth Opportunities – Higher growth opportunities = Higher ERC**
- NI indicates possible future growth
- 5) Similarity of Investor Expectations – Higher similarity = Higher ERC**
- 6) Informativeness of Price – Higher informativeness = Lower ERC**
- Price lead earnings (reflects all publicly known info/anticipates GN/BN)
  - More informative P = less info content in earnings = lower ERC

### **Implications**

Improved understanding of market response = improved decision usefulness of F/S

- ERC increases with earnings quality – quality valued by investors
- ERC decreases with leverage – supports disclosure of liabilities
- Growth important to investors – supports disclosure of segment info, MD&A
- ERC increases with persistence – supports disclosure of components of NI

### **5.5 Caveat About Best Accounting Policy**

Is best accounting policy the one that produces the greatest market reaction?

Ans: To some extent since investors & accountants may be better off but not necessarily society as a whole

- Info = public good (consumption by 1 does not destroy it for another)
  - Can't charge for F/S – legislation requires production of F/S
  - Annual reports not free
  - Investors view F/S as free so consume a lot of it & may perceive accounting info as useful when from society's standpoint costs > benefits to investors
- Info affects people differently

→ Can't charge investors full cost of info they use so can't rely on extent of market response to tell us which accounting policy to use (and therefore how much info to produce)

### **Conclusion:**

-Accountants can be guided by market response to improve competitive position as suppliers of info

-Markets work better when security prices provide good indications of investment opportunities

-Social considerations suggest that accounting standard-setters should be wary of using market response as sole guide

## Chapter 6: Measurement Approach to Decision Usefulness

**Measurement approach to decision usefulness:** incorporation of current values into F/S proper, providing this can be done with reasonable reliability

- Goal = enable better predictions by means of more informative info system/  
increase decision usefulness
- Usefulness increases if increase in relevance > decrease in reliability

Reasons for moving towards measurement approach:

- Market not as efficient as previously believed
  - Non-rational behavior questions market efficiency
  - Close enough (except during liquidity pricing) to serve as guide
- Beta is not the only risk measure
- Clean surplus theory: low proportion of share P variability explained by HC-based NI
- Legal liability when firm is financially distressed

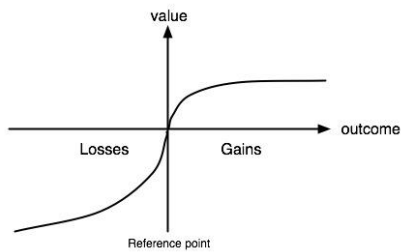
## 6.2 Are Markets Fully Efficient?

**Behavioral Characteristics Questioning Rationality/Efficiency:**

1. Limited attention: No time, inclination or ability to process all available info
  - Will concentrate on readily available info & ignore supp info
  - Under-reaction
2. Conservative: lower than avg revision of beliefs
  - Biased reactions
3. Overconfident: overestimation of precision of info collected yourself
  - Under-reaction to info not self-collected
4. Representativeness: assigning too much weight to evidence consistent with impressions
  - Over-reaction to current evidence (under-reaction to past evidence)
5. Self-attribution bias: believing good decision outcomes are due to own abilities & bad outcomes due to unfortunate state realizations (not at fault)
  - Momentum can develop if enough investors behave this way  
(reinforced confidence following rise in P leads to purchase of more shares, P rises further, process continues)
6. Motivated reasoning: accepting info consistent with preferences (GN) & skepticism/attempting to discredit info inconsistent with preferences (BN)

**Prospect Theory:** investor considering a risky investment (“prospect”) will separately evaluate prospective gains & losses

→ In decision theory, investors evaluate decisions based on total wealth



Utility for gains → risk-aversion  
 Utility for losses → risk-taking

- Theory assumes loss aversion
  - Rate of utility decrease for loss > rate of utility increase for gain
  - Implies strong -ve investor reaction to small reported loss, which creates mgmt incentive to avoid such small loss & manage earnings upward
  - Incentive declines for larger losses since -ve reaction not as great
  - More difficult to manage earnings sufficiently to avoid large loss
- Disposition effect: investor holds/buys losers & sells winners
- Assumes individuals under or over weight probabilities (leads to too low probabilities for likely states & too high probabilities for unlikely states)
  - Underweighting – from overconfidence
  - Overweighting – from representativeness

**Beta** – Not dead but other risk variables also explain share returns (B/M, firm size)  
 Higher B/M ratio = higher risk  
 Higher firm size = lower risk

- Contradicts CAPM which assumes beta = only firm-specific determinant of  $r$
- Study results show beta = significant predictor of return in LR
- CAPM assumes beta = stationary but may change – Additional volatility introduced to share P since different estimates of  $\beta$  = different decisions

Implications → increased role of F/S in reporting useful risk info

**Stock Market Bubble:** when share prices risk far above fundamental values

- Represents extreme case of market volatility – questions efficiency
- Can be attributed to a combination of behavioral factors which increase volatility
- Ex: Security price behavior leading up to 07-08 crisis
  - Does not necessarily contradict market efficiency
  - Relevant question = whether or not info publicly available to investors at the time was sufficient to diagnose actual riskiness

### 6.3 Efficient Securities Market Anomalies

(Inconsistencies with market efficiency due to behavior biases)

**1) PAD:** abnormal security returns tend to drift upward (GN)/downward (BN) for some time following earnings announcement  
 -Under efficiency – once earnings released, price reacts quickly

-Persists because investors ignore/don't understand/underestimate correlation between current & future earnings

## 2) Market Response to Accruals

NI = CF from Operations +/- Net Accruals

-Accruals more subject to estimation error & mgmt bias than CFs (lower reliability) so would expect stronger response to GN/BN the greater the CF component but does not happen

-The less reliable, the less persistent but investors ignore this lower persistence (the less reliable, the more investors overestimate persistence & the greater mispricing)

1- Returns of high accrual firms tend to drift downward over time rather than fall right away

2- Returns of low accrual firms tend to drift upward over time rather than fall right away

## 6.4 Limits to Arbitrage

→ These are the costs incurred by investors that limit their ability to fully exploit an anomaly & arbitrage it away

→ Would expect investors to correct biases but anomalies persist due to

-Complex environment make it hard to tell if reason for loss = bias or changes in economy

-Limits to arbitrage

1) **Transaction Costs:** brokerage commission, bid-ask spread, time & effort

2) **Risk:** from reduced diversification - investors try to earn higher return than market portfolio by investing in shares they perceive to be mispriced (arbitrage rather than diversified strategy)

Investors differ in: sophistication, transaction costs, risk

Large institutional investors trade on anomalies & can arbitrage anomalies away

Greater expertise & economies of scale = lower transaction costs & risk

## 6.5 Defense of Average Investor Rationality

Rational investors face estimation risk & refine estimates over time

- In face of estimation risk, will revise beliefs by less than if sure of persistence & by more than if sure of no persistence
- To reduce estimation risk, will seek additional info

If anomalies occur even if investors = rational, theory of investor rationality holds but markets not fully efficient → Rationality relaxed

**Adaptive market hypothesis:** investors are boundedly rational; when their environment changes, individuals do not react right away (as with rational

expectations assumption) but instead, they adapt to their new environment over time

→ Produces effects on returns similar to behavioral factors

-Prices react but with a delay (investors search for additional info)

-Investor reaction delay implies less than full market efficiency

-Higher accounting quality = lower delay

-Increase in delay = Increase in abnormal return

Higher estimation risk = Higher expected return

**High order beliefs:** investors make decisions based on their beliefs about the beliefs of others instead of on their own beliefs about states of nature

→ Produces effects on returns similar to behavioral factors

**Noise traders:** additional risk reducing demand

Market P of shares converges to fundamental value over time

-The above slow convergence of share P to FundV

-Does not follow efficiency (price changes exhibit serial correlation rather than random walk) but investors still rational

## 6.6 Summary of Securities Market Inefficiencies

In inefficient market, prices do not reflect fundamental value

Explained through: behavioral finance, noise traders, investors learning over time, high order beliefs

Inefficient P – does not include all publicly available info or incorporates it with bias

Role of financial reporting = reduce inefficiencies by making mispricing between inefficient & efficient P as small as possible & moving efficient P towards fundamental value

Better understanding of investor behavior = improve decision usefulness

-Fine tuning of full disclosure & transparency

-Relax rational expectations & common knowledge in favor of closer attention to investor behavior

## 6.7 Conclusion About Efficient & Rationality

Question: extent of efficiency?

- Markets not always fully efficient but reasonably close (except during periods of liquidity pricing) to be guided by theory but must realize convergence to efficient P may take time

Question: which best underlie market behavior; rational or behavioral theories?

