

## 2. THE FUNDAMENTALS OF FINANCIAL ACCOUNTING AND REPORTING

### 2.1. Introduction to the Chapter

To study the current state and future prospects of intangibles in financial accounting and reporting, it is necessary to obtain an understanding of the accounting function and its underlying theories. That is because the latter generally determines the purpose of a financial accounting and reporting system. The design of such a system again is based upon pre-defined objectives.<sup>13</sup> Therefore, the discussion of fundamentals establishes principles that may be used to further analyze the financial accounting and reporting of intangibles and to identify potential shortcomings of current standards.

IFRSs center their objectives around entities whose securities<sup>14</sup> are listed and traded on an accredited exchange.<sup>15</sup> That is why the following paragraphs examine the accounting function within a capital markets context. Economic and finance theory is employed in order to justify and to explain the existence of financial accounting and reporting. Based on this analysis, the objectives and potential user groups of IFRSs are further explicated. Then, the subsequent section outlines the definition and characteristics of decision-useful information, as outlined by the CONCEPTUAL FRAMEWORK of IFRSs.

### 2.2. Justification for the Existence of Financial Accounting and Reporting

This section draws upon the efficient-markets hypothesis and the agency problem to justify the existence of financial accounting and reporting. The former is embedded in neoclassical economic and finance theory and focuses on information processing on capital markets. The agency problem is a major part of new institutional economics

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<sup>13</sup> According to GASSEN, the objectives of financial accounting are crucial determinants of standard setting and research (cf. GASSEN, J. (2008), p. 2). Similarly, CHAMBERS argues that accounting definitions are a matter of choice, leading to quite different purpose or objects (CHAMBERS, R. J. (1965), p. 37).

<sup>14</sup> The term *security* is to be interpreted in a broad manner. That is, a security may refer to an entity's listed equity, e.g. stocks, or to its debt instruments, such as publicly traded bonds and debentures.

<sup>15</sup> Cf. BOHL, W. (2006), § 1 para. 29. Accordingly, companies governed by the law of an European Union's (EU) member state have to prepare their consolidated financials in conformity with IFRSs, if their securities are admitted to trading on a regulated market of any member state (cf. REG (EC) 1606/2002, Article 4).

and explains and intends to solve the problem of information asymmetries in different settings.

### 2.2.1. Neoclassical Economic and Finance Theory

The neoclassical view in finance theory builds its analytical models upon two major assumptions: the homo economicus and perfect competition.<sup>16</sup> The former implies that market participants act rationally and intend to maximize their individual utility function.<sup>17</sup> Perfectly competitive financial markets are characterized by different conditions. Besides the notion about rational and utility optimizing behavior,

- market participants are price takers and have perfect information;
- neither trading costs nor taxes nor any other market barriers exist; and
- all assets are perfectly divisible as well as tradable.<sup>18</sup>

In such markets, financial accounting and reporting appears to be obsolete. Under the above circumstances, no frictions exist at all. All value relevant information is available to every market participant as there are no information asymmetries.<sup>19</sup> Market prices reflect the actual fundamental values of companies.<sup>20</sup> Hence, the legitimacy of financial accounting and reporting as information source in capital markets cannot really be explained by simply employing the narrow assumptions of perfectly competitive markets.

The price on perfectly competitive markets may also be considered as pareto-efficient, as all resources on such markets, e.g. capital, are perfectly allocated and no market participant can be better off without making one worse off.<sup>21</sup> However, perfectly competitive markets and pareto-efficiency have to be distinguished from the idea of market efficiency. The former is especially concerned with the market equilibrium and

<sup>16</sup> Cf. SCHMIDT-TANK, S. (2005), p. 11 et seqq. For example, the efficient-market-hypothesis, the random-walk-hypothesis, the fair-game-model as well as the capital asset pricing model or the Modigliani-Miller-theorem are models in finance theory that are based on neoclassical views (cf. RUMMER, M. (2006), p. 13 with additional references).

