L1 corporate governance and accounting 1. The role of financial accounting is determining the gain/losses, the cash flow generated & the net wealth at the end of a given period. However, determination of profits is not univocal & accounting rules may create wrong incentives to report inflated earnings. 2. What go wrong? Accounting standards allowed : (a)firms to report inflated earnings(b) managers had wrong incentives & pushed for short term profits (c) auditing firms didn't assess correctly the underlying value of risky assets(d) rating agencies didn't consider the systematic risk & the potential contagion effect of the lending.3. Global financial crisis: increase regulation (Sarbanes-Oxley Act): board members to sign off the accounts, compliance to stricter & more costly standards, higher vigilance from the regulatory bodies.4. The role of financial reporting in reducing financial risks in the market: (a)The quality of reported financial information **is influenced by the quality of accounting standards** and also by other **institutional factors** that affect the demand for and the supply of financial information.(b)Market participants seek **high-quality financial information** because it mitigates information asymmetry between the management of the firm and outside investors. (c)Reduced information asymmetry has desirable effects on firms' cost of capital and the volatility of security prices.(d)These benefits motivate regulators around the world to strive for high quality accounting standards.5. High quality financial reporting: high quality standards; corporate governance system; legal system & investor protections6. Corporate governance (CG) is the system by which companies are directed and controlled7. characteristic of CG mechanisms: (a) internal: board of directors, remuneration committee, audit committee, employees, shareholders(constitution and membership of the board of directors and its committees; the structure of share ownership and financing arrangements; the form of executive compensation) (b) External: competitors; APRA; reserve bank; ASIC; stock exchange; media; lenders/banks; institutional investors; external auditors; ratings agencies; financial analysis (monitoring by outside parties such as significant shareholders and institutional investors, activists, external auditors and regulators/government)8. CG model determined by :corporate ownership model, legal system, investor protections.9. CG system worldwide: (a) Family-owned or state-owned firms that are very common in some parts of Europe and elsewhere are common in continental Europe(a strong controlling owner, a family or the state control the company), (b) Keiretsu model in Japan which is based on banks holding both debt and equity, directly and indirectly, through cross shareholdings and debt-holdings with other group companies. (c) Public company in the Anglo-American world (shareholders are very small & dispersed. There is not always a major owner who is interested in monitoring managers. The board is appointed by shareholder & is expected to monitor managers. It is made up of managers&independent directors. Outsiders are supposed to control that shareholders' interests are pursued)10.The ownership model will interact with countries' legal system and shareholder protections: common law and civil law .Common law countries tend to have stronger shareholder protections than civil law country11. Discuss what corporate governance is and why it is needed. the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Good corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved. Why ' good governance systems ' ? It increases the competitive edge both at a national and on a firm level. Good governance enhances firms' profitability and decision making. It facilitates economic growth through a better allocation of resources Enron Cases Corporate culture is important - culture of deception, self-interest, dishonest management, Governance failure at the Board level (Too much trust, Incompetence of awareness and understanding of role, control & reporting systems, Lack of motivation, conflicts of interest). The tone for a company's ethical culture is set at the top. Employees, consciously or not, will follow the lead of their supervisors and managers. If they see rules being bent, they will bend the rules. And once that process starts, it is very difficult to stop. -Market to market accounting could be false value to a company's financial statements. Regulation is not enough in ensuring "high governance practices" – Corporate collapse while complying with regulation, Agency Problem cannot be removed with regulation, Compliance with a set of tick the box guidelines, After new strong regulations, the collapses till happened. Beyond Compliance (Governance culture) Global Financial Crisis (GFC) (1) Increasing regulation (i.e. Sarbanes-Oxley Act) Board members to sign off the accounts (personally responsible and liable). Compliance to stricter & more costly standards; Higher vigilance from the regulatory bodies (2) what role for audit companies? rating agencies and financial analysts (3) Measurement models: more than 20 different from Historical Cost, to Value in Use to Fair Value.