- Market behavior = reasonably consistent with avg investor rationality but regardless both result in similar actions

## 6.8 Reasons Supporting Measurement Approach

Measurement approach can improve decision usefulness

- Markets not as efficient so investors need more help assessing probabilities than obtained with HC
- Firm value depends on fundamental accounting variables (clean surplus)
- Can reduce auditor's liability

## 6.9 Low Value Relevance of F/S Information

Studies show that most of info in NI already built into share P before announcement date so market response to GN/BN quite small

→ Questions value relevance

Earnings quality: ability of NI to predict company's future earnings

Value relevance: ability of info in F/S to capture firm value

$R^2$  = proportion of return explained by F/S info

ERC = abnormal change in share P for each dollar of unexpected NI

- Falling  $R^2$  & ERC but abnormal returns have been increasing  
Reason: Increased tendency of large firms to report other accounting info (active disclosure) at same time as earnings announcement  
Share P response to NI falling but response to earnings mgmt as a whole increasing

Conclusion → Little abnormal return explained by NI (low value relevance) so a lot of room to improve info content of F/S

- Recognition lag of NI in recognizing economically significant info lowers  $R^2$  & ERC – reason most GN/BN already reflected in share P
- Earnings quality could be improved by measurement approach since recognized value relevant events sooner

## 6.11 Auditor's Legal Liability

Auditors under pressure from mgmt & politicians to bend GAAP to meet targets

- Can result in substantial legal liability

Ex of auditing failures: Deloitte, Arthur Andersen (Enron)

How can auditors protect themselves against pressure & potential liabilities?

- Ethical behavior, conservative accounting, measurement approach
  - Conservative accounting requires impairment tests (version of CV)
  - CV requires greater use of estimates & judgment but because of legal liability, increase in relevance may be > decrease in reliability

## 6.13 Conclusion on Measurement Approach

- Behaviorally biased investors may need help figuring out full implications of accounting info – may be done by moving info like CV from notes to F/S
- Measurement approach has reliability problems so not all F/S can be on CV basis

## Chapter 7: Measurement Applications

### 7.2 Current Value Accounting

2 Versions of current value accounting:

- 1) **Value in use:** discounted PV of cash expected to be received or paid with respect to the use of the asset or liability
  - Reliability – issues exist since FCFs must be estimated (subject to error & managerial bias)
  - Relevance – ultimate but depends how item used & mgmt might strategically change how intends to use asset/liability
- 2) **Fair value:** price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date
  - IFRS 13
  - Market incompleteness prohibits having FV for all assets/liabilities
  - Well-working market P doesn't exist for all A&L (see hierarchy)

### FV Hierarchy for Assets & Liabilities

**Level 1** – Reasonably well-working market P exists

**Level 2** – Market P can be inferred from market P of similar items

**Level 3** – Market value can't be observed or inferred; use best available info about how market participant holding A/L would value item

IFRS 13 requires extensive supplementary disclosures about how FV determined Level 3 & to lesser extent level 2 – reliability concern since estimates & mgmt judgment required

Studies suggest relevance of FV > reliability about concerns

- Supports decision usefulness
- More so for level 1&2 than level 3

### **Current Value Accounting & Income Statement:**

CV – recognizes revenues before they are realized, since anticipated future CFs are capitalized into assets values

FV – recognizes gains & losses as changes in FV occur

HC – revenue recognized when considered to be realized

Using FV:

- Improves ability of NI to report on manager stewardship, assuming dual role
- Useful indication of future prospects

-BS of greater importance since NI explains changes in FVs

**Summary:**

Both types of CV offer higher relevance than HC but face reliability problems

Value in use → future CFs estimated & mgmt. may change intended use

FV → well-working market values may not exist

**7.3 Measurement Examples**

→ F/S based on mixed measurement model but contain substantial CV component

- 1) **A/R & A/P:** Valued at expected amount of cash to be received/paid
  - Length of time to payment is short so approximates PV
- 2) **CFs Fixed by Contract:** Valued at PV of future interest & principal payments
  - FINANCIAL leases initially valued at lower of FV of asset & PV of min lease payments
    - Rules regarding classification to avoid off-BS financing
- 3) **Inventories:** Valued at lower of cost or market
  - Can only be written up to cost
  - Justified by conservatism (reduces probability of overstatement)
- 4) **Revaluation Option for PPE:** PPE can be valued at FV if can be done reliably
- 5) **Impairment Test for PPE:** loss recorded if  $BV > \text{recoverable amount}$  where
  - Recoverable amt = greater of:
    1.  $FV - \text{Costs of disposal}$
    2. Value in use
  - Reversals allowed up to BV if no impairment loss had been recorded

**7.4 Financial Instruments**

Financial instrument: a contract that creates a financial asset for 1 firm and a financial liability or equity instrument for another firm

Financial Asset	Financial Liability	
Cash	Unfavorable contractual obligation	-Accounts/notes receivable/payable -Debt & equity securities -Bonds
Equity instrument of another firm		→ These are primary instruments (derivative instruments also exist)
Favorable contractual right		

## 7.5 Primary Financial Instruments

### Market Meltdown 07-08:

Following meltdown, FV writedowns were huge since MV = liquidity pricing

Management viewed these as excessive

Setter made modifications since they imposed FV accounting based on assumption that markets were working well

→ Stopgap measures due to political pressure from mgmt & regulators:

- IASB & FASB - When markets not working well, can determine FV by using own assumptions of FCFs
  - Reduced reliability (possible bias)
  - Required extensive supplementary disclosure of how determined
- FASB - Weakened rules requiring certain securities to be written down to FV if felt to be temporary
- IASB – Allowed reclassification of certain financial assets to relax FV under “rare” circumstances

### LR Changes:

IASB replaced previous standard for financial assets/liabilities \*IFRS 9

- Recorded at FV at acquisition
- Subsequent valuation
  - Liabilities – at amortized cost
  - Assets – at FV except business model is to collect interest & principal (at amortized cost & must be written down if impaired)
    - Standard makes it difficult to change intended use to affect PV since changes in business model expected to be rare
- Expanded supplementary disclosures
- Transfers between classes difficult since classification between 2 valuation bases requires change in business model (expected to be rare)

Classification of Financial Assets – US GAAP:

- 1) Trading – intention of reselling; valued at FV with unrealized gains/losses included in NI
- 2) Held to maturity – intention of holding until maturity; valued at amortized cost & written down to FV if impaired but can't be reversed (unlike IFRS 9)
- 3) Available for sale – valued at FV with unrealized gains/losses included in OCI

Allowing certain unrealized FV gains/losses to be included in OCI reduces NI volatility (since FV = volatile) → concession for mgmt dislike income volatility

**FV Option (IFRS 9):** At acquisition, firm can designate financial assets &/or liabilities that would normally be valued at amortized cost into FV category if this reduces a mismatch

Mismatch: earnings volatility in excess of real volatility facing firm; arises when some assets/liabilities are fair valued but related liabilities/assets are not

- Changes in FV under this option included in NI
  - If results from a change in credit risk, change included in OCI
- US has similar option without mismatch criteria

### **Conclusion:**

- IFRS 9 backs off somewhat from FV relative to US GAAP since allows increased use of amortized cost accounting by introducing business model concept
- Unless standards converge, seems F/S under US GAAP will exhibit greater use of FV
- Both standards attempt to reduce volatility of NI that FV accounting creates:
  - 1) Allowing certain unrealized gains/losses to be included in OCI
  - 2) FV option

## **7.7 Liquidity Risk & Financial Reporting Quality**

Lack of liquidity = Markets do not work as well

07/08 Meltdown – concerns about transparency of reporting contributed to lack of liquidity (higher concerns = lower buying = costs of buying/selling rose)

**Liquidity risk:** uncertainty about what buying & selling cost should be  
Higher liquidity risk = Higher cost of capital  
Higher financial reporting quality = Lower liquidity risk

## **7.8 Derecognition & Consolidation**

To control off-BS financing & bring it out in open

**Derecognition:** When asset is removed from BS & revenue recognized on resulting sale

- Usually at point of sale
- Alternative = retain transferred assets on BS & treat proceeds received as secured borrowing (firm borrows \$ & gives asset as security)
  - Appropriate if risks & rewards have not really been transferred to buyer
- Incentive to derecognize since improves leverage

Standards:

-Before meltdown left opening for firms to derecognize even though they retained some liability should the transferee suffer losses on the transferred assets (liability did not appear on firms' BS)

-Modified after meltdown

IFRS 9: derecognize when firm transfers substantially all risks & rewards of ownership of a financial asset but not if firm retains control of that asset (prevents off-BS abuses)

**Off-BS Financing:** method of financing with purpose of keeping large capital expenditure off BS

Incentives to use:

- Improve leverage ratios
- Hide capital expenditure
- Keep debt off BS

**Consolidation:** F/S of a group in which assets, liabilities, equity, income, expenses & CFs of parent company & its subsidiaries are presented as those of a single economic entity

- IFRS 10 – consolidation required when 1 entity controls other  
Control: When 1 entity has rights to the variable returns of another entity & can affect those returns through its power over that entity (power & risk)

New standards require substantial additional disclosures relating to consolidation & derecognition

Before meltdown → investors did not have enough info to fully evaluate off-BS activities which is why new standards were mandated

## 7.11 Accounting for Intangibles

Intangibles: capital assets that do not have physical substance

Ex: patents, trademarks, franchises, workforce, location, restructurings, IT, Internet site names, goodwill (general)

Valuation:

Reasonable certainty of future net benefits – at cost & amortized over useful life

Acquired in business combination & FV reliably determinable – FV at acquisition

Impairment: same as PPE

Impaired if recoverable amount < BV

Recoverable amt = > of:

1. FV net of costs to sell
2. Value in use

Intangibles make up much of firm value but value often difficult to establish reliably  
Value of intangibles appears through IS (value realized through earnings)

