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”).
Diversity in Accounting Principles: Problem, Imperative or Opportunity?

What is GAAP? Why do we need GAAP? Why worry about diversity?

- GAAP is not “fundamental truth” or “axiomatic”
- Need limits on what can be said → GAAP
  - A set of commonly accepted conventions backed up by some legally authoritative body
- GAAP is inductive, not deductive → “open”
  - In other words, evolving, debateable.
- Users must have some idea of how the numbers were prepared to understand what they mean.
  - Would not have this problem if GAAP were like laws of physics, with “fundamental” principles and constants.

Digression:
In accounting we say “Sales were $8,000,000.” Or “Sales grew from $6,000,000 to $8,000,000.” What do these statements mean?

- What is “sales”?  
  - Revenue recognition rules matter here
- How do you know it is 6 or 8 million?  
  - Uncertainty matters here
    - How much is realized? Realizable?
- Is 8 million larger than 6 million?  
  - How to tell? Let’s try Stats 101 trick – t test.
    - Mean values alone will not do the trick
    - Need some idea of variance
- Why report only means (and ignore variance)?
What might variance be in our context?

➤ Think of changes in accounting principles
➤ Think of changes in business model
  o Think Gibson greetings .. change in business
  o Think Enron … trading firm but using revenue recognition rules meant for power utilities.
    ▪ “foolish consistency”?

"A foolish consistency is the hobgoblin of little minds" - Emerson

Conclusion: The three main financial statements CANNOT be interpreted without “variance” disclosure (footnotes).

<End digression>

Work through the example (Exhibit 2-6) to refresh your understanding.

Exhibit 1 provides a handy list of topics where diversity is a source of material differences (you can use this list to get ideas for your research project as well).
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 prentheses, 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?