<sup>17</sup> Cf. MANKIW, N. G. (2001), p. 4 et seqq. For an introduction of how market participants are characterized in economic theory. For a detailed overview of the homo economicus and its application in economics and other social sciences cf. KIRCHGÄSSNER, G. (2008), p. 1 et seqq.

<sup>18</sup> Cf. COPELAND, T. E./WESTON, J. F. (1992), p. 331; STEINER, M./BRUNS, C. (2007), p. 3.

<sup>19</sup> Cf. WICHELS, D. (2002), p. 44.

<sup>20</sup> Cf. VELTE, P. (2008), p. 20.

<sup>21</sup> Cf. VORSTIUS, S. (2004), p. 16.

the allocation of resources. The latter sheds light on the information processing on capital markets, studying the relationship between market prices and their underlying information. More specifically, the concept examines how information is incorporated into market prices.<sup>22</sup> Due to its focus, the notion of efficient markets may be utilized to justify the information function of financial accounting and reporting on capital markets.

### 2.2.1.1. The Efficient-Market Hypothesis and Empirical Evidence

The term *efficient market* was first defined by FAMA in developing the efficient-markets-hypothesis (EMH).<sup>23</sup> Accordingly, a “*market in which prices always ‘fully reflect’ available information is called ‘efficient’.*”<sup>24</sup> The definition implies that prices on efficient markets incorporate new information completely and immediately.<sup>25</sup> There is no delay in price adjustments at all. Therefore, prices on efficient markets always match the firms’ fundamental values, which are justified by the information that is available at the time.<sup>26</sup> All securities are valued correctly. It is impossible to gain any excess returns by performing any type of financial analysis, e.g. technical or fundamental analysis.<sup>27</sup> As the concept of perfectly competitive markets, the EMH is based on different assumptions:

- there are no transaction costs in trading securities;
- all information is available to all market participants at no cost; and

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<sup>22</sup> Cf. WAGENHOFER, A./EWERT, R. (2003), p. 104.

<sup>23</sup> Cf. FAMA, E. F. (1965), p. 34 et seqq.; FAMA, E. F. (1970), p. 383 et seqq.; FAMA, E. F. (1976), p. 143 et seqq.; FAMA, E. F. (1991), p. 1575 et seqq. Most research examines market efficiency empirically rather than theoretically. Still, various views and definitions of the concept exist. For an overview and discussion refer to VOLLMER, R. (2008), p. 43 et seqq.

<sup>24</sup> FAMA, E. F. (1970), p. 383. The EMH has its origins in the random walk model, which concluded that time series of prices on product or share markets do not follow a certain pattern; that is, successive price changes are independent, identically distributed random variables (cf. FAMA, E. F. (1970), p. 386; VORSTIUS, S. (2004), p. 16). As a series of price changes does not have any memory, the future cannot be predicted by using the past in any meaningful way (cf. FAMA, E. F. (1965), p. 35).

<sup>25</sup> Cf. VOLLMER, R. (2008), p. 40.

<sup>26</sup> Cf. HEPERS, L. (2005), p. 45; RUMMER, M. (2006), p. 18. According to GREENBAUM/THAKOR, “*every security’s price equals its ‘true’ economic value.*” (GREENBAUM, S. I./THAKOR, A. V. (2007), p. 21). They define *true economic value* as a price that includes all information available to investors at the time.

<sup>27</sup> Cf. FRANKE, G./HAX, H. (2004), p. 398; VOLLMER, R. (2008), p. 40.

- all agree on the implication of current information for the current price and distributions of future prices of each security.<sup>28</sup>

However, the above assumptions are sufficient but not necessary for market efficiency.<sup>29</sup> That is because a market may even be efficient if a sufficiently large number of investors have ready access to available information.<sup>30</sup> The level of market efficiency depends on the degree of information that is reflected in security prices. According to FAMA, there are three different efficiency levels, whereas higher levels include the conditions of the lower ones:<sup>31</sup>

- in the *weak* form of market efficiency, current prices reflect all information contained in the record of past prices. The notion implies that knowledge of historical prices cannot lead to any excess returns. Thus, technical or chart analysis of past market prices is obsolete;
- the *semi-strong* form of market efficiency requires that current prices not only reflect past prices but also all public information. That is, any newly published information will be incorporated into current market prices immediately. For example, market prices will instantly adjust due to an announcement of quarterly earnings. Therefore, the analysis of public information, e.g. the fundamental analysis of published financial data, does not lead to any excess returns; and
- in the *strong* form of market efficiency, current prices incorporate all public and private information that is value relevant at the time. That is why the knowledge and analysis of insider information do not induce any excess returns. Prices adjust instantly once new information – public or private – becomes available.