Goodwill: exists if firm earns more than its cost of capital on its net assets

Reporting goodwill on BS:

1. Increases relevance since reveals mgmt's inside info about future expected earning power
2. Serious reliability problems (somewhat less if purchased since estimated cost figures available)

1) Purchases goodwill – attained through business combination

Goodwill = Purchase Price – FV of Net Assets

- Not amortized but tested for impairment
- Writedowns can't be reversed
- Initial valuation & impairment writedowns (amt & timing) require judgment therefore possibility of opportunism

2) Self-developed goodwill – IAS 38 prohibits capitalization of internally generated goodwill (costs harder to determine) so expensed as incurred

EX: R&D

- Shows up as abnormal earnings in subsequent IS (this recognition lag is a major reason why share P responds to earnings announcements)
- Low proportion of abnormal return explained by NI (low value relevance of earnings) & declining
  - Due primarily due to failure to properly account for self-developed intangibles
  - R&D expensed so lower NI but market won't penalize firm to extent it expects +ve results & may even reward it (results in low association since share P responds positively to costs)

### Capitalization of R&D?

-LZ suggestion: Capitalize & amortize over estimated useful life if passes a test showing R&D project likely to be successful

-Reduces reliability but increases relevance since reveals inside info to market about firm's R&D efforts

Market reaction – Higher capitalized R&D = Higher share P

- Market reacts positively to increased profit R&D create
- Signalling effect – Market views amt spent on R&D as a signal of research potential (higher amt spent = higher potential)

→Mgmt will therefore overinvest in R&D

Market reaction once realize overvalued – bid down share P to reflect actual profitability (overinvestment remains since costs already incurred)

RESULT = FULLY REVEALING SIGNALLING EQUILIBRIUM

When reporting not completely reliable (some costs will be profitable & others no):

- Creates estimation risk so investors will not bid up share P as much as under complete reliability
- Firm's incentive to overinvest is reduced

CONCLUSION: In theory, considerable unreliability in reporting of R&D costs can be tolerated in situations where mgmt has incentive to over invest (supports LZ)

### 7.13 Conclusion

## Chapter 8: Efficient Contracting Approach to Decision Usefulness

2 roles of financial reporting:

- 1) Decision usefulness
  - 2) **Efficient corporate governance** – efficient contracting & responsible mgmt performance
- To enhance corporate governance, contracts must be efficient
  - Accounting contributes to efficient contracting since contracts usually depend on accounting variables (Ex: Debt contracts – covenants; Mgmt bonuses – earnings)
  - Theory assumes managers are rational – concerned about own self-interest
    - Managers may bias or manage contract variables for own benefit

### 8.2 What is Efficient Contracting Theory?

→ Studies role of financial accounting information in moderating info asymmetry between contracting parties, thereby contributing to efficient contracting & stewardship and efficient corporate governance

Info asymmetry:

- Mgmt possesses inside info about state of firm
  - Mgmt's effort not directly observable from outsiders
- Outsiders look to accounting info for protection

**Efficient contract:** optimal tradeoff between benefits & costs of contracting

Managers will only act in best interest of investors if this is also in own best interest causing conflicting interests among managers, lenders & shareholders

- Efficient contract design helps align conflicting interests

**Implicit contract:** arises from continuing business relationships

### 8.3 Sources of Efficient Contracting Demand for Accounting Info (Policies)

#### 1. Lenders

- Info asymmetry: Mgmt has best info about state of firm that may not share with lenders or may choose policies to hide such info so lenders demand protection

-Payoff asymmetry: Lose if firm performs poorly but gains limited therefore concerned with protecting themselves on downside so lenders demand policies that help prevent financial distress & provide early warning of distress

## 2. Shareholders

-Info asymmetry: Mgmt efforts can't be observed so shareholders demand policies that encourage responsible manager efforts & discourage opportunistic manager actions

## 8.4 Accounting Policies for Efficient Contracting

### Reliability:

- Lenders more concerned with BN future-oriented info (than GN)
  - Demand reliable info that protects them against opportunistic policies
  - More concerned with reliability than relevance relative to equity investors
  - Overstated performance reduces protection provided by debt covenants
- Info should be based on realized transactions & verifiable

### Conservatism:

- Payoff asymmetry creates demand from lenders for conditional conservatism (impairment tests)
  - Provides early warning sign of distress
  - By understating asset value, lenders provided with lower bound to evaluate security
- Conditional conservatism also demanded by equity holders for stewardship purposes
  - Makes it more difficult for managers to opportunistically manage earnings to enhance reputation/compensation
  - May motivate mgmt to correct actions leading to losses & alerts shareholders about losing operating/investing policies

## 8.6 Employee Stock Options

**ESO:** stock option issued to mgmt or other employees giving them the right to buy company stock over some time period

Old standard – way of not recording expense & failure to do so understates compensation cost & overstates NI

June 1993 – FASB proposed new standard

- Record compensation expense based on FV at grant date
- FV can be determined by Black-Scholes or other option pricing formula
  - Black-Scholes overstates FV of ESO at grant date (due to substantial probability of early exercise) so draft proposed using expected time to

exercise rather than expiry date in Black-Scholes formula which reduced overestimation

Expensing ESOs:

- Higher relevance – reduction in earnings anticipates lower div thereby helping investors predict FCFs
- Lower reliability – difficult to measure reliably since must know employee's optimal exercise strategy
  - Upward bias and possible error & bias in estimating timing of employees' early exercise decisions in face of wide variability of these decisions
  - Other Black-Scholes inputs (ex: share variability)

June 1994 – FASB dropped exposure draft since did not have sufficient support & turned to supplementary disclosure

-Lack of mgmt. support not surprising since overestimation of cost = underestimation of NI

Reporting scandals - senior executives attempted to increase value of their ESOs (by manipulating stock price)

### **Opportunistic Mgmt Tactics**

**GOAL** = increase probability that ESOs will be deep in the money

- 1) Pump & dump:** managers take actions to increase share value shortly before exercising options & sell shares before price fell back
- 2) Spring loading:** manipulation of ESO award date; pressure by mgmt to grant unscheduled ESOs shortly before GN (gives manager low exercise P & subsequent benefit as share P increases after release of GN)
- 3) Late timing:** Backdating of ESO awards to a date when share P was lower than at actual ESO grant date (not disclosing = violation of GAAP)
- 4) For firm with scheduled grant dates,** mgmt uses tactic to lower share P (ESO exercise P) leading up to award date & manages earnings upward after grant date
- 5) Use of mgmt discretion over accruals** to manage earnings downward during period that ESOs granted

2005 – Required to expense ex ante ESO cost

Consequences:

- Mgmt reacted to concerns about lower reported earnings by managing ESO expense downward
- Reduced use of ESOs as compensation device

### **8.7 Summary of ESO Expensing**

Mgmt objected to ESO expensing claiming:

- Lower share P
- Higher cost of capital
- Shortage of managerial/employee motivation

Possible reasons:

- Did not accept market efficiency
- Contracts (lower reported earnings increase possibility of debt covenant violation & decrease mgmt compensation if dependent on NI or if no longer get ESOs)

Seems compensation contracting not efficient if allowed for opportunistic tactics

### **8.8 Distinguishing Efficiency & Opportunism in Contracting**

Way to improve contract efficiency = income escalator clauses

Income escalator clause: increases covenant level of net worth firm is required to maintain by a % of NI

- Firms with such clauses more likely to choose conservative accounting policies since conservatism lowers reported NI hence lowers the increase in covenant net worth requirement
- Conservative accounting benefits lenders through asset retention & early warning sign of distress so encouragement of conservatism therefore increases debt holder confidence, enabling lower interest rate

Both efficient contracting & opportunism exist in real world

- Some manager accounting policy choice (even if within GAAP) may be opportunistic = failure of corporate governance
- Importance therefore on full disclosure so investors not misled  
If not: may face restatements, lawsuit, securities commission investigation which damage reputation of accountant & mgmt.

