

FINANCIAL ACCOUNTING THEORY

- **Purpose:** To create an awareness of the financial reporting environment in a market economy

Chapter 1

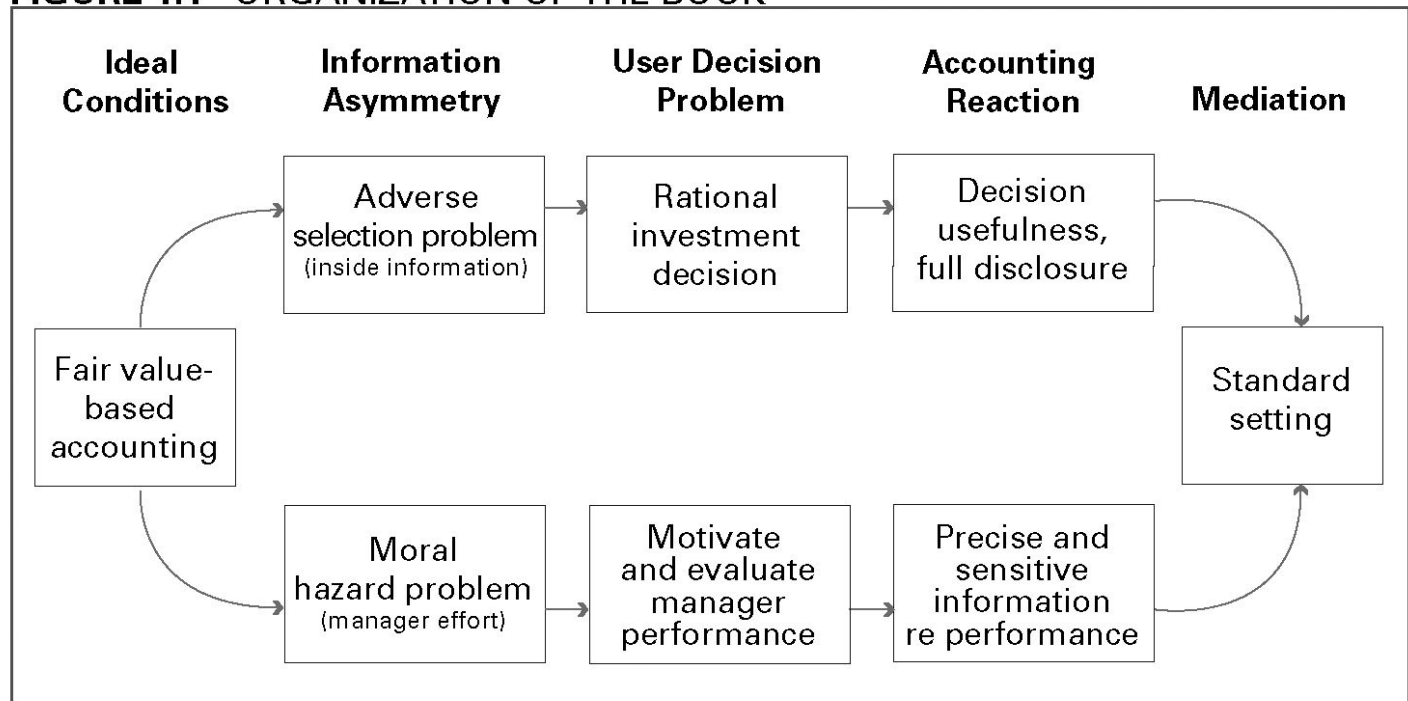
Introduction

Some Historical Perspective

- **Paciolo, 1494**
- **English Corporations Acts**
 - Compulsory audit
- **Developments in the United States**
 - Corporate income tax, 1909
 - SEC, 1934
 - The search for accounting principles

Organization of the Book

FIGURE 1.1 ORGANIZATION OF THE BOOK



Information Asymmetry

- **Two Main Types**
 - **Adverse selection**
 - Persons with an information advantage exploit this advantage
 - Insider trading
 - **Moral hazard**
 - Manager knows his/her actions in managing firm but shareholders do not
 - Manager shirking

User Decision Problem

- **In Presence of Adverse Selection**
 - Rational investment decision

- **In Presence of Moral Hazard**
 - Motivate and evaluate manager performance

Role of Financial Reporting

- **To Control Adverse Selection**
 - Decision usefulness
 - Full and timely disclosure
- **To Control Moral Hazard**
 - Net income as a managerial performance measure
 - Sensitive and precise net income

The Fundamental Problem Of Financial Accounting Theory

- The best measure of net income to control adverse selection not the same as the best measure to motivate manager performance
 - This implies that investor and manager interests conflict
 - Standard setting viewed as mediating the conflicting interests of investors and managers in financial reporting

ENRON CORP.

Implications for Accountants

Enron, Cont'd.

- **Special Purpose Entities Associated with Enron**

- **On Enron Books**

- **Dr Note Receivable \$1.1 (billion)**

- Cr. Capital Stock \$1.1**

- **Capital stock issued to Special Purpose Entity (SPE) (a limited partnership)**

- **SPE owned by Enron officers**

Enron, Cont'd.

- **GAAP** requires amounts due from shareholders be deducted from shareholders' equity
 - Is a limited partnership, owned by Enron officers, a shareholder?

ENRON, Cont'd.

- **Off-Balance Sheet Financing**

- **On SPE books:**

- Cash xxx

- Debt xxx

- SPE borrows money, using Enron stock as security.

- Note payable to Enron xxx

- Cash xxx

- Cash is paid to Enron to reduce its note receivable from SPE

- Enron has the cash but debt does not appear on its books

ENRON, Cont'd.

- Enron Renders Services to the SPE
 - A/C receivable \$628 (millions)
 - Net income \$628
 - Services rendered to SPE 1997-2000 incl.
 - If Ltd. partnership had been consolidated, revenue only recognized when earned outside the consolidated entity.

ENRON, Cont'd

- Enron records its share of SPE profits

– Investment in SPE xxx

 Net income xxx

SPE profits include increases in fair value of its holdings of Enron shares.

Result: Enron includes increases in the market value of its shares in its net income.

ENRON, Cont'd

- In 3rd quarter, 2001, Enron Recognized that the SPE should be Consolidated:
 - Dr Shareholders' equity \$1.1
 - Cr Notes receivable \$1.1
- To deduct loan to SPE from shareholders' equity
- Also, restate previous 4 years' earnings to reduce by \$628 millions

ENRON, Cont'd

- Impacts of the Writeoffs
 - No effect on operating cash flow
 - Debt/equity ratio, debt covenants affected
 - Loss of investor confidence
 - Share price falls from \$90 to 66¢
 - bankruptcy protection 2 Dec/01
 - SEC, Dep't of Justice, Congressional Investigations
 - Where were the auditors? The Board?

ENRON, Concl.

- **Points to Think About**
 - **Crucial role of investor confidence in financial information**
 - **Role of auditor in adding credibility to financial information**
 - **Off-balance sheet financing**
 - **Earnings management**