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<sup>28</sup> Cf. FAMA, E. F. (1970), p. 387; FAMA, E. F. (1991), p. 1575.

<sup>29</sup> Cf. VORSTIUS, S. (2004), p. 17; TRAUTWEIN, A. (2007), p. 23.

<sup>30</sup> Cf. FAMA, E. F. (1970), p. 387. Thus, conditions of efficient markets are not as restrictive as the ones for perfectly competitive markets. That is why markets may still be efficient but not perfect, as the prices may still reflect all information available at the time.

<sup>31</sup> Cf. FAMA, E. F. (1970), p. 383 et seqq.; FAMA, E. F. (1991), p. 1575 et seqq.; BODIE, Z./KANE, A./MARCUS, A. J. (2002), p. 342 et seqq.; BREALEY, R. A./MYERS, S. C. (2003), p. 351.

Hence, the assumption of strong market efficiency implies that market prices equal the firms' values.<sup>32</sup>

The EMH has been tested intensively over the course of the last decades. Researchers generally examine security markets to determine their degrees of market efficiency. The weak form of market efficiency is tested by tests-for-return-predictability<sup>33</sup>, whereas the semi-strong and strong forms are examined by event studies<sup>34</sup> and tests for private information<sup>35</sup>, respectively. Empirical results vary across the three forms as well as within the categories.<sup>36</sup>

### 2.2.1.2. Implications of the Efficient-Market Hypothesis

As all information is incorporated in security prices, no information asymmetries exist on capital markets that are characterized by strong efficiency. Under such conditions, the analysis of information cannot produce any excess gains at all. Thus, the analysis of financial data is useless.<sup>37</sup> Prices even reflect inside information about a firm's financial position. Hence, the legitimacy of financial accounting and reporting as

<sup>32</sup> Cf. KAMES, C. (2000), p. 29; HEPERS, L. (2005), p. 47; SCHILDBACH, T. (2006), p. 10; VELTE, P. (2008), p. 22.

<sup>33</sup> In general, tests-for-return-predictability examine whether price records are actually based on a random walk, implying that time series of stock prices or returns are independent from each other (cf. VOLLMER, R. (2008), p. 63). Research focuses on the forecast power of past returns or other variables like dividend yields, earnings/price ratios or term-structure variables, across varying time horizons (cf. FAMA, E. F. (1991), p. 1577 et seq.). Common test designs are correlation tests or run-tests; additionally, simple chart rules may be tested (cf. STEINER, M./BRUNS, C. (2007) p. 44). Examples of studies that test for the weak form of market efficiency are ALEXANDER, S. S. (1961), p. 7 et seq.; ALEXANDER, S. S. (1964), p. 25 et seq.; DE BONDT, W. F. M./THALER, R. (1985), p. 793 et seq. For additional studies refer to FAMA, E. F. (1991), p. 1577 et seq.

<sup>34</sup> The focus of event studies is the reaction of stock prices due to the publication of firm specific data, e.g. earnings estimates, financial statement data or the like. Tests measure the reaction time and the extent of stock price adjustments (cf. WICHELS, D. (2002), p. 56). That is, researchers analyze stock prices before and after a specific event in order to determine whether there have been any abnormal returns (cf. VOLLMER, R. (2008), p. 77). Examples of event studies are BALL, R./BROWN, P. (1968), p. 2 et seq.; BEAVER, W. H. (1968), p. 63 et seq.; FAMA, E. F. ET AL. (1969), p. 1 et seq.; CHAREST, G. (1978), p. 297 et seq.; LEE, C. M. C. (1992), p. 265 et seq. For additional examples refer to FAMA, E. F. (1991), p. 1603 et seq.