### **8.9 Summary of Efficient Contracting for Debt & Stewardship**

Theory asserts that accounting policy choice is part of firm's overall need to attain efficient contraction & corporate governance

- To attain efficiency contracting, info should be reliable & conservative
- Accounting policies matter to managers so may strategically choose them
- Firms face tradeoff in accounting policy flexibility granted to mgmt
  - Too little – contract inefficient when standards change
  - Too much – possibility of manager opportunism
  - Reasonable compromise = allow mgmt to choose policies in GAAP

### **8.10 Implicit Contracts**

(Not a formal contract)

**Implicit contracts:** trust-based relationships between firm and its customers/suppliers/investors

- Consistent profitability & reputation of transparent info environment creates trust (confidence)
- Firm rewarded with higher product P, better purchase terms, lower cost of debt & equity capital
- When firm's past behavior creates valid expectation that firm will continue to behave with integrity, implicit contract called a **constructive obligation**

### 8.11 Summary of Efficient Contracting

Raises 2 important questions:

- 1) Should Framework give greater recognition to verifiability such as moving it from enhancing characteristic to component of representational faithfulness?
  - Would strengthen reliability, reducing concern of mgmt opportunism
- 2) To what extent should F/S provide early warning sign of distress to DH?
  - Conditional conservatism does so by recognizing unrealized losses

Both opportunism & efficient contracting exist so it is possible to align manager & investor interests

### Chapter 9: An analysis of Conflict

**Agency theory:** study of design of contracts between principal & agent to motivate a rational agent to act on behalf of the principal when the agent's interests would otherwise conflict with those of the principal

→ **Efficient contract** does this at lowest cost to principal

Interest of principal & agent conflict

- Principal may want more effort than agent will to exert
- Often, too hard for principal to observe agent's effort which creates moral hazard problem
- Agent will work hard if motivated
  - Sources of motivation: reputation, ethics, compensation based on performance

2 important agency relationships:

1. Firm-Managers (employment contract)
2. Firm-Lenders (lending contract)

-Both types often depend on reported earnings (compensation based on earnings for managers & covenants based on earnings for lenders)

-Accounting policies matter to managers since affect compensation & covenant violation

NI has different role in managerial contracting than in reporting to investors  
Managers - monitor & motivate performance so needs to be sensitive to manager effort

Investors – provide useful info

\*Characteristics of NI needed to fulfill both roles not necessarily the same

## 9.2 Agency Theory

### Contract: Firm Owner – Manager

Actions of agent affect probabilities of payoffs

- Higher effort = Higher probability of high payoff
- Despite hard work, can still have low payoff since hard work can't always overcome risks faced by firm
- Despite shirking, can still have high payoff due to good economic times

Reservation utility: utility that could be attained by manager in next best employment opportunity

- Manager will only be willing to work for owner if his expected utility is at least = to opportunity cost (reservation utility)]
- Manager obviously wants  $E(U) > R(U)$  but if does not accept  $R(U)$ , firm would just hire someone else so manager willing to work for  $R(U)$

Once contract entered into, each party chooses actions that maximizes their utility  
Assume managers = effort-averse

- If managers receive same salary regardless of result, will have tendency to shirk (moral hazard)

### **Designing Contract to Control Moral Hazard:**

Option = refuse to hire manager but all managers would act the same so would either go out of business or run firm yourself - UNLIKELY

- Owners may not have required skills to run firm

### Other Options

1. Hire manager & put up with shirking – UNLIKELY
2. Direct monitoring at no cost – 1<sup>ST</sup> BEST
  - Can amend contract to pay manager less if shirks
  - Desirable risk-sharing
    - Manager bears no risk – good since risk-averse
    - Owner bears all risk – good since risk-neutral
  - Often unattainable – hard for owner to establish if manager is in fact working hard (moral hazard since manager knows his effort level).
3. Indirect monitoring – 1<sup>ST</sup> BEST
  - Impute effort (act) based on payoff observed

- Can amend contract to pay manager less if shirks
  - Desirable risk-sharing
  - Can't always be relied on
    - 1) Only possible in case of moving support (not fixed support)
      - Moving support: set of possible payoffs different depending on which act is taken
      - Fixed support: set of possible payoffs is fixed regardless of act
    - 2) Legal/institutional factors may prevent sufficient penalization of manager to force no shirking
4. Owner rents to manager - INEFFICIENT
- Owner gives manager firm (manager gets 100% of profits) for a fixed rental fee
  - Owner no longer cares about manager actions since fixed rental fee received regardless
  - Owner worse off due to inefficient risk-sharing
    - Owner bears no risk – bad since risk-neutral
    - Manager bears all risk – bad since risk-averse
    - Owner faces agency cost – must lower rent to make up for additional risk of manager (loses utility)
5. Give manager share of profits – 2<sup>ND</sup> BEST
- Problem = payoff not fully observable until next period yet manager must be compensated at end of current period
    - Solution = base compensation on performance measure (jointly observable variable that is informative about manager effort)
    - NI used but not fully informative of effort due to poor corporate governance allowing error/bias & recognition lag
    - NI = noisy, unbiased message about payoff (payoff predictor)  
Greater noise = less precise prediction of future payoff

-More risk borne by manager = higher profit share needed to overcome manager's risk-aversion & enable  $R(U)$  to be attained

More profit to manager = less for owner = higher agency cost

-Noisy NI = additional compensation risk for manager

-Min compensation risk needed to motivate manager = Lowest agency costs

-Lowest agency cost = most efficient contract

-Less noisy NI reduces compensation risk = Lower profit sharing = Higher efficiency

Less noisy = more precise

Incentive compatibility: terms of contract motivate manager to work hard (incentive to work hard = compatible with owner interests)

### 9.3 Manager's Information Advantage

Can decrease noisiness of NI through improved measurement

NI not unbiased – managers may manage reported earnings

Manager Information Advantages:

1. Pre-contract info: info about payoff before signing contract
  2. Pre-decision info: info about payoff after signing but before choosing act
  3. Post-decision info: info about payoff after choosing act but before report
- 1) Manager know actual effort level which is unobservable by owner  
2) Manager knows realized NI but owner only knows reported NI = potential bias

Controlling Earning Management:

Earnings management can lead to shirking

- Strengthen corporate governance
  - GAAP & competent audit control magnitude of earnings mgmt
- Limit through GAAP to restore mgmt incentive to work hard
- Can't complete eliminate (not cost-effective)

## 9.4 Summary

- If manager effort can be observed (directly or indirectly): fixed salary subject to penalty if manager shirks (1<sup>st</sup> best)
  - Performance measure = effort
- If manager effort can't be observed: share of NI (2<sup>nd</sup> best)
  - Performance measure = NI
- If effort, payoff, & NI unobservable: rental contract (inefficient)
  - No performance measure; max agency cost since all risk on manager

2<sup>nd</sup> best contract – lowest risk on manager while maintaining reservation utility & manager's incentive to work hard

Higher precision of NI = Higher efficiency of compensation contract

NI as performance measure – manager has info advantage over owner

- Mgmt controls accounting system while owner only observes reported # leading to possible earnings management
- Incentive for managers to work hard maintained through efficient corporate governance

Ethical behavior of manager increases contract efficiency

## 9.5 Protecting Lenders from Manager Information Advantage

Moral hazard – managers can act opportunistically against best interests of lenders

Ex: paying excess div, undertaking additional borrowing, undertaking excessively risky projects

→ Probability reduced by concern about reputation but not by enough

Ways to motivate managers to act in lenders' best interests:

- Rational lenders anticipate manager behavior & raise interest rate
- Debt covenants
  - Lowers interest rate
  - Do not guarantee firm will avoid distress (earnings management possible as firm approaches distress)
- Require management to hold company debt (manager becomes lender)
  - Possible result = managers too safe (against SH interests)
  - Optimal contract includes manager compensation based on E&D
    - E proportion high when significant growth opportunities
    - D proportion high when substantial risk of bankruptcy
    -

## 9.6 Implications for Accounting

2<sup>nd</sup> best contract can be made more efficient by basing it on 2<sup>nd</sup> performance measure in addition to NI (ex: share P)

- Reduces agency costs
- Provided 2<sup>nd</sup> measure = observable & contains additional info about manager effort (not contained in 1<sup>st</sup> measure)
- Share P reflects info content of NI + more info

Under EMT, NI competes with other info sources for investors

Under AT, NI competes with other info sources for motivating managers

Required characteristics of PM to contribute to efficiency:

- Sensitivity: rate at which expected value of a performance measure increases as manager works harder/decreases as manager shirks
  - Unbiased = expected value increases at same rate as payoff
- Precision: in predicting payoff from current manager effort
  - Precise = low probability that differs substantially from payoff
  - Reduces manager's compensation risk

NI = biased predictor of payoff (mixed measurement) → tradeoff between sensitivity & precision

- CV increases sensitivity but reduces precision - recognizes income sooner
- Goal for accountants = obtain best tradeoff
- Characteristics of NI needed to fulfill manager performance-enhancing role (sensitivity & precision) may not be the same as those needed to fulfill usefulness role to investors (relevance & reliability)

### Contract Rigidity

-Impossible to anticipate all contingencies (states) when entering into a contract

-Contracts that don't anticipate all possible state realizations = **incomplete**

- Unforeseen state realizations impose costs on firm and/or manager
- Can have possible renegotiation built into contract beforehand
  - If generous towards manager, may reduce effort

## 9.7 Conclusion

EMT → choice of accounting policy doesn't matter since market will see through to ultimate CF implications (as long as discloses)  
 BUT managers care about changes in accounting policies since they affect provisions in contracts

- Policies affect NI & compensation can be based on NI
- Policies affect different covenant variables

## Chapter 10: Executive Compensation

**Executive compensation plan:** agency contract between firm & its manager that attempts to align interests of owners & managers by basing manager's compensation on 1 or more measures of manager's performance

→ Usually based on NI & share P

NI's role in motivating manager performance is equally as important as its role in informing investors

NI needs to be sensitive & precise to be informative of manager effort

## 10.2 Are Incentive Contracts Necessary?

Fama: Not necessary because managerial labour market controls moral hazard

- 1) If manager develops reputation of high payoffs, MV (compensation he can demand) will increase/If manager shirks & develops reputation of low payoffs, MV will decrease

Result → Manager won't shirk

- 2) Internal monitoring – Shirking by lower level managers will be reported by managers below them looking to get ahead

ARGUMENT: If manager contemplates downward effect of current shirking on reservation utility of future employment contracts, shirking will be deterred