L2 agency theory, information asymmetries and role of financial reporting1. Agency relationship : Agency theory is concerned primarily with relationships and conflicts where one party (the principal) delegates decision making to another party (the agent). 2. Information asymmetry: It is a feature of any agency relationship, that one party will have more access to information than the other party. 3. Much of agency theory is concerned with the relationship between the owner of a public company (the principle) and the manager to whom the running of the company has been delegated (the agent)4.Wealth maximisers (or utility maximisers):Agency theory assumes that all parties to the agency relationship will act in their own best interests at all times.5.Misalignment of interests lead to agency conflicts. Agent will not act in the best interests of the principle.6. Agency conflict: the lack of trust between shareholders (principals) and managers (agents).(A.Managers may not always want to give their best efforts and may want to maximize consumption of perquisites/ B. may be more risk adverse than owners/may have a different time horizon/ C. may prefer to retain dividends) Consequence: managers might pursue actions in their own interests7.Agency conflicts will Cost : Monitoring costs; Bonding costs; Residual loss.8.how the behavior be controlled: A. Discover the agents behavior by investing in information systems (eg. Reporting procedures, boards of directors)9. Misalignment of Principle and Agent relationship: 3 problem: managerial risk aversion:shareholders can always diversify away their investment but managers cannot easily get a second job. Dividend retention : shareholders call for more dividends but managers would rather keep the funds internally. Time-horizon problems(时间范围): management may have a more short-term view.10. The role of accounting information:is extremely relevant in informing investors about the current value of the shares based on future expectations. Henceforth financial reporting has a valuation purpose. A.Moral hazard: principals cannot observe the agent's behavior (without excessive costs); agents use this position to maximize their self interest at the expense of the principals. This is an area where FR can play a relevant role because 'incentive contracts' could be designed in a way to keep managers accountable to their shareholders. Here, FR has stewardship role. B.Information asymmetry: adverse selection: means that investors would make wrong choices if they do not have access to relevant info about the firm.:(a Agents have access to superior info & may fail to disclose it.(b) Investors need to obtain info about the current & future prospects of a corporation9.Reduce agency conflict: agency cost arise because principals (shareholder) need to monitor agents (managers)How?managementcompensation; managerial labour market (ex & internal); auditing (ex & internal); CG practices & policies; market for corporate control.

L3 introduction to accounting theory---link to w4 CF, w2 agency theory is positive theory

1.**2 type of theory**: **a.Normative theories** are prescriptive:how we "should" behave and what is the "right way";contain a value judgment that cannot be verified or falsified because it is subjective;often done by governments and regulators that have to decide what is best for everyone. **b.Positive theories** describe how we actually behave; Positive theory and research is empirical. This means that it is based upon data, observation or experience; inductive, that is they travel in the direction of observation to theory. Agency; positive accounting; efficient contracting ; legitimacy –theory for explain and predict executive remuneration practice.

Tut How has financial accounting evolved over time? What are the forces shaping it?: theories in financial accounting--normative theory& positive theory----theoretical &prescriptive(says what "should" be) & Empirical & Explains and predicts.

Tut What is the role of theory in accounting? How do theories support our real choices? **(a)**.Explain & predict how different pay structure incentives managers; **(b)** guidance for companies--how package executive pay to generate desired incentives; **(C)** ASX corporate governance rules on remuneration---agency theory; **(d)** conceptual framework--guidance to individuals responsible for preparing general purpose financial statements (normative theorizing)

2.**How theories support accounting choice**? Positive research can be used to predict what might happen if a new accounting requirements in introduced. The development of a theoretical framework (CF) for accounting standards is an example of normative theorising, which prescribes the best way to go. Normative theorising can be tested empirically which could be the best of both worlds.3. **Positive theory**: agency theory; positive accounting theory; efficient contracting theory; legitimacy theory.4.**Three options available for executive pay**: **a.**Fixed salary; **b.** Salary based on results achieved; **c.** A mix of both5.**Understanding remuneration through agency theory and PAT** – aligning incentives through contracts

6. **Solution** : **A** common practice to pay part of an executives' salary via a bonus scheme and/or share ownership scheme that aligns their interests with those of the shareholders (bonding cost in agency theory). **B.** Owners then monitor managers' behaviour by measuring their performance against their employment contract conditions. This measurement often uses audited accounting information (monitoring cost in agency theory).**C.** To the extent that the remuneration contract does not generate complete alignment, there will be residual loss.7.**Legitimacy theory**:companies operate under a social contract and that they are ultimately responsible to society for how they operate and what they do. Legitimacy theory explains the means by which the social contract is maintained. Companies that lose legitimacy can be penalized in a number of ways including:**(a)**Significant adverse media attention; **(b)**Fall in share price; **(c)**Legal action; **(d)** Political intervention.