<sup>35</sup> Tests for private information examine whether any investor has information that is not fully incorporated into current market prices (cf. FAMA, E. F. (1991), p. 1576 et seq.). More specifically, researchers investigate whether certain market participants, e.g. financial analysts or insiders, are capable of gaining returns in excess of the market (cf. WICHELS, D. (2002), p. 56 et seq.; VOLLMER, R. (2008), p. 90). Examples of studies that test strong market efficiency are: JAFFE, J. F. (1974), p. 410 et seq.; FINNERTY, J. E. (1976), p. 1141 et seq.; HENRIKSSON, R. T. (1984), p. 73; STICKEL, S. E. (1985), p. 121 et seq.; SEYHUN, H. N. (1986), p. 189 et seq.; MEULBROEK, L. K. (1992), p. 1661 et seq. For additional studies refer to FAMA, E. F. (1991), p. 1599 et seq.

<sup>36</sup> Cf. WICHELS, D. (2002), pp. 55-57. Also refer to VELTE, P. (2008), pp. 20 and 22.

<sup>37</sup> Cf. HEPERS, L. (2005), p. 55.

information source for capital markets cannot be upheld on markets with strong efficiency.<sup>38</sup> However, the idea of strong market efficiency is rather unrealistic and simply a theoretical model.<sup>39</sup>

As the semi-strong form of efficiency suggests that current prices reflect all publically available information, it may be questioned whether the information function of financial accounting and reporting is legitimate. Under such conditions, financial data published by companies is already included in current prices. Once a company releases new information, either mandatorily or voluntarily, prices instantly adjust. Therefore, some argue that financial accounting and reporting is redundant, as its analysis cannot help to identify any undervalued stock or to gain any returns in excess to the market.<sup>40</sup> However, this view is not really convincing. Even though fundamental analysis may be useless, financial accounting and reporting still acts as an intermediary, transferring private into public information.<sup>41</sup> In the absence of any reporting requirements, market participants would be faced with less informative prices. That is why even additional voluntary disclosures appear to be useful.<sup>42</sup> Hence, the information function of financial accounting and reporting cannot be denied in the case of semi-strong efficiency.

Current prices on markets of the weak form of efficiency do not incorporate any public or private information. They only reflect records of historical prices. Under such conditions, fundamental analysis of data derived from different sources, e.g. from financial accounting and reporting, may help to identify undervalued stock and to potentially earn returns in excess to the market. Thus, the information function of financial accounting and reporting cannot generally be denied.<sup>43</sup>

As shown, financial accounting and reporting supports the information efficiency of capital markets: on semi-strong efficient markets, private information is made public

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<sup>38</sup> Any additional reporting, e.g. an optional intangible assets and goodwill reporting, would also be useless (cf. VELTE, P. (2008), p. 22 with additional references).

<sup>39</sup> Cf. VOLLMER, R. (2008), p. 51. The absence of any private information is especially questioned (cf. BODIE, Z./KANE, A./MARCUS, A. J. (2002), p. 343; HEPERS, L. (2005), p. 47 with additional references). Even FAMA admits that the strong version of market efficiency is false (cf. FAMA, E. F. (1991), p. 1575). However, he further elaborates that it is a clean benchmark that allowing him to avoid the issue of deciding what are reasonable information and trading costs.

<sup>40</sup> Cf. HEPERS, L. (2005), p. 46 et seq.

<sup>41</sup> Similarly in the case of investor's relations, cf. WICHELS, D. (2002), p. 55.

<sup>42</sup> Cf. FISCHER, T./WENZEL, J. (2005), p. 6. Additionally, cf. VELTE, P. (2008), p. 22 et seq.