→ Does not consider manager may be able to disguise effects of shirking (at least in short run) by managing release of info therefore managerial labour market subject to adverse selection and moral hazard

- GAAP limits ability to shirk to some extent
- Will eventually be discovered as accruals reverse (reputation lost)

If expected costs of lost reputation strong enough to supply missing effort motivation, incentive contracts would not be necessary but reputation is not completely effective in motivating effort

Conclusion: internal & market forces can help control manager's tendency to shirk but do not eliminate it

→ Incentive based contracts therefore desirable for efficient contracting

### 10.3 Managerial Compensation Plan

Maximizing current performance may be at expense of LR interests

ESOs & share ownership give executives longer-term interest in success of firm

- Reduces temptation to engage in opportunistic practices to increase earnings in SR
- Encourages longer-term decision horizon

Compensation risk faced by investors → economy/industry events may affect earnings & share P but are not informative about mgmt effort, firm-specific risk also exists

- Agents must bear risk if they are to work hard
- Too much requires increased compensation for risk-averse manager or generates opportunistic behavior

3 main incentive components:

- 1) ST – based on earnings & individual achievement
- 2) LT – stock options whose value depends on share P performance
- 3) MT - value depends on both

### 10.4 Theory of Executive Compensation

**Relative weights of NI & share P in evaluating manager performance:**

Lower noise (higher precision) or Higher sensitivity = Greater proportion

Increasing sensitivity of NI

- CV improves sensitivity of NI (reduced recognition lag) but reduces precision
- Full disclosure (effort & thus persistence better evaluated)

Share P has little precision (affected by economy-wide factors which create volatility) but sufficiently sensitive (reveals additional payoff info beyond that contained in NI)

Proportion of each measure influences decision horizon

More based on share P = LT → substantial investment opportunities

More based on NI = ST → short-run initiatives such as cost-cutting

Decision horizon traded off with sensitive & precision

Increase weight on PM (even if results in decision horizon other than what wanted) if that PM reflects informative mix of sensitivity & precision

→ Tells more about effort therefore increases efficiency of contract

### **Risk in Executive Compensation:**

Risk-averse manager trades risk & return

More risk manager bears = Higher expected compensation

To motivate manager @ lowest cost:

- 1) Get most motivation for given amount of risk
- 2) Least risk for given level of motivation

Too much risk → manager may underinvest in risky projects, decision horizon shortened, managers encouraged to inflate earnings in ST (against LT interests), excessive hedging

Too little risk → low manager effort

Ways of controlling compensation risk:

- 1) Relative performance evaluation (RPE): performance measured by difference between firm's NI and/or share P & avg performance of a peer group of similar firms
  - Systematic risk filtered out so better reflect mgmt effort
  - Weak supporting evidence
- 2) Bogey: level of financial performance that must be reached for incentive compensation to kick in
  - If not, would have -ve compensation (personal bankruptcy not best motivator)
  - Limits downside risk - upside risk should therefore be limited too if not would have everything to gain & little to lose which may result in excess risk taking
    - Cap: level at which incentive compensation ceases
    - Conservative accounting (through delaying recognition of unrealized gains & discouraging premature rev recognition)
      - Constrains ability to manage earnings
- 3) Discretion of compensation committee of BOD
  - If overly generous in not penalizing mgmt for things not its fault, will reduce effort incentive

### **ESOs**

- Lowest can be worth = 0 but much to gain → encourages risk taking
- Cost to shareholders = dilution + inefficient contracts
- Higher value of ESO holdings = Greater incentive to misstate F/S
- Encourage upside risk & longer-run decision horizon

### **Conclusion:**

Mix of performance measures desirable

- 1) Share P-based compensation → encourages upside risk, encourages risk taking, incentive to invest in risky projects
- 2) NI-based compensation → imposes downside risk, discourages excessive risk taking, little incentive to invest in risky projects

Managers may attempt to shed risk by selling shares/options or excessive hedging  
 -Decreases effort incentive so contracts should limit such behavior

## 10.6 Politics of Executive Compensation

- JM: top managers not overpaid but compensation too unrelated to performance, did not bear enough risk to motivate good performance so recommended larger manager stock holdings
  - Would expect pay-performance relationship to be low for larger firms due to size effect
  - Difficult to put much downside risk on executive of larger firms (much too loose from small decline in firm value which can result in excessive avoidance of risky projects)
    - Pay-performance relationship lowered by including low-persistence losses (imposes excessive downside risk) & limited upside risk
- GM: moral hazard problem increases with firm size due to increased complexity of corporate governance & increased opportunity for manager opportunistic behavior

→ Both suggest managers not overpaid; higher compensation driven by increase in costs if overcoming moral hazard (to reimburse manager for utility costs if risk & effort)

-To reduce ESO abuses (ex: Enron & WorldCom), firms issued restarted stock  
 Adv over ESO = can't be sold during a fixed period so less flexibility to opportunistically time sale

-Political opposition to manager compensation has increased due to adverse public reaction to bonuses paid to financial institutions involved in 07/08 meltdown

-Due to deferral of bonuses & requirements to hold share-based compensation for some time, managers bear firm-specific risk

Value (Utility) to managers < Cost to firm

-Golden parachutes (part of compensation contract that grants a substantial severance pmt regardless of reason for leaving) = source of political pressure

- RX: Probability & magnitude of severance pay increases as incentive effect of stock/ESO holdings falls (when stock P is low)
  - Otherwise, managers would be less inclined to adopt risky/LT projects (severance pay raises inclination closer to desired level)

& also increases for younger top executives (suffer more from loss of reputation/compensation) and with probability of distress/take over (higher likelihood of top mgmt being fired)

→ Results show that severance pay = important way to control risk in compensation contract

Political controversy regarding perceived excess compensation continues (reinforced by mgmt abuses)

## 10.7 Power Theory of Executive Compensation

Suggests executive compensation in practice driven by manager opportunism not efficient contracting

Idea: Managers have sufficient power to influence their own compensation & they will use this power to generate excessive pay at expense of SH value

- Receive  $> R(U)$  – efficient contracting says market forces prevent this
- Source of power = ability of CEO to influence BOD (including compensation committee)
  - CEO can influence director appointment
  - Directors may want to avoid anti-management reputation
- Limits to manager's power over compensation
  1. Outrage (if compensation too high, attracts -ve publicity & Board will have to step in)
    - Ways to hide excessive compensation exist
      - Hire compensation consultants to add legitimacy (may want to make executives happy not to get bad rep)
      - Tie total compensation to peer group of similar companies
  2. Market for corporate control (discontent SH may result in take over or dismissal)
- Weaker corporate governance = Greater manager power
- Has some validity – extent of validity depends on quality of corp governance

Accountants can assist corporate governance

- Full disclosure – helps tie pay to performance
- Expensing ESOs – reduces incentive for excessive ESO compensation & encourages firms to move to more efficient vehicles such as restricted stock

Attempts to control excessive pay:

- Security commissions require full disclosure of executive compensation so users have enough info to determine if excess
- Limit amount of manager compensation deductible for tax purposes

## 10.8 Social Significance of Well-Working Managerial Labour Markets

More informative PM = more efficient compensation contracts = better reporting on stewardship = better operation of managerial labour market = higher firm productivity & social welfare

Informative = appropriate sensitivity/precision tradeoff + full disclosure

## 10.9 Conclusion

- Labour market subject to adverse selection (ex: earnings mgmt to disguise shirking) so incentive contracts still necessary but reduce severity of moral hazard (by taking reputation into account)
- Executive compensation contracts require balance of incentives, risk & decision horizon
- Components of compensation usually based on several PM: individual achievement, NI, share P
- Financial reporting has important role in motivating executive performance & controlling manager power
  - Full disclosure – to better relate pay to performance
  - Expensing ESOs – to help control abuse & encourage more efficient compensation vehicles

## Chapter 11: Earnings Management

- Some earnings management can be useful as it can communicate mgmt's inside info to investors
- Managers can choose accounting policies from a set (GAAP) so they will choose policies that help achieve their objectives
- Study of earnings mgmt is important to improve understanding of usefulness of NI (for reporting to investors & contracting)

**Earnings management:** choice by a manager of accounting policies, or real actions, affecting earnings as to achieve some specific reported earnings objective

- Policies → policy per se & discretionary accruals
  - Accruals reverse – if used to manage earnings upward in current period, will force earnings downward in future
- Real variables (more costly but lower risk of legal/reputation consequences)

Fine line between earnings management & misleading/fraudulent reporting  
→ Need effective corporate governance reinforced by standard setters

## 11.2 Patterns of Earnings Management

- 1) **Taking a bath:** if firm reports loss, mgmt may feel might as well report a large one since writeoffs will increase probability of future CFs as accruals reverse
- 2) **Income minimization:** less extreme than taking a bath; may be used during periods of high profitability or for tax considerations
- 3) **Income maximization:** may be used for bonus purposes or to avoid covenant violation
- 4) **Income smoothing:** may be used to receive relatively constant compensation, to reduce NI volatility to smooth covenant ratios over time (decrease probability of violation), to reduce likelihood of reporting low earnings not to get fired, to convey inside info to market by communicating firm's expected persistent earning power

