Financial Reporting Strategy and Analysis when Managers have Proprietary Information

Noise and distortion (bias) are distinct sources

- May need different “filters” to detect/remove
- Noise → future is uncertain, differences of opinion
- Bias → managers’ and auditors’ incentives differ from shareholders, investors and stakeholders

Discretion: help or hinderance?

- Hinderance … managers can misrepresent
- Help … why???? → need to think this through
- Overall: good or bad???? → think through …

Accounting Conventions a source of noise:

- Relevance vs. reliability
- Why choose based on reliability?
  - Lower cost of verification
  - Higher Credibility
  - Litigation
  - Think about option accounting (WSJ handout)

Quality of Data: life in an economy with uncertainty

- Honest differences of opinion (Intel estimates)
- Differences in probabilities
- Differences in volumes
- Differences in prices
- Differences in materiality thresholds
- Differences in disclosure thresholds (FAS 5 is vague vs. FAS 13 on leases)
Three major implications:

- Investors cannot costlessly “undo” distortions
  - When we wave our hands and say “the market is smart, it will figure things out, we need to ask ourselves how will the market do it?"
  - Managers have better information about decision elements (see quality of data above) and that benefit has to be traded off against the risk of puffery (see discretion help or hinderance above)

- Managers’ disclosure strategies matter
  - Value of the firm can be higher or lower depending on whether management communicates an optimistic number or a pessimistic number (what should Intel do?)
  - Value of the firm can depend on how much and how effectively management communicates (what should Intel do?)

- Financial analysts matter
  - Value of independent digging
  - Getting at “inside” information by trying to find “outside” information that can be a legal basis for trading or trading advice (cannot trade on “insider information”).
Intel
Start with Problem 6.

The numbers are uncertain but the event is quite likely … meets the FAS 5 “probable” test.

What number to report? Low? High? “Expected value”? 
- Low is “optimistic”. 
  - Risk of deception
- High is “conservative”. 
  - Why is conservative “good”? 
  - Good for whom? 
  - Can managers use this to “smooth” income? 
- How about EV (“average”)? 
  - Average is math – THAT # will never “occur”. 
    - In fact, we KNOW EV is “wrong”!!!
- Back to option accounting debate again? 😊

Do the entries:

12/31/y1 Dr. Expense
Cr. Liability

dd/mm/y2 Dr. Liability
Dr. Expense (if original estimate too low)*
Cr. Cash
Cr. Gain (if original estimate too high)*

* You will either Dr. Expense or Cr. Gain depending on the condition shown in parentheses, you cannot have both simultaneously.
1. When to accrue liability?
   - June → few votes
   - Oct → few more
   - Nov → few more
   - Dec → You bet! (everyone)

Notice the range of opinions even among “disinterested” observers … none of you have a personal stake here.

2. Program (i) or Program (ii)?
   How about sticking with only “need-based” replacement?
   - Intel Inside ↔ this is consumer marketing
   - Consider the brand equity at stake here.
   - Can we learn from J&J and Tylenol????

Notice the range of opinions on which program is “right”.

3. Costs? # to be replaced * cost per chip
   - 300,000-8,000,000 * $50-$100
   (Just for ease of computation, we include the 2M chips in inventory at the same average cost as the chips sold)
   - $15M to $800M

4. Costs under chip+labor policy? Add up to $400-$750 per chip installed. Another $12M to $4.5B.
Starting to add up isn’t it? This is looking different from Tylenol … additional costs could be quite significant.

5. a. How much? Management’s incentives to low-ball (under-estimate) or high-ball? → to be continued…
   b. What to communicate? HOW to communicate?
   c. Is a filing needed?