<sup>43</sup> Cf. HEPERS, L. (2005), p. 46 with additional references.

and is therefore incorporated into security prices; on markets of weak efficiency, market participants can employ the data derived from financial accounting and reporting in their fundamental analysis.<sup>44</sup> Accordingly, financial accounting and reporting serves as a protective mechanism in two ways.

On the one hand, the publication of financial records may protect the functioning of capital markets. One of the primary objectives of capital markets is the allocation of financial resources. Because resources are limited, they need to be allocated efficiently among capital providers<sup>45</sup> and market participants who intend to raise funds, whereas allocative efficiency refers to the pareto-efficient distribution of capital.<sup>46</sup> As discussed, financial accounting and reporting contributes to the information efficiency of capital markets, disclosing information that otherwise might have been kept private. Information efficiency again is a necessary pre-condition for capital markets to be allocative-efficient. Therefore, publishing financial data also adds to the allocative efficiency of capital markets.<sup>47</sup>

On the other hand, financial accounting and reporting protects market participants as individuals. Due to the publication of financial data, market participants are generally presented with security prices that *ceteris paribus* reflect more information. As such, mispriced stocks may be identified easier and market participants are capable of making better informed decisions.<sup>48</sup> If there was no information or if market participants were not as protected, they might invest in the wrong stocks, hesitate to

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<sup>44</sup> Cf. Section 2.2.1.1.

<sup>45</sup> Note that the term *capital providers* may relate to providers of equity or of debt. Also refer to the discussion related to the primary user group of IFRSs (cf. fn. 130).

<sup>46</sup> Cf. BIENERT, H. (1996), p. 15.

<sup>47</sup> Note that information efficiency initially is a necessary but not sufficient requirement for valuation efficiency. On value-efficient capital markets, security prices reflect the company's actual value, which is the present value of expected future cash flows available for distribution to the respective security (cf. MERTON, R. C. (1987), p. 93). As such, capital markets need to be information-efficient at some level so that prices incorporate all information available at the time. Value efficiency again is a necessary assumption for capital markets to be allocative-efficient. That is, value-efficient security prices are required for an efficient allocation of capital resources (cf. BAUMOL, W. J. (1965), p. 36), providing accurate signals for potential investment opportunities. However, if prices do not incorporate all relevant available information, they do not reflect actual values and have limited capabilities to serve as investment indicators (cf. VOLLMER, R. (2008), p. 102 et seq.).

<sup>48</sup> As discussed above, on weak-efficient markets investors may even employ fundamental analysis in order to identify undervalued stock.

invest or not invest at all. In this respect, protection of individual market participants is a requirement for capital markets to function efficiently.<sup>49</sup>

In summary, EMH appears to be a useful concept to justify the existence of financial accounting and reporting. Focusing on the processing of information on capital markets, the theory examines the various degrees of information that are already reflected in current prices. Nevertheless, EMH is still based upon rather unrealistic conditions.<sup>50</sup> Even though the assumptions are only sufficient, they still need to exist to some extent in order to explore the different degrees of market efficiency. Thus, neoclassical theory has been criticized various times for not being capable of explaining real phenomena.<sup>51</sup> That is why it appears to be useful to employ a further theory that can explain the legitimacy of financial accounting and reporting based on more realistic assumptions. Therefore, the following section introduces the theory of new institutional economics.

## 2.2.2. New Institutional Economics and Principal Agent Theory

The main objective of new institutional economics (NIE) is to explore and explain institutions, perceived as a set of contractual or statutory rules that act as a penalty-reward system to establish order and to minimize uncertainty.<sup>52</sup> Thus, theories in NIE focus on transactions and their respective institutional frameworks.<sup>53</sup> As opposed to

<sup>49</sup> Cf. HOMMELHOFF, P. (2000), p. 772; KAHLE, H. (2002), p. 97; LOPATTA, K. (2005), p. 9 et seqq.; VOLLMER, R. (2008), p. 27.

<sup>50</sup> For a detailed analysis of the EMH assumptions, cf. HEPERS, L. (2005), p. 47 et seqq. It is especially difficult to uphold the assumptions for strong market efficiency (cf. fn. 39).