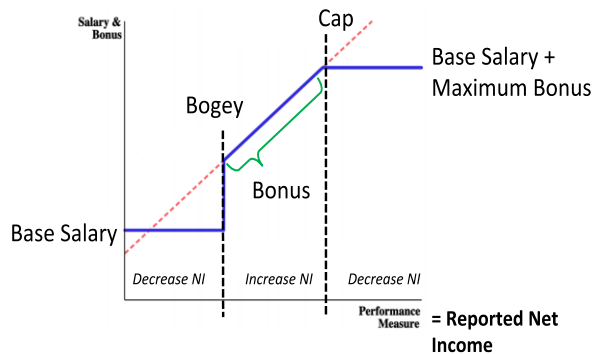
→ May have conflicting needs during point in time or needs may change over time

## 11.3 Evidence of Earnings Management for Bonus Purposes

Healy: Since outside parties can't know what actual earnings # is, predicted managers would manage NI so as to maximize bonuses

Cap → bonus ceases beyond a certain level

Bogey → bonus only kicks in when specified level of financial performance reached



Bogey-Cap → Bonus increase linearly

$NI \leq \text{Bogey} \rightarrow \text{Bonus} = 0$

$NI \geq \text{Cap} \rightarrow \text{Bonus} = \text{Constant}$

If no cap, bonus would continue to increase linearly from bogey

Called piecewise linear

### Incentives to Manage NI:

1. NI below bogey – incentive to take a bath since writeoffs will reduce future amortization charges so higher probability of receiving bonus in future
2. NI above cap – incentive to minimize income
3. NI between bogey & cap – incentive to increase income

## 11.4 Other Motivations for Earnings Management

(In addition to bonus contracts)

- 1) Other contracting motivations
  - Avoidance of debt covenant violations
    - Violation imposes heavy costs on firm
      1. Direct – higher interest rate
      2. Indirect – impaired business relationships, reduced ability to raise financing in future
    - Public debt contracts contain less stringent covenants to compensate for greater rigidity compared to private
- 2) To meet investors' earnings expectations
  - Investors revise probabilities of future performance based on unexpected earnings
    - Earnings > Expected (GN) → Share P increase
    - Earnings < Expected (BN) → Share P decrease
  - Market seems to penalize firms for BN by more than it rewards firms for GN
  - If firm does not meet expectations explanation can be:
    - 1) Plausible – increased forecasts & opinion of mgmt
    - 2) Non-plausible – decreased forecasts & opinion of mgmt.
  - Consequences of failure to meet expectations
    - Direct effect – share P & cost of capital as investors revise probabilities of good future performance downward
    - Indirect effect – reputation (particularly if explanation perceives as excuses)
- 3) Stock Offerings
  - If firm plans to issue new/additional shares, mgmt may be tempted to manage earnings upward to maximize amt received from issue
  - Investors may or may not fully anticipate such earnings mgmt
    - If does → no share P decline as firm reports lower future NI
    - If doesn't → share P declines as investors realize overpaid

## 11.5 Good Side Of Earnings Management

Blocked communication: when agent obtains specialized info as part of his expertise but such info can be prohibitively costly to communicate to principal

- Can reduce efficiency of contracts – agent may shirk on info acquisition
- Can be reduced by earnings management by “unblocking” inside info

-Market knows manager would not report higher earnings than can be sustained  
Due to: oversight, inevitable reduction in future earnings will punish him through market reaction

- Credibility of unblocking reinforced by confirmatory role of NI which has 2 roles:
  1. Inform investors about future expected earning power (inside info)
  2. Confirm honesty to investors (misstatements will be revealed)
- Earnings management to unblock communication can be upward or downward

## 11.6 Bad Side of Earnings Management

- Opportunistic manager behavior
  - To maximize bonus
  - To overvalue share P to maximize proceeds of new issues
- Excess provisions of low-persistence special items (impairment writedowns, costs of restructuring) to increase future earnings
  - Market interprets frequency/amt as proxy for potential misuse (would not be so if effect on earnings of past provisions was disclosed)
  - Standard setters took such bad earnings mgmt into consideration
    - IAS 37: provision = liability for which timing/amount of future pmts are uncertain & to be recorded, such pmts must be probable (more likely than not) & capable of reliable estimation

Analyst increasingly providing operating CF forecasts as well as earnings forecasts

- This provides forecast of operating accruals (can compare to actual)
- Result = increase transparency of accruals-based earnings mgmt
- Mgmt resorted to other tactics (real variables & talking down analysts who's forecasts > expected by mgmt) but overall result = reduced bad earnings mgmt & improved corporate governance

Research shows that in countries with lower investor protection, there was more earnings management

Less investor protection = More opportunistic earnings mgmt

### Do managers accept securities market efficiency?

Yes – rely on poor disclosure to keep extent of earnings mgmt as inside info

No – reminder of low persistence prior year's special item gain > loss (encourages investors to ignore prior gain so benchmark lowered to increase chance of showing improvement)

No – managers emphasis on pro-forma earnings (when GAAP IS available, efficient market would quickly adjust for useful items omitted from pro-forma)

No – contracting variables & accounting policies matter to managers since they think market will not see them through

### Manager's Speech & Bad Earnings Management:

Written/spoken words reveal underlying beliefs about future performance & whether truthful in communication these beliefs

**Cognitive dissonance:** guilt felt when person behaves in a manner contrary to that person's self-perception

- Individual subject to cognitive dissonance will try to reduce it by
  - Attempting to change beliefs
  - Back-off from dissonance-creating statement
- The more cues exist that manager is suffering from cognitive dissonance, the more skepticism there is around manager's initial statement (bad earnings mgmt more likely)
- Once managers know speech being analyzed, will likely learn strategies to be better at hiding truth

### **Implications for Accountants**

Not to reject market efficient but instead improve disclosure to bring earnings management into open

- Advantages of high quality disclosure
  - Helps investors evaluate F/S
  - Reduces manager's incentive to exploit poor corporate governance \* market inefficiencies
  - Reduces mgmt's ability to overstate expected performance through speech
  - Assists corporate governance (can reward good mgmt performance)
- Improving disclosure includes:
  - Clear revenue recognition policies
  - Detailed descriptions of low-persistence items & discretionary accruals
  - Effects on current earnings of previous special writeoffs

### **11.7 Conclusion**

Earnings management possible since true NI doesn't exist & GAAP leaves flexibility for managers in choosing accounting policies

Financial reporting = compromise between needs of investors & managers

-Many other factors affect choice of policies than informativeness to investors

Earnings management useful if kept within bounds

### **Chapter 12: Standard Setting – Economic Issues**

Standard setting = form of regulation, ultimately responsibility of govt

Govt's typically delegate responsibility to specific agency (securities commissions)

Agencies delegate responsibility to semi-autonomous bodies

IASB, AcSB, FASB → called regulators (standard-setting bodies)

Standard setter = mediator between conflicting interests of investors & managers

Socially right amount of info = amt that equates marginal social benefits of info production to the marginal social costs of info production  
→ Called FIRST BEST amount of info production

First best not possible to attain

- Market without regulation – info asymmetry exists since users don't pay for info so producers under-produce
- Standard setters – regulation has cost so must determine *extent*  
*Too little standard setting = too much info asymmetry*  
*Too much standard setting = greater cost on society than benefits of lower info asymmetry*

Deregulation – followed from belief that markets can be relied upon to produce enough info

- Enron, WorldCom, market crash resulted in increased regulation

## 12.2 Regulation of Economic Activity

Reasons for regulation:

- To increase info production to compensate for underproduction (Externality → actions of 1 party affect outside parties)
- To protect individuals who are at an info disadvantage due to info asymmetry

**Standard setting:** regulation of firms' info production decisions by a regulator

Type of info manager possesses:

1. Proprietary info: directly affects future CFs; costs of releasing such info can be quite high  
Ex: info about patents, plans for strategic initiatives (takeovers, mergers)
2. Non-proprietary info: does not directly affect CFs  
Ex: F/S info, earnings forecasts, details of new financing, audit

## 12.4 1<sup>st</sup>-Best Information Production

Benefits of info production:

- Better-informed investment decisions
- Lower cost of capital
- Better-working markets due to greater investor confidence from lower info asymmetry

Costs of info production:

- Direct costs of preparation & release
- Possible release of proprietary info
- Possible increased contracting costs

For some competitive industries with large # of firms & customers → market forces can approximate first best with relatively little regulation

Ex: agriculture & other commodities

Characteristics of info & costs/benefits to society so complex that market forces alone unlikely to attain 1<sup>st</sup> best

## 12.5 Market Failures in Production of Information

(Preventing 1<sup>st</sup>-best)

### 1) Externalities & Free-Riding

*Externality*: action taken by firm/individual that imposes costs/benefits on other firms/individuals for which entity creating externality is not charged or does not receive revenue

*Free-riding*: receipt by firm/individual of a benefit from an externality at little or no cost

- Costs/benefits of info production perceived by firm differ from those to society
- Investors won't pay for info since use by 1 individual does not destroy use for another (investors can "free-ride")
- Firm can't generate revenue from info production so will produce less than it would otherwise
- Regulator tries to restore social correct amount of production

### 2) Adverse Selection

- Insider trading – useful info withheld from market for insiders' benefit
- Managers postpone/avoid releasing -ve info

