Solutions Manual for Financial Accounting Theory CDN 8th Scott

CHAPTER 1

INTRODUCTION

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1.2 Some Historical Perspective

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1.6 Rules-Based versus Principles-Based Accounting Standards

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1.10 The Fundamental Problem of Financial Accounting Theory

1.11 Regulation as a Reaction to the Fundamental Problem

1.12 The Organization of This Book

- 1.12.1 Ideal Conditions
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LEARNING OBJECTIVES AND SUGGESTED TEACHING APPROACHES

1. The Broad Outline of the Book

I use Figure 1.1 as a template to describe the broad outline of the book. Since the students typically have not had a chance to read Chapter 1 in the first course session, I stick fairly closely to the chapter material.

The major points I discuss are:

- Accounting in an ideal setting. Here, present-value-based accounting is natural. I go over the ideal conditions needed for such a basis of accounting to be feasible, but do not go into much detail because this topic is covered in greater depth in Chapter 2.

- An introduction to the concept of information asymmetry and resulting problems of adverse selection and moral hazard. These problems are basic to the book and I feel it is desirable for the students to have a "first go" at them at this point. I concentrate on the intuition underlying the two problems. For example, adverse selection can be illustrated by asking who would be first in line to purchase life insurance if there was no medical examination, or what quality of used cars are likely to be brought to market. For moral hazard I try to pin them down on how hard they would work in this course if there were no exams.

- The environment in which financial accounting and reporting operates. My main goal at this point is that the students do not take this environment for granted. I discuss the procedures of standard setting briefly and point out that this is really a process of regulation. In the past, there have been well-known cases of deregulation, such as airlines, trucking, financial institutions, power generation. However, regulation of financial institutions increased following the 2007-2008 market meltdowns (Section 1.3). Currently, at least in the United States, some of these regulations are being rolled back. Instructors may wish to anticipate briefly the pros and cons of markets v. regulation now since this topic becomes important in Chapters 12 and 13.

2. The Concept of Information

By now, I will have referred to the term "information" several times. I suggest that it is easy to take this term for granted, and call for definitions. This usually generates considerable hesitation by the students. The purpose at this point is simply to get them to realize that information is a complex commodity. Indeed, I make an analogy between the financial accounting and reporting industry and a stereotypical manufacturing industry such as agriculture or automobiles, and ask what is the product of the accounting industry, why is it valuable, how is it quantified? I do not go deeply into the answers to questions like these, since some decision-theoretic machinery needs to be developed (Section 3.3) before a precise definition of information can be given. Nevertheless, I try to end up with the conclusions that information has something to do with improving the process of decision-making, and that it is crucial to the operation of securities markets.

3. Relevance to Accounting Practice

My undergraduate accounting theory classes usually consist of a majority of students who are heading for a professional accounting designation. There are usually also some students heading for careers in management.

Since students who are facing professional accounting exams can be quite focused in their learning objectives, it is essential that the nature of the course in relation to these objectives be discussed up front.

I begin by pointing out that the book is intended to give the student an appreciation and understanding of the financial reporting environment, which should help with breadth questions on professional exams. I also argue that one's career continues well beyond attainment of a professional accounting designation, and that the nature of the textbook is longer-run and designed to foster a critical awareness of the financial accounting environment, which is needed if one is to become a thoughtful professional.

Arguments such as these can only be pushed so far. Nevertheless, I think it is important to make them. I also point out that the text includes coverage of major accounting standards such as financial instruments, impairment, consolidations, and de-recognition; and that they will have the opportunity to learn the broad outlines of these standards on the way through.

I also refer the students to Section 1.13, and emphasize that the text recognizes an obligation to convince them that the material is relevant to their careers. To do this, the text explains theoretical concepts in intuitive terms, and illustrates and motivates the concepts based on a series of Theory in Practice vignettes, and problem material based frequently on articles from the financial press and relevant research findings.