<sup>51</sup> Cf. VELTE, P. (2008), p. 23.

<sup>52</sup> Cf. RUHWEDDEL, F. (2003), p. 67; HEPERS, L. (2005), p. 62. The rules are to secure potential but uncertain cooperation payoffs (cf. NEUS, W. (1998), p. 10; ZIMMERMANN, G./WORTMANN, A. (2001), p. 289; VELTE, P. (2008), p. 32). Moreover, cf. WATTS, R. L./ZIMMERMAN, J. L. (1983), p. 614, who view firms as sets of contracts.

<sup>53</sup> Cf. RUMMER, M. (2006), p. 27. NIE consists of different research branches, e.g. the *property rights theory*, the *transaction cost approach* and the *principal agent theory*. For an overview and comparison of the three theories cf. JONGOWOOK, K./MAHONEY, J. T. (2005), p. 223 et seqq. The *property rights theory* constitutes the foundation of the other concepts in NIE, examining the optimal allocation of different types of rights (cf. VOLLMER, R. (2008), p. 13). The notion is especially concerned with the effects of statutory and institutional rules on the behavior of market participants (cf. PERRIDON, L./STEINER, M. (1999), p. 513; RUMMER, M. (2006), p. 28; in addition, cf. FURUBOTN, E. G./PEJOVICH, S. (1972), p. 1137 et seqq. for a detailed overview). The *transaction cost approach* is closely related to the property-rights theory. It investigates the question why an organization, such as a firm, emerges at all in a specialized exchange economy, in which the price mechanism coordinates the allocation of resources. That is why transaction costs are introduced. Such costs are incurred during the utilization of the market's price mechanism. They can be eliminated or at least kept at a minimum within an organization. Thus, the formation of a firm substantially lowers such costs. However, it creates additional ones, e.g. organizational



the neoclassical view in economics and finance theory, NIE is not based upon the strict assumptions of perfectly competitive markets or on the homo economicus concept.<sup>54</sup> NIE rather accepts the existence of deficient market conditions. That is, the theory specifically includes imperfections in its analysis, e.g. information asymmetries or transaction costs.<sup>55</sup> Correspondingly, the behavior of market participants assumed in NIE generally resembles the actual behavior in the real world.<sup>56</sup> In summary, the main attributes of NIE are the limited capability to process information, opportunistic behavior and relations constructed through long-term contracts.<sup>57</sup>

As part of NIE, *the principal agent theory*<sup>58</sup> examines the delegation of rights within an agency relationships framework.<sup>59</sup> According to JENSEN/MECKLING an agency relationship is defined as “*a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.*”<sup>60</sup> Hence, agency relationships are characterized by the separation of ownership and control, i.e. the power of disposition.<sup>61</sup> Thus, such relationships occur whenever the engaged person is not completely liable and does not have to bear all of the financial consequences due to her actions.<sup>62</sup> The agent rather makes decisions that not only impact her own well-being, but also the one of the principal. In the context of this task

costs (cf. COASE, R. H. (1937), p. 386 et seqq.; WILLIAMSON, O. E. (1975); WILLIAMSON, O. E. (1981), p. 548 et seqq.). The *principal agent theory* will be explicated in this section in more detail.

<sup>54</sup> Cf. RUMMER, M. (2006), p. 27. Nevertheless, individuals are assumed to seek their own interest and to maximize their utility, which is subject to the limits established by the existing organizational structure (FURUBOTN, E. G./PEJOVICH, S. (1972), p. 1137). Accordingly, bounded rationality plays an important role in NIE (cf. FURUBOTN, E. G. (2001), p. 133 et seq.). SIMON introduced the notion of bounded rationality to replace the global rationality of the economic man as the former is “*compatible with the access to information and the computational capacities that are actually possessed by organisms, including man, in the kinds of environments in which such organisms exist.*” (SIMON, H. A. (1955), p. 99).

<sup>55</sup> Cf. VOLLMER, R. (2008), p. 12 with additional references.

<sup>56</sup> Cf. RUHWEDER, F. (2003), p. 67; HEPERS, L. (2005), p. 61. Additionally, cf. the remarks in fn. 54.