L4The conceptual framework and standard setting

Tut what are the constituent of a conceptual framework? How do they related to each other :A Conceptual Framework is 'a coherent system of concepts, which are guidelines to accounting standards used for Financial Reporting", including : Purpose & Objectives of Financial Statements ; Qualitative features of financial information ; Identifies basic elements of accounting (asset, liabilities, equity) and how they should be recognised and measured.

Tut What is a 'transaction neutral' approach to accounting? How is it practiced in Australia and NZ and what is the future of this approach likely to be as things stand today? Account same transaction same way, all firms, organizations, regardless status/legal form (publicity listed,private held,state-owned,NFP ect)**Aus:** from 2005, Australian accounting standards adopted IFRS, use same CF, same Accounting Standards (IFRS), some enhancements to meet needs Public & NFP sector (prefix AUS in standard)...means financial statements across sectors are comparable, can be read & understood by anyone with understanding IFRS.2010 CF(stewardship into decision usefulness, limited primary users), concerns might lead to accounting standards not appropriate government NFP,...no investors, main principle accountability & stewardship. Delayed adopting IASB's 2010 CF, adopted DEC 2013, add AUS paragraph to encompass broader group users applicable to NFP's & public sector

AASB intends continue have one slightly adjusted CF & one set adjusted standards meet needs all entities. **NZ:** Until 2012, transaction neutral approach, in 2010 evaluated two broad accounting standards framework options: enhance NZ IFRS equivalents or moving to multi-standards approach one set standards for for-profit entities, another for PBE's.Concluded 2012, single set accounting standards not adequately address user needs, would adopt multi-standards approach-giving effect to this conclusion required new framework be developed.Some new arguing modified definition transaction neutrality that is compatible with multi-standards approach, provided CF substantively same.

1.**primary users of financial reports**: Investors;Creditors;Employees;UnionsRegulators; The public generally2.**objectives of financial reporting**:Stewardship;Decision usefulness

3.**stewardship**:As a steward, management's performance should be evaluated in terms of both profit and the accomplishment of social objectives.4.**decision usefulness**:Information is decision-useful if it assists users in making resource allocation decisions5.**transaction neutral approach**:The longstanding practice in Australia and NZ of seeking to have transactions and events common to all sectors accounted for in the same way by all entities

Lecture 5 Measurement issues in financial accounting

Tut What is the relationship between the objectives of financial reporting & different measurement models?Using different measurement models leads to different income figures and book value of equity. They also have different informational characteristics.

The standard setter first selects who will be the "user" of financial information and then considers what are expected to be the information needs of that user or users. Historically, the purpose of accounting was to assess the stewardship or accountability of managers. More recently with the growth and dominance of global capital markets, the number of recognised users has reduced and so the purpose of accounting has also narrowed in order to meet the needs of the smaller group with the growing focus being upon investors and creditors and their need for information in order to make resource allocation decisions. It follows that if different classes of user have different informational needs then the qualitative characteristics of that information will also change. Obviously different measurement models will fit different qualitative characteristics better than others. **Consider two purposes of accounting information**: Stewardship and Accountability; Decision-Usefulness (Valuation) **The stewardship** or accountability of managers- Historical cost Level 1Fair Value; **Investors and creditors – Fair value**

Tut why did the IASB decide to keep mixed measurement rather than move to a single measurement model? **(A)**IASB mixed measurement model gives option chose most relevant model for what trying to represent; **(B)**Consider matters of cost/benefit ; **(C)**Found during financial crisis,FV works when markets both deep and liquid; **(D)**Pro-cyclicality: in rising market,