Master in Management
FINANCIAL
AND
ESG REPORTING
Class 6

Lisbon School of Economics & Management
Universidade de Lisboa

Fall, 2024

Dr. Yi Wang (ISEG, Uni. of Lisbon) & Dr. Hwa-Hsien Hsu (Durham Uni.)

Individual written test:

Time: 10:00 a.m. to 11:30 a.m. on October 25th (1.5 hours)
Classroom: Auditório 5 at the Quelhas building
Question types:

- Multiple-choice questions
- Short-answer questions
- Calculation questions (financial ratio analysis)

Coverage: Weeks 1-6 (slides, group discussions, group work, in-class exercises)

Individual written test with a minimum grade of 8 points (60%)

Objective of this class:

1. The concepts of information asymmetry and the market for lemons
2. The role of corporate reporting and accounting disclosures
3. Different managerial reporting incentives
4. What is the effect of corporate reporting
5. Individual written test-exam revision

Information asymmetry and the market for lemons

What is information asymmetry?

Information asymmetry occurs when one party (e.g., **managers**) has an advantage over the other parties (e.g., **investors** and **other interested parties**) as the former one possesses more information about the current and future prospects of the company, and can decide when and how to disseminate such information.

Why does information asymmetry occur?

George Akerlof (1970) —

Adverse Selection: The Market for Lemons

Car A: £10,000

Car B: £5,000

Do these two used cars look alike?

If you are a buyer, which one will you choose?

Watch this Youtube video

https://www.youtube.com/watch?v=sXPXpJ5vMnU

The market for lemons — An example from the view of an investor (1)

Assume:

1. You would like to invest in companies producing “lemons”.
2. There are two companies in the market.
3. Their products look alike.

Company A
Good

Expected Return: 20%

Company B
Poor

Expected Return:10%

The market for lemons —
An example from the view of an investor (2)

Will you invest in Company A (Good) or Company B (Poor)?

Why?

The market for lemons — An example from the view of an investor (3)

However, if we assume that:

1. You only know that there are companies producing "lemons" in the market.
2. You can not tell ***which one is good*** and ***which one is bad***.

Good
(A or B???)

Expected Return: 30%

Q: How will you invest?

Poor
(A or B???)

Expected Return:6%

The market for lemons —
An example from the view of an investor (4)

Outside investors: face uncertainty about the quality of the products produced by Companies A and B

- 50% of investment opportunities are “good” (r_G=30%)
- 50% of investment opportunities are “poor” (r_P=6%)
- Average return expectations:

  0.5 * 30% + 0.5 * 6% = 18%

=> Investors will use the expected return of 18% as a benchmark to determine the target share price of their potential investment.

The market for lemons —
An example from the view of an investor (5)

Managers — Good knowledge about the quality of their products

Q: If you are the manager, are you happy that the expected return of 18% is used to be the basis to determine the value of your company's share price?

- If you are the manager of the "Good" company, you may choose to leave the capital market. You may find a private channel to finance your company (private finance).

=>

The average return expectation will go further down in the market.

0.33 * 30% + 0.66 * 6% = 14%

The market for lemons — An example from the view of an investor (6)

Lisbon School of Economics & Management
Universidade de Lisboa

Q: What is the major problem arising from the example?

Ans:

What is the potential solution to reduce "information asymmetry"?

Ans:

Accounting information can enhance "Information flow" between firm and the external capital market.

The role of corporate reporting and accounting disclosures

What is the impact of improper accounting behaviors?

An example:

Toshiba's Accounting Scandal in 2015

Q: What did they do?

Ans:

What is the impact of the accounting scandal?

Market value fell by 30% in 5 months

Why is financial reporting and accounting important?