For the management students in the class, and for the professional accounting students who may some day be managers, I emphasize that the text does not ignore them. Chapters 8 to 11 inclusive (the bottom branch of Figure 1.1) deal with topics of interest to managers, including economic consequences, conflict resolution, executive compensation and earnings management. All of these topics demonstrate that management has a legitimate interest in financial reporting. I also argue that Chapters 2 to 7 inclusive (the top branch of Figure 1.1) are relevant to managers since they give insights into how financial accounting information is used by investors. Finally, since management is a major constituency in standard setting, a critical awareness of the need for standard setting and the standard-setting process (Chapters 12 and 13) is useful for any manager.

I have not had problems with student course evaluations as a result of using the material in this book. In fact, I have constantly been surprised at how far one can push the students in a theoretical direction providing that I rely on the textbook material to give the students an intuitive understanding, and concentrate in class on illustrating, motivating and discussing the application of the concepts. For this, I find that the financial media are helpful sources of current articles which I bring to class to serve as a basis for discussion. Numerous such articles form the basis of most "Theory in Practice" vignettes scattered throughout the text.

4. The Structure of Standard-Setting Bodies

This edition continues to orient itself to International Accounting Standards Board (IASB) standards, although attention is also given to several U.S. standards. Instructors may wish to briefly discuss the structure of standard-setting bodies at this point.

5. Social Issues Underlying Regulation

Instructors who wish to dig more deeply into social issues underlying financial reporting and standard setting can usefully spend some class time on the 1982 Merino and Neimark paper (in Section 1.2). This paper raises fundamental issues about the role of financial reporting in society, which go well beyond the textbook coverage of this topic. The textbook confines itself, for the period that Merino and Neimark consider, to a brief description of reporting problems leading up to the great stock market crash of 1929 and the creation of the SEC. The topic provides food for thought both for those who do and do not favour the present financial reporting environment. For a contrasting view from that of Merino and Neimark, Benston's 1973 article is also worth discussing.

This edition continues its discussion of the Enron and WorldCom financial reporting disasters, since these are still relevant to accounting theory and practice. I continue to include (Section 1.3) a description of the 2007-2008 market meltdowns surrounding financial assets and institutions, since these events are driving many new accounting standards and changes in executive compensation discussed later in the text. In spite of the bewildering collection of acronyms, instructors may wish to discuss these market meltdowns early in the course, since they pervade the book and continue to have major implications for financial accounting.

Section 1.5 introduces the topic of ethics. With the extent of accountant and auditor involvement in numerous financial reporting disasters that have come to light since 2000, such as Enron and WorldCom, and more recent criticisms of fair value accounting and off-balance sheet entities, the importance of ethical behaviour is very much apparent. Indeed, ethical behaviour underlies the distinction between rules-based and principles-based accounting standards (Section 1.6). This distinction is important since the IASB constitution commits the IASB to principles-based standards.

I emphasize, however, that ethics tends to produce similar behaviour as a longer-run maximization of one's own interests (although the mind sets are different). Thus, a longer–run view of ethical behaviour quickly turns into questions of full disclosure, usefulness, reputation, and cooperative behaviour. The text tends to emphasize these latter components of professional responsibility. Some instructors may wish to introduce and discuss ethical issues more broadly.

6. Some influential accounting academics are critical of the moves by standard-setting bodies towards current value accounting. Chapter 8 is devoted to an alternative view, namely efficient contract theory (also called positive accounting theory). A brief introduction to this topic is given in Section 1.4. Instructors who wish to introduce this topic now may wish to discuss why accountants are generally regarded as conservative, whether financial accounting can help to attain strong corporate governance, and whether managers like current value accounting.

7. I have not prepared any questions and problems for this chapter. One reason is that I usually like to let the first week of classes pass before giving formal assignments. More fundamentally, I use this first week to describe and motivate the text material, as outlined above, and most of the material in Chapter 1 is covered in greater detail later. However, extensive problem material is provided for the remaining chapters of the book.