### 3) Moral Hazard

- Managers can disguise shirking by opportunistically managing earnings &/or by reducing voluntary disclosure → part of reason NI not completely informative about effort

### 4) Unanimity

- If markets work well, shareholders will be unanimously in favour of manager maximizing firm value
- Markets that don't work well (due to info asymmetry) lack unanimity
  - Manager motivated to choose info production that maximizes firm value
  - SH prefer high-quality info (demand more info than manager willing to supply)

**Conclusion:** For markets to work well, need combination of regulation & private info production

## 12.6 Contractual Incentives for Info Production

(No regulator needed to force production)

- To monitor compliance with contracts

Ex: observable measure of operations off which to base manager compensation or ratios off which covenants based

- When private firm goes public
  - New investors will bear some of shirking costs so manager will engage in more shirking once firm goes public (moral hazard)
  - Incentive to exploit inside info at expense of new investors (adverse selection)
  - Investors will be aware of these agency costs & bid down amt willing to pay for new issue by expected amt of costs
  - Manager now has incentive to release high quality info (ex: appoint prestigious auditor or adopt conservative accounting which decreases manager ability to recognize unrealized gains)

### 12.7 Market-Based Incentives for Info Production

- Managerial labour market
  - If release poor-quality info, manager will suffer damage to reputation
  - Reputation consideration reduces amt of incentive needed to motivate manager
- Capital market
  - More info = increased investor confidence = higher share P/lower cost of capital → Higher profitability = Higher utility/compensation for manager
- Takeover market
  - Higher failure to increase firm value = More upset SH = more likely takeover = more likely replacement of manager

### 12.8 Closer Look at Market-Based Incentives

**Disclosure Principal:** managers will release all info, good or bad

- Investors assume that if managers will release info if favorable so if info is not released, investors will assume it is bad & bid down share P
- Therefore managers may as well release even the unfavorable info
  - Any release of credible info will prevent MV from falling as low as it would otherwise
- Does not always hold
  - Manager will only disclose info if cost-effective (disclosure has costs)
  - Can break down due to conflict between info desired by investors & info needed for contracting purposes

**Signalling:**

Signal: action taken by a high-type manager that would not be rational if that manager was low-type

- Must be less costly for a high-type manager than for low-type (what gives signal its credibility since irrational for low-type to mimic high-type)
- Action = signal of competence
- Examples:
  - Proportion of equity retained by manager making an IPO – high-type would retain larger proportion
  - Auditor quality – high-type can afford to hire high-quality auditor
  - Forecast – high-type more likely to release GN forecast
  - Voluntary disclosure – high-type more likely to release more info
  - Capital structure – high-type firm more likely to issue bonds or finance internally
  - Dividend policy – high-type more likely to pay more div but not as effective since high div may also mean little prospect for profitable projects that could be financed internally through RE
  - Accounting policy – high-type can afford to use conservatism
  - Earnings mgmt – high-type more likely to take part in good earnings mgmt (way to release inside info to outside)

Manager must have a choice – standards to enforce uniform accounting destroy manager's ability to signal

-Diverse reporting practices can be undesirable due to reduced comparability (impose costs of restating F/S to common basis)

-To extent that firms' choices of signal credible info about firm, diversity of reporting practices = desirable

### **Private Information Search:**

More info = higher manager reputation, lower investor estimation risk, lower cost of capital

Investors may not be passive but may actually conduct private info search in presence of noise traders or market inefficiencies (which cause investors to be less price-protected)

- Limits time available to insiders to capitalize on inside info so adverse selection problem reduced
- Costly from society's perspective → >1 investors incurs costs to discover same info (cheaper if firm produced info once making it public)

### **12.9 Are Firms Rewarded for Superior Disclosure?**

Benefits = higher share P & lower cost of capital

Ways to achieve such benefits:

- Improve ability of investors to diversify

- Only some investors know about each firm so can't fully diversify so market risk not diversified away
- Higher risk = higher cost of capital
- Superior disclosure increases investors knowledge about firms
- Improve liquidity
  - Voluntary disclosure reduces info asymmetry thereby increasing liquidity
  - Higher liquidity attracts more investors = higher demand
- Reduce investor estimation risk
  - Investors demand higher returns the more inside info exists relative to outside info
  - Superior disclosure reduces inside info which lowers expected return (cost of capital)
- Reduce market synchronicity (extent to which share prices move together)
  - Done to extent high quality disclosure enables share prices to reflect firm-specific info
  - Reduced info asymmetry through more disclosure → share p reflects more info about firm relative to market events → investor's estimation of beta falls so cost of capital falls

Research:

- Bid-ask spread = measure of info asymmetry
  - The greater the concerns about inside info, the less investors are willing to pay relative to amounts asked by sellers
  - Higher disclosure quality = lower spread
- Lenders seem to assign lower credit risk to firms with higher quality disclosures
  - Higher quality disclosures = lower cost of debt
- Higher earnings transparency = lower cost of capital
- Higher IC deficiencies (lower quality reporting) = higher beta, estimation risk & cost of capital
- Bets increase as FV valuations moves from level 1-3 (as estimation risk increases)

→ Most evidence supports benefits of superior disclosure but sources & extent of these benefits not yet fully understood

## 12.10 Decentralized Regulation

Management has flexibility in reporting

- Comparability reduced
- Improves relevance since reporting adapted to particular firm's circumstances

Examples:

### 1. Segment reporting

- Increases relevance (relevant info may be buried in consolidated totals)

-Reliability threatened to extent mgmt acts opportunistically (may reveal info to competitors or mgmt may want to cover up poor segment performance by including such performance in consolidated total)

Regulation – IFRS 8

Requires firm normally report segment info on same basis as it organizes its segments internally for top mgmt

-Reporting externally on same basis as internally will give investors most relevant insights into firm's operations

-Cost of opportunism high since requires firm to change internal organization to be able to change segment reporting format

2. Financial instrument risk disclosure

Regulation – IFRS 7

Requires reporting of risk data to be based on info provided internally to key mgmt

3. FV option

Conclusion → Decentralized standards have potential to generate decision useful info despite reduced comparability

### 12.11 How Much Info is Enough?

Regulation incurs substantial costs:

Direct costs: to administer regulations & compliance costs of firms

Indirect costs: reduced opportunity to signal, costs of any “wrong” amt of info

Complex cost/benefit → WE DO NOT KNOW HOW MUCH REGULATION IS ENOUGH

Question = What extent of regulation is socially desirable?

**Theorem of second best:** adding/removing a constraint to the economic system (such as an accounting standard) creates ripples throughout economy, making it difficult, if not impossible, to determine whether new standard is beneficial or harmful

Social benefits = sum of effects (+/-) on all constituencies

If new accounting standards were socially desirable, value relevance of NI should increase as regulation increases

→ Research shows that no significant increases were found

### 12.12 Conclusion

Presently, there is substantial regulation of info production

Whether extent of standard setting = socially desirable is open to debate

Question of standard setting = cost-benefit tradeoff

Costs – enforcement costs, costs of wrong regulator decisions

Benefits – reduced market failures

→ Extent to which benefits > costs not know but giving some flexibility has adv.

So far concentrated on economic side of standards setting but must also consider political side since information benefits may not be distributed fairly among society

### Chapter 13: Standard Setting – Political Issues

We do not know whether decreased market failures from expanded accounting standards would be of greater benefit to society than various costs of standard-setting process

Unanimity problem → amount of info firms would privately produce need not (and generally will not) = amount investors want

- Demand for info by investors created by info asymmetry
- Since investors want more than what firms willing to produce, investors push for regulation of info production

Chapter 12 – concerned with size (net of costs) of info “pie” (whether generated by market forces, regulation, or both) – larger size = better for society

Chapter 13 – concerned with distribution of benefits of info production among constituencies which further complicates standard setting since their interests often conflict

Standard setting → interests of different constituencies traded off

**Public interest theory:** regulation should maximize social welfare (Ch 12)

**Interest group theory:** individuals form coalitions (constituencies) to protect & promote their interests by lobbying the government

→ These coalitions viewed to be in conflict to obtain their share of benefits from regulation

Acceptable standard:

- More requirements than decision useful & reduces info asymmetry
- Must be acceptable to various constituencies

Regulator faces info asymmetry since manager has best knowledge of firm’s cost, sources of D, info environment

-Manager may not willingly & truthfully reveal info to regulator

### 13.2 2 Theories of Regulation

#### 1) Public Interest Theory

- Regulation assumed to have best interests of society at heart
- Regulation = tradeoff between costs & benefits in for of improved operation of markets
- Problems with implementation
  - Deciding on correct amount of info = complex

- Moral hazard problem – possibility that regulator will operate on own behalf rather than on behalf of public

## 2) Interest Group Theory

- Various interest groups (constituencies) will lobby the regulator for various amounts & types of regulation
  - Lobbying = for or against regulation
- Outcome depends on which group is relatively most effective in applying pressure on regulator
  - Prevailing group determined by expenditure & organization but must realize pressures of competing groups can offset one another
- Ability of constituencies to pursue interest constrained by laws, courts, media, public opinion
- Interest groups are assumed rational
  - If group sees pressure won't prevail, will cut losses by discontinuing efforts