Information flow

- Decision usefulness
  - Useful for making prediction about what may happen in the future
  - Provide feedback on previous decisions
- Stewardship (or accountability) role
  - Managers prepare **a report** to **the providers of the resources** and explain how well they have managed them.
    - Shareholders — Separation of managers and owners
    - Other stakeholders (e.g., lenders, costumers, suppliers and governments)

⇒ Discipline managers
  - Monitor managerial performance
  - Set managerial incentive scheme

Types of corporate reporting and accounting disclosures

- Corporate reporting/disclosures could be **mandatory** or **voluntary**
    - Financial statements (Statement of financial position, Statement of comprehensive income & Statement of cash flow)
    - Corporate governance (board of directors, executive compensation & shareholdings, and block ownership)
    - Risk disclosures
    - Future business strategy
    - ESG reporting

Different managerial reporting incentives

Why do (don't) managers have incentive to disclose information? (1)

There are some theoretical rationalities: (See, **Healy and Palepu, 2001**)

- Capital Market Transaction Hypothesis
- Corporate Control Contest Hypothesis
- Stock Compensation Hypothesis:
    - Insider Trading;
    - Stock Liquidity;
    - Contracting Costs (undervaluation)
- Litigation Cost Hypothesis
- Management Talent Signalling Hypothesis
- Proprietary Cost Hypothesis

Why do (don't) managers have incentive to disclose information? (2)

- Capital Market Transaction Hypothesis
  - Managers have incentive to provide more internal information in order to obtain cheaper external finance (Beyer et al., 2010).

- Corporate Control Contest Hypothesis
  - Managers are more likely to be replaced when their firms' share perform poorly in the market. They therefore have incentive to make an accounting choice in a manner that can help avoid the firm is undervalued by its shareholders (Christie and Zimmerman, 1994).

What is the effect of corporate reporting and accounting disclosures? (3)

- Stock Compensation Hypothesis:
  - Managers' reporting behaviours may be subject to their share-based compensation packages. (Beyer et al., 2010)
    - Provide more disclosures in order to avoid restrictions or concerns of insider trading.
    - Provide more disclosures in order to increase the liquidity of shares and avoid undervaluation of the shares.
    - Provide more disclosures to decrease the contracting costs with new employees who have share-based compensation.

Why do (don't) managers have incentive to disclose information? (4)

- Litigation Cost Hypothesis
  - Managers have incentives to or not to disclose information in order to reduce the cost of litigation.
    - Litigation against in appropriate level of disclosures (especially bad news)
    - Litigation risk due to unexpected errors (such as earnings forecast errors).

- Management Talent Signalling Hypothesis
  - Managers have incentives to provide quality disclosures to signal their ability to anticipate and respond to future changes.

Why do (don't) managers have incentive to disclose information? (5)

- Proprietary Cost Hypothesis
  - Managers have incentive not to disclosure information if such information may threat to the firm's competitive advantage in the product market.

The effect of corporate reporting

What is the effect of corporate reporting and disclosures?

- Dependent on the **quality** and **reliability** of the reports and disclosures.