<sup>57</sup> Cf. HAX, H. (1991), p. 56.

<sup>58</sup> For a fundamental overview and the origins of the principal agent theory, cf. JENSEN, M. C./MECKLING, W. H. (1976), p. 306 et seqq.; FAMA, E. F. (1980), p. 288 et seqq.; FAMA, E. F./JENSEN, M. C. (1983a), p. 301 et seqq.; FAMA, E. F./JENSEN, M. C. (1983b), p. 327 et seqq.

<sup>59</sup> The principal agent theory has been widely employed to explain the function of financial accounting and reporting (cf. HOMMEL, M. (1998), p. 18; VELTE, P. (2008), p. 32; VOLLMER, R. (2008), p. 14 et seq., all with additional references).

<sup>60</sup> JENSEN, M. C./MECKLING, W. H. (1976), p. 308.

<sup>61</sup> Cf. FAMA, E. F./JENSEN, M. C. (1983a), p. 307 et seqq.; HAX, H. (1991), p. 60; HEPERS, L. (2005), p. 63.

<sup>62</sup> Cf. HOMMEL, M. (1998), p. 19.

sharing, information asymmetries arise between the principal and the agent; the parties do not have the same level of information. Because individuals possess limited capacities to process information, the principal cannot fully observe the agent's characteristics and behavior.<sup>63</sup> Therefore, the latter has an information advantage over the principal.<sup>64</sup> Conflicts may emerge, as the agent has her own agenda and intends to maximize her utility.<sup>65</sup>

Research examines the agency problem in various scenarios and focuses on the arrangement of contracts or other measures to solve the respective issues, i.e. the information asymmetries.<sup>66</sup> The classical agency relationship is the one between the manager and owner of the firm.<sup>67</sup> Within the scope of capital markets, the current or potential investor can be considered as the principal, who has to decide whether to begin, continue or cancel the relationship by investing or withdrawing her funds.<sup>68</sup> The corporation's management is the agent, who controls the invested capital on behalf of the investor. Other typical agency settings would be between the auditor and stockholder<sup>69</sup> or the borrower and creditor<sup>70</sup>.

### 2.2.2.1. Information Asymmetries and Agency Costs

Information asymmetries may emerge before or after the conclusion of a contract. Correspondingly, the information issue comprises different attributes. Before entering into a formal relationship, the principal is not capable of obtaining all of the relevant information about the agent's attributes (hidden characteristics). Thus, uncertainty exists about the agent's qualification. The principal will only be willing to pay a price

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<sup>63</sup> Cf. HEPERS, L. (2005), p. 63. Moreover, cf. GÖBEL, E. (2002), p. 100; RUHWEDEL, F. (2003), p. 68. Also cf. the remarks in fn. 54. Information asymmetries not only emerge due to the individual's limited capacities, but also because of incomplete contracts.

<sup>64</sup> Cf. BENTELE, M. (2004), p. 5. The agent has different advantages. On the one hand, she knows her own characteristics better than the principal. On the other hand, she has superior knowledge about the operations of the firm.

<sup>65</sup> Cf. ALCHIAN, A. A./DEMSETZ, H. (1972), p. 779 et seq.; ROSS, S. A. (1973), p. 134; JENSEN, M. C./MECKLING, W. H. (1976), p. 308; BENTELE, M. (2004), p. 5. If all parties could acquire information at no cost, there would be no principal agent problem (cf. PICOT, A. (1991), p. 150).

<sup>66</sup> The optimal design of contracts is seen as the pivotal problem of NIE (cf. HAX, H. (1991), p. 58).

<sup>67</sup> Cf. BENTELE, M. (2004), p. 5.

<sup>68</sup> Cf. HEPERS, L. (2005), p. 67.

<sup>69</sup> For example, cf. RONEN, J. (1979), p. 424 et seq.; EWERT, R. (1990), p. 19.

<sup>70</sup> Cf. SCHILDBACH, T. (1986), p. 57 et seqq.

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