### PREDICTIONS

1. Creation of standard-setting bodies – cost of operating such bodies lower than costs of organizing cohesive investor group (large & diverse) so investors support these bodies to act on their behalf
2. Activities subject to market failure – more likely to be regulated
3. Due process – interest groups have chance to react to standards before implementation (public hearings, exposure drafts, super-majority voting)
  - Way of monitoring constituency conflicts; if constituencies do not get what they want; they will appeal to the political process
  - Public interest theory → implementing new standard only requires regulator to evaluate social benefits as being > costs; no interest group involved
  - Standard setting = dynamic process influenced by demands of managers, bankers & governments which can change over time depending on state of economy

### **Which theory applies to standard setting?**

- Public interest theory difficult to implement
  - Market forces can't be relied upon to generate socially right amt of info & regulators do not know how to calculate best tradeoff between conflicting needs of investors & managers
  - Therefore standards better viewed as conflict between constituencies
- Interest group theory = better predictor of regulation

### **13.4 Distribution of Benefits of Information- Regulation FD**

Complication of standard setting = distribution of benefits of info  
 Society best off when no redistribution of wealth makes 1 person better off without making another worse off

Society leaves resolution of distributional issues to bargaining, contracting & market forces, with regulation stepping in when needed

Ex: SEC Regulation FD [Goal = improve fairness of info distribution]

→ Prohibits companies from selectively disclosing info (for example, to analysts)

-Concern was that “big guys” had more resources to obtain info, which put small investors at an info disadvantage

-To enhance public confidence in fair marketplace & contribute to liquidity

Studies: extent to which benefited small investors unclear but goal to decrease analysts’ info advantage met

### 13.5 Criteria for Standard Setting

#### 1. Decision usefulness

- Evidence that security prices respond to accounting info means investors find it useful (more informative = stronger reaction)
- Standard with greatest may not be best for society
  - Investors don’t pay for accounting info so may “overuse”
  - Changes in standards can impose contracting costs on firm/mgmt

#### 2. Reduction in information asymmetry

- Expanding disclosure by means of standards works towards fair distribution of benefits to all investors = Reduced concern about info asymmetry & resulting estimation risk
- Must consider cost – difficult to know when standards to reduce info asymmetry stop being cost-effective

#### 3. Economic consequences of new standards

- New standards impose costs on firms & managers
  - Costs of producing info
  - Costs of contracting rigidities
  - Reduction of competitive advantage
  - Reduction in manager’s freedom to choose policies (reduction in extent to which private forces for info production can operate)
- Higher degree of competition = better disclosure (may be less need for standard in some industries than others)
- Regulators should weigh possible economic consequences of new standard (affect need for & willingness to accept standard)

#### 4. Consensus

- Must be sufficiently strong that even a constituency that does not like new standard will go along with it

**Conclusion** → Standard setters can be guided by decision usefulness & reduction in info asymmetry but these are not sufficient to ensure successful standard. Must

consider interests of mgmt & other constituencies and pay careful attention to due process.

### **13.7 International Integration of Capital Markets**

Result = better-working markets, lower costs of capital & increased investment, more efficient contracting

#### **Convergence of Accounting Standards:**

One response = common set of international accounting standards

→ Would result in:

- Lower F/S preparation costs
- Lower costs of capital (able to get more liquid sources of financing)
- Increased comparability (lowers costs to users who only need to learn 1 set of GAAP)
- Overall better working of markets

2002 Norwalk Agreement - Agreement between FASB & IASB to work toward a common set of high-quality standards

- Some progress made on convergence but more remains which will take some time & will likely require further development of Conceptual Framework

#### **Effects of Customs & Institutions on Financial Reporting:**

\*Must be aware & keep in mind (such factors can affect reporting quality)

Common law countries → standards set in private sector and oriented primarily to investors

Code law countries → standards set primarily by government (subject to more political influence)

Differences:

-Less info asymmetry in code law countries since important constituencies are insiders rather than outsiders

Additional constituencies represented within corporate governance structure under code law

-Greater recognition lag in code law countries

Insiders quickly learn info so less need for timeliness

-Less need for conservative standards (ex: impairment tests) in code law countries & agency costs of contracting between manager-owners lower under code law

Insiders already aware of losses so can rapidly put pressure on mgmt to make correction

→ High recognition lag & less conservative accounting suggests financial reporting under code law = lower quality but not necessarily more opportunistic

-High quality standards (such as IFRS) will not necessarily improve financial reporting by themselves since even such standards are flexible (allow considerable judgment/discretion in policy application)

-Additional consideration = govt influence

In some countries, firms encouraged to manage earnings to reduce possibility of state involvement, which may dominate any concerns about lower quality reporting

### **Enforcement of Standards:**

Standards must be enforced to contribute to higher quality reporting

#### Issues

-Enforcement of IASB standards of particular concerns since up to jurisdictions & if enforcement not adequate, may not result in high quality reporting (investors face serious estimation risk, markets won't work as well & incentive for voluntary disclosure will decrease)

-Minority shareholders in firms with highly concentrate ownership may suffer at hands of controlling interest

Minority investors will be wary of moral hazard & won't invest or will demand a higher return (market won't work as well)

→ Such firms may have incentive to adopt policies to signal to outside investors that their interest = protected (ex: hire high quality auditor)

Auditing = important enforcement mechanism

- Increases investor confidence & efficient contracting
- Requires full disclosure which protects minority interests
- Reputation & legal liability considerations drive ethical auditor behavior & audit quality

### **Benefits of High Quality Standards:**

- Decrease in info asymmetry & estimation risk
- Increase in analyst forecast quality
- Increased info content of earnings /Decreased market synchronicity
- Higher liquidity
- Lower cost of capital
- Improved efficiency of managerial compensation contracts → increased compensation committee's perception of earnings quality & comparability
- Overall better working markets

#### Conclusion

Shift from local GAAP to IASB GAAP can benefit economies involved especially if

1. 2 GAAPs differ significantly
2. Strong legal & institutional regime to enforce & encourage investor protection & quality financial reporting (strong regulatory environment)  
\*includes auditing

However, extent of benefits depends on how flexibility of GAAP is used (benefits realized only if flexibility used to increase reporting quality)

### **Relative Quality of IASB & FASB:**

Mixed evidence about which is of higher quality (IFRS or US GAAP)

Lack of comparability but increased recently due to increasing convergence

Comparability & quality of 2 sets of standards will move together over time if standards convergence progresses

### **Alternative to Convergence → Competition:**

Competition = allowing firms to use domestic accounting standards *or* IFRS (giving choice on which standards to follow)

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- When economies of scale are low – case in standard setting (unlikely that unit cost per standard would increase substantially)
- Both bodies have similar organizational structure so unlikely that lower cost for 1 would drive other out of business
- When regulator at info disadvantage relative to regulated firm – case in standard setting (firms likely to have better info than regulator about best policies but regulator limits managers' ability to exploit info advantage which may actually reduce info quality)
  - Firm given greater flexibility to choose GAAP best tailored to particular info environment → can increase quality of reporting if not used opportunistically

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- Increases costs (US investors would have to support two standards instead of one)

→ Whether benefits > costs unknown at this time but some ability of firms to choose between sets of accounting standards should not be ruled out

### **Should US adopt IFRS?**

1X adoption as took place in Canada unlikely in US

More likely that there will be a gradual adoption aided by increasing convergence

Whether convergence will continue to point where differences = minimal remains to be seen

Future convergence is threatened to extent that 2 bodies adopt different conceptual frameworks

Benefits:

- Lower F/S preparation costs for US-based multinationals
- Greater flexibility (principles-based IFRS vs. rules-based US GAAP)

Seems to be little difference in overall quality of 2 standards so overall benefits will be small

Costs:

- 1X transition costs of F/S preparation
- Increased audit fees
- Contracting costs from effects on accounting variables used in existing contracts

- Additional costs
  - 1) US investors must become familiar with IASB standards
  - 2) How standards fare in face of US legal system

## 13.8 Conclusions

Ideal conditions - accounting standards not needed

Only way to account is on basis of PV of firm's FCFs

DO NOT EXIST

Info asymmetry creates estimation risk

\*Info asymmetry is what makes accounting challenging

- 1) Adverse selection: insiders know more about outsiders about state/prospects of firm

Accounting challenge = convey info from inside to outside firm, improving investor decision making & limiting ability of insiders to exploit info advantage thereby enhancing operation of capital markets

- 3) Moral hazard: manager effort is unobservable to SH & lenders in all but smaller firms

Accounting challenge = provide informative measure of managerial performance to enable efficient incentive contracts to motivate manager effort, protect lenders & SH from manager opportunism & inform managerial labour market

→ Financial reporting = compromise between 2 challenges

Investors (including securities commissions acting on their behalf) push for additional info → CV

Mgmt pushes other way when proposed standard affects their flexibility under contracts, inhibits ability to credibly communicate with market through policy choice or reduce ability to hide poor performance through opportunistic earnings mgmt or to choose tradeoff between full disclosure to investors & agency costs created

Standard setters must seek a compromise between these conflicting interests

With increasing globalization of commerce, standard setters & investors will have to adapt to take additional challenges into account

- Need for internal accounting standards will continue to expand
- Additional difficulties (in addition to investor-manager conflict)
  - New constituencies from economic development
  - Differing business practices & cultures