Managerial reporting decisions, behaviours or strategies. E.g.,

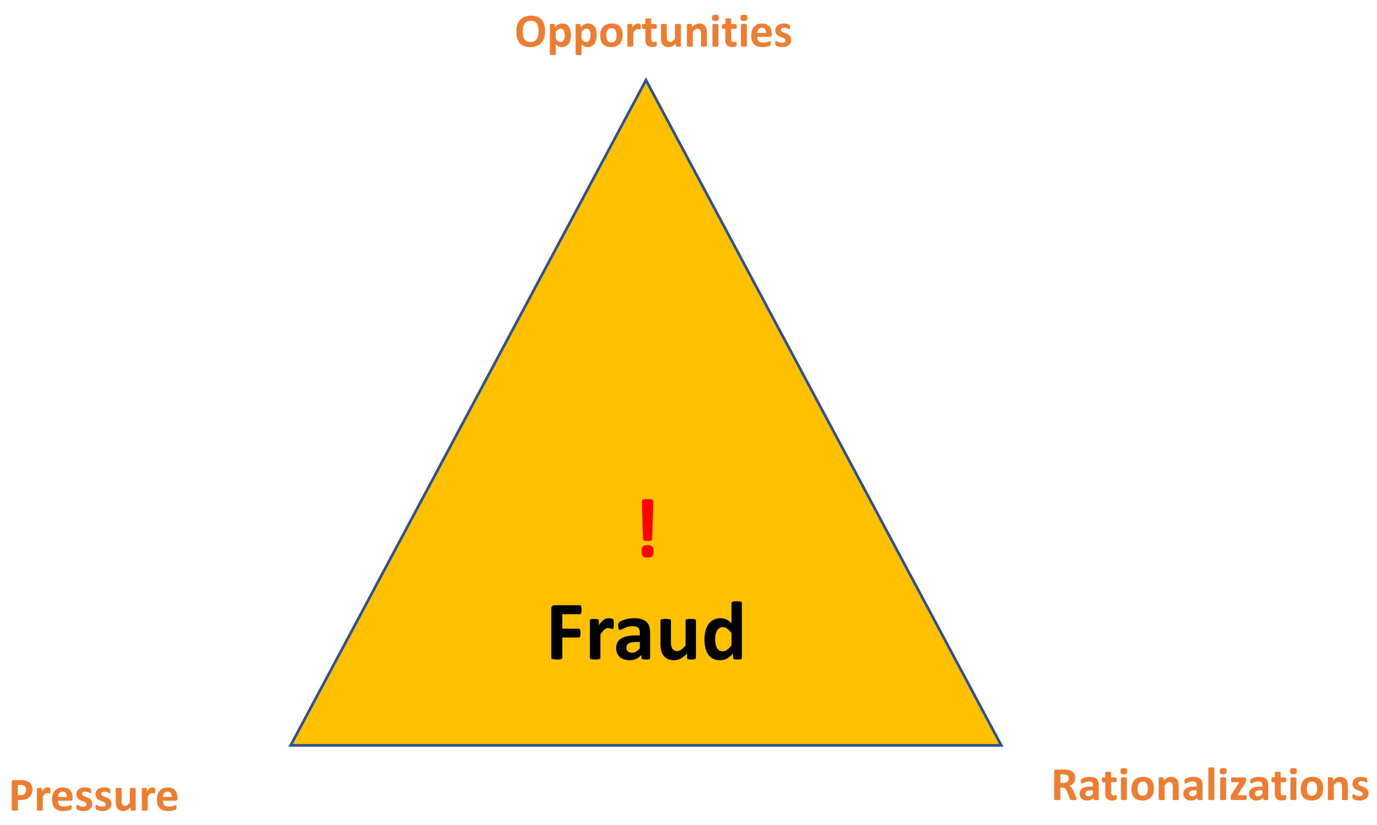
- Earnings management
- Accounting conservatism
- Voluntary disclosures

Perception or behaviours of information users and organisation (e.g., shareholders, debtholders)

- Share price (e.g., Lang & Lundholm, 2000)
- Cost of equity (e.g., Francis et al., 2008)
- Cost of debt (Dhaliwal et al., 2011; Zhang, 2008)
- Other organisational outcome — e.g., Investment efficiency (Lara et al., 2016)

Tesco Scandal 2014

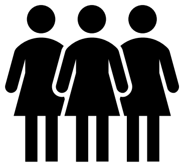
Fraud triangle



Managerial behaviour

- Agency conflicts (Jensen and Meckling 1976)
  - Directors (agents) operate companies on behalf of shareholders (principals)

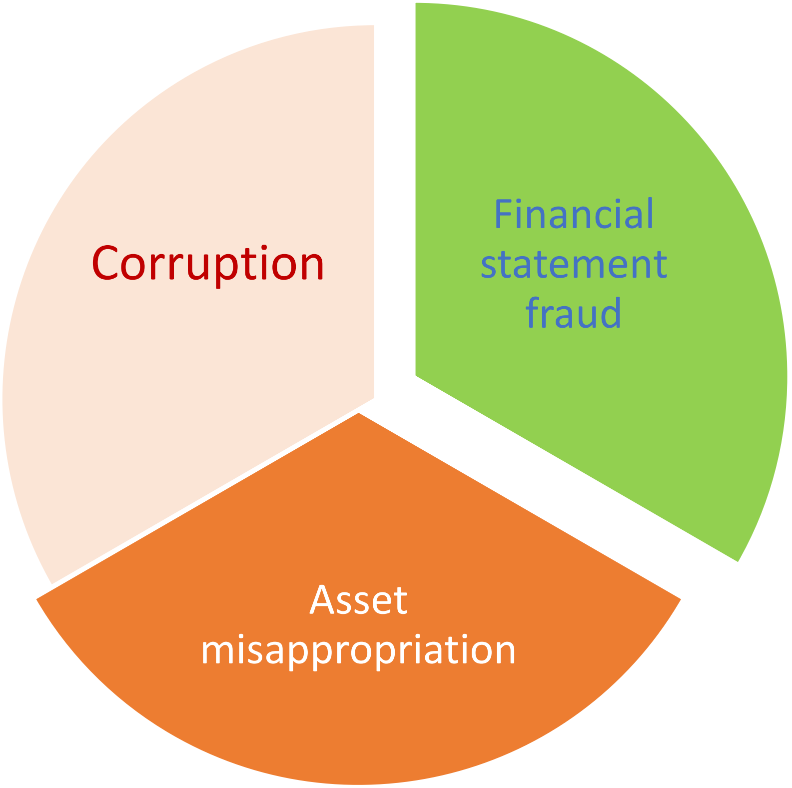
Director/Manager



Shareholders

- Information asymmetry (Akerlof 1970)

Types of fraud



Association of Certified Fraud Examiners (2020)

Polling Question 1

- **What type of fraud is the most common one?**
  - A. corruption
  - B. asset misappropriation
  - C. financial statement fraud

Polling Question 2

- **What type of fraud is the most costly one?**
  - A. corruption
  - B. asset misappropriation
  - C. financial statement fraud

There were a lot of financial scandals

2003 Parmalat

2004 American International Group

2008 Lehman Brothers

2011 Autonomy

2014 Tesco

2015 Toshiba

2018 Patisserie Valerie

Tesco scandal (2014)

Fact sheet

- 517, 000 colleagues
- 7817 shops around the world
- Over 80 million shopping trips per week

2014 Annual report (52 weeks ended 22 Feb 2014)

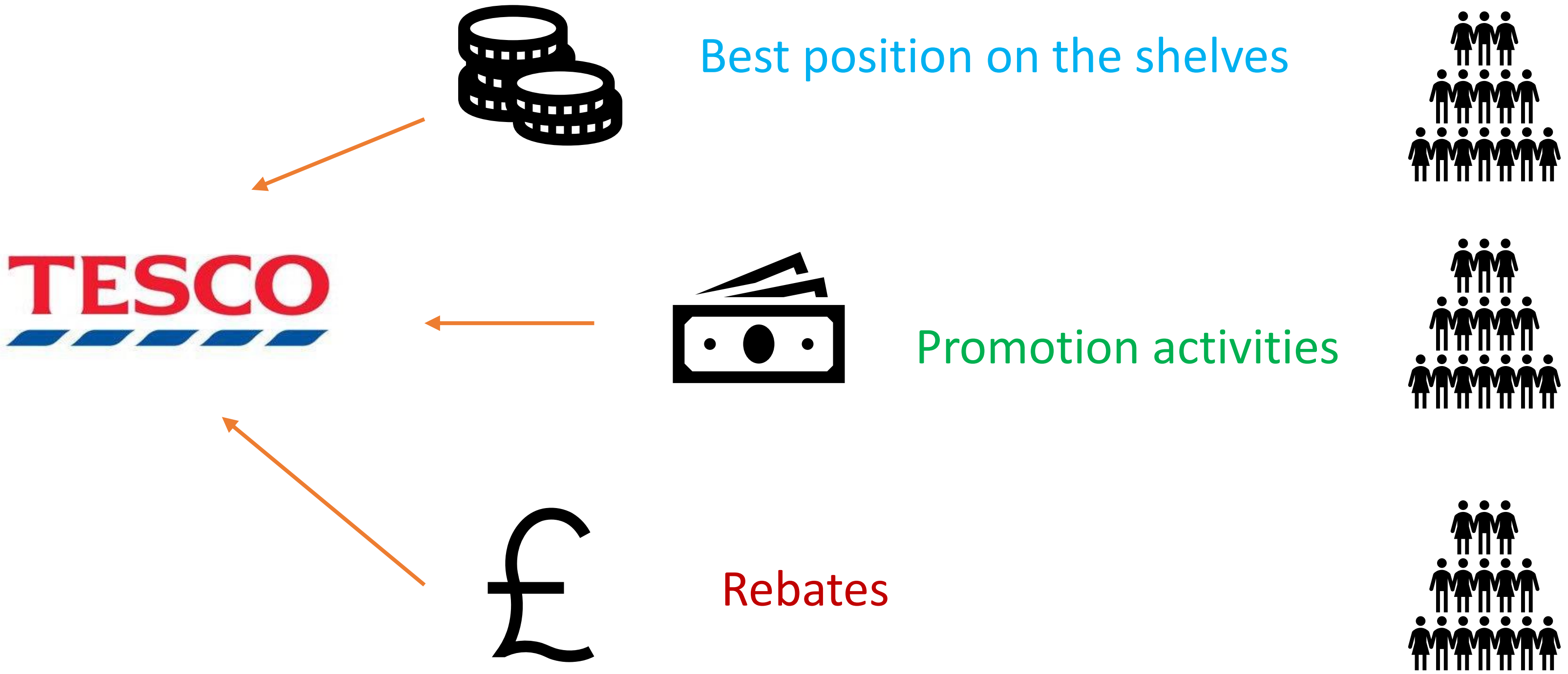
- Group Revenue £ 63.5 bn
- Group operating profit £ 2.6 bn

Tesco’s pressure

Source of pictures: bbc.co.uk

Commercial income

Economic relationship with supplier



Cooked the book

- **Overstatement of profits by more than £250 million**
  - Accelerate revenue recognition
  - Delay accruals of costs

- **PwC served Tesco since 1983 (32 years)**

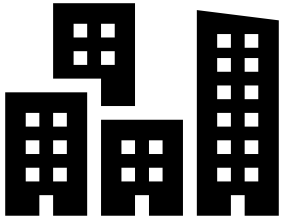
Aftermath

- UK finance director: Carl Rogberg
- UK managing director: Chris Bush
- UK food commercial director: John Scouler

Arrested and charged

Financial costs due to the scandal

£129 million



Serious Fraud Office

£85 million

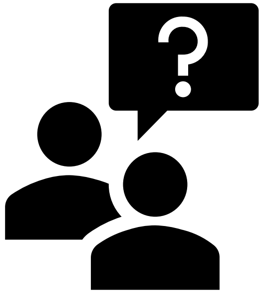
Investors

Guilty?

Tesco admitted fraud and agreed a £129m to the Serious Fraud Office !!!

- 2018

  Former Tesco directors have been acquitted of charges of fraud and false accounting due to lack of evidence



Questions

- Q1: What are the problems inherent in the accounting practices/policies in the Tesco's scandal?
- Q2: In what respect might the Tesco's managers hope to benefit from using such accounting practices/policies?
- Q3: Did Tesco benefit from such accounting practices/policies?
- Q4: Does disclosing the accounting treatment for **commercial income** help to mitigate the concern arising from the scandal? Any other mechanism could be put in place to mitigate the concern over accounting misbehaviours?

References:

Core readings:

Akerlof, G. A. 1970. The market for "lemons": Quality uncertainty and the market mechanism. *The quarterly journal of economies* 84 (3): 488-500.

Healy, P. M., and K. G. Palepu. 2001. Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. *Journal of Accounting and Economics* 31: 405-440.

Exam revision

General guidelines

- The emphasis of the exam is on understanding rather than rote memorisation.
- You are not required to memorise everything, but you need to comprehend the material.

Memory-You don’t need to memorise Examples	But you need to understand Examples
The founded years of GRI, SASB, or <IR>	Why we need these ESG disclosure standards
Each principle of PRI	Why we need ESG investment and the role of PRI
Authors and detailed research finding	Implications behind research findings
Detailed history of the development of IFRS and the full name of the corresponding organisational structure	Why IFRS is important and the potential challenges

Structure of the exam (20 marks)

❑Multiple Choice Questions

- 6 marks
- 6 questions

❑Open Short-Answer Questions:

- 6 marks
- 3 questions

❑Calculation Questions:

- 8 marks
- 4 questions

Multiple Choice Questions:

- Coverage: weeks 1-6
- Most of the questions aim to test your understanding on a specific topic
- Example:

Which of the following is a key component of integrated reporting?

- Some questions would be more flexible
- Example:

Which industry is most likely to have the longest receivable collection period?

Open Short-Answer Questions:

- A reasoned response
- To prepare for this section, you can focus on discussions from the slides and in class.
- Coverage: weeks 1-6

Open Short-Answer Questions:

- Example 1:

For a company like Unilever, which operates in the food and consumer goods industry, the ESG report should prioritize material topics that address both its impact on society and the environment. Considering this context, please list four material topics that should be prioritized in an ESG report of Unilever:

Topics + a brief explanation

e.g., Food Safety and Quality: consumers are the key stakeholder of the company. The company has a responsibility to ensure the safety and nutritional value of its products, protecting public health and strengthening consumer trust in the brand. Food safety issues can lead to significant risks such as product recalls, legal liabilities, and reputational damage, all of which can have substantial financial repercussions. By maintaining high standards of food safety, the company can mitigate these risks and ensure long-term sustainability.

- Example 2:

Briefly explain the two benefits and two potential challenges of sustainability assurance.

Calculation Questions:

- Coverage: week 2 (financial statements, WCR, ratio analysis)
- The calculation questions will not be longer than the in-class exercises, considering the time constraints.
- To prepare for this section, you should familiarise yourself with the following:

✓The structure of financial statements, particularly the balance sheet and income statement.

✓Understanding and calculating the working capital requirement.

✓The formulas for financial ratios and, importantly, the implications of each ratio.

Calculation Questions:

The following questions will all focus on the data available below, regarding the financial statements of the Company A for the FY20X4. Please, present all your computations and use the spaces below to computations and justifications. All calculations are retained to one decimal place.

FINANCIAL POSITION STATEMENT

€'000		€'000	
xxx	xxx	xxx	xxx
xxx	xxx	xxx	xxx
xxx	xxx	xxx	xxx
xxx	xxx	xxx	xxx
xxx	xxx	xxx	xxx
Total assets	xxx	**Total liabilities + Owner's equity**	xxx

INCOME STATEMENT

	€'000
xxx	xxx
xxx	xxx
xxx	xxx
xxx	xxx
xxx	xxx
xxx	xxx
xxx	xxx
xxx	xxx
Earnings after tax (EAT)	**22,800**

- Example:

➢ **Calculate the inventory turnover period for Company A in 20X4.**

➢ **Horizontal analysis: The industry average is xx days. Analyse one potential advantage and one potential disadvantage that this inventory turnover period may present.**

➢ **Vertical analysis: calculate ROA for the year 20X4. The ROA for Company A in 20X3 was xx. Please analyse the possible reasons for the change in this ratio between 20X3 and 20X4.**

Conclusion:

1. The concepts of information asymmetry and the market for lemons
2. The role of corporate reporting and accounting disclosures
3. Different managerial reporting incentives
4. What is the effect of corporate reporting
5. Individual written test-exam revision