Accounting theory exam review

Science

Stock should not change by the change in accounting policy, two examples in book where this did not hold (1 . Employee stock option - authorities proposed that employee stock options be expense has no impact on cash therefore should have no impact on stock price but rice was falling strong indication that accounting policies do matter 2.

Dry holes companies were allowed to amortize dry holes but there was no revenue generated so it does not make sense so the only holes you could amortize is the successful ones e holes where they found the oil.. Dry holes would be expensed does not affect cash flow therefore should not affect price of stock, companies who were amortizing dry holes saw their price fall - accounting policy does matter significance = accounting theory/policy matter.. Managers of a company are going to try and keep up the price f stock therefore they will do things that have an influence on price and determines the cost of capital)information that it trades on is important - difference between positive accounting theory (predict what will happen? measure is how accurate it is) and normative theory (predicts what should happen? is a good theory if it is logical - ex single person decision theory) managers will shift the income into the current period in order to increase their bonus (difficult to measure the shifting of income).

Come up with three hypothesis that would support the positive accounting theory 1 . Bonus plan (managers will try to move the Income into the period where Its going to benefit them) 2. Debt convenient (managers will try to avoid a default In the contractual arrangement of debt, try and Increase net Income If they are at risk of debt covenant) 3.

Political cost (companies that are facing political heat will try and lower their net income so they can argue that they are not making that muchmoney) change they can affect the contracts (one party may benefit and the other may lose out) -major problem with testing positive accounting theory = hard to measure the earnings management (many ways to do so but some are not so obvious? discretionary approvals) 2 versions of PAT 1. Opportunistic (managers do what's in their best interest) 2. Efficient contracting (managers do what's best for the company) - slight overlap...

Efficient contract tends to be more common -firms targeted for takeovers and debt violators will increase income , share price is more correlated with net income then cash flow, limited use of derivatives, what are the implications of the evidence that the efficient contacts are dominate over opportunistic = owners f the company cannot run the company themselves therefore they hire agents, conflict is controllable. Chapter 9: conflict resolution: 3 kinds of agency contracts = 1. Rent (rent the company to the agent so principal receives fixed income and the agent gets profit and risk, agents are risk adverse) 2.

Percentage of profit (second best? you pay a bonus to the manager, get a percentage of the profit.. Problem is the agents efforts are not seen until after they're actually paid.. Overcome by basing compensation on a performance basis) 3. Salary (first best.. You can observe the gent, principal takes all the risk - problem is moral hazard) they argue that you can create a contract that causes truth telling-could be a penalty for honesty, no restrictions on the contract, could be legal implications. Can agents be trusted?

Can they get away with earnings management? To extent, gives them some leeway, cannot fake numbers too large extent, audits prevent this. People assume that managers are going to manage earnings and they'll manage to the greatest extent. Characteristics 1 . Sensitivity 2. Precision (put 10% more effort get 10% more change Advantages and disadvantages of using historical cost account= precise but not sensitive.. Market price is sensitive but not precise. (similar to the tradeoff of relevancy and reliability) why are changes to accounting policies controversial?

Cue contacts are rigid. Chatter 10: executive compensation.. Second role for financial account- stewardship What two roles do.. Performance measures are used In aging contracts, establishes the value in the.. FAME argues that employment contracts are not needed because the manager relies on reputation, does that mean we do not need measurements? The labor markets are not efficient therefore you still need contracts and if you rely on the labor market it needs measurement. You need performance measurements.

Someone predicted that employment contracts will be complicated and research determines its truth.. Historical cost on net income is precise but not sensitive should add another measure of share price. What's the problem with share price? Is sensitive but not precise. Should executives bear any risk? Yes they should need risk to ensure effort. Not too much risk though. Chapter 1 1: earning management.. 4 hypothesis to test theory 1. BATH - decrease net income as much as possible to set yourself up for a better bonus next time. Income minimization - try and increase income to get the bonus.. F you're over the bonus cap you would lower your income to save for next year. CAP(Max for bonus) vs.. BOGEY (min for bonus) Income smoothing happens at every level concept to reduce risk.. Rather than take all audits and accruals prevent from bad earnings management bad side? Misleading information, excessive write downs, 6 reasons why managers would manage earnings.. Bonus, debt covenant, political reasons, initial public offerings, monomaniac inside info to investors, to meet investors expectation.. Is earnings management consistent with efficient market theory?

No semi strong theory share price fully reflects biblically known information Chatter 12: market forces should hold therefore you don't need any regulations. Demand for information and supply of information. Information is a public good no one pays for it therefore there's unlimited demand for it. Better disclosure will result in more investor interest, increase liquidity, more institutions trading, reduce estimation risk, narrower bids and asks and therefore lower cost of capital and interest rates. How do you define information? Should be more detailed, additional information, more credibility.

Disclosure principal: market knows that the managers has information, if they do not release the info the market assumes its bad. But its not as bad as everyone thinks - flea. Foods the market know that the manager has the information? Release of the information may be costly and is disclosure truthful. If there's no regulatory body there's no guarantee info to reliable. High type (good company, try to differentiate themselves, adopt conservative accounting policies, not overstate assets, or understate expenses, use top auditing firms) and low type (poor company Chapter 13: standard setters political issues.. Public interest theory (first best , regulators would set the quality and quantity in the best interest of society, problem what is the ideal amountћ moral hazard kicks in)&& interest group (conflict between stakeholder, policies are best decided by hacking input by everyone) 2nd theory is best Principal vs.. 4 criteria for deciding successful standards? 1 . Decision usefulness 2. Reduce info asymmetry 3. No serious economic consequences and 4. Should be consensus MATH: