Financial Accounting Theory
Seventh Edition
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Purpose: To create an awareness and understanding of the financial reporting environment in a market economy

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everything here !

grade

- final exam 50%
- mid-term test (up to and including chapter 4) 20%
- group project on research paper 20%
  - in class presentation 10%
  - group report 10%
- class participation 10%

group project

- 9 research papers
- 9 groups of about 5 members each
- each paper relating to a particular topic of our class
- presentation near when topic is being taught
- finalize group members and research paper selection today

presentation topics

Presentation 1: Ball, R. & Brown, P. (1968). An empirical evaluation of accounting income numbers.

Presentation 2: Bok, B. , Jun, K.K. , Jin M.K. (2010). Local institutional investors, information asymmetries and equity returns.

Presentation 3: Barton, J. & Mercer, M. (2005). To blame or not to blame: Analyst's reactions to external explanations for poor financial performance.

Presentation 4: Healy, P. (1985). The effect of bonus schemes on accounting decisions.

Presentation 5: Beatty, A., Ramesh, K. and Weber, J. (2001). The importance of accounting changes in debt contracts: The cost of flexibility in covenant calculations.

Presentation 6: Matsumura, E. and Shin, J.Y. (2006). An empirical analysis of an incentive plan with relative performance measures: evidence from a postal service.

Presentation 7: Gayle, G.L. , Miller, R. (2009). Has moral hazard become a more important factor in managerial compensation?

Presentation 8: Zhang, Y., Uchida, K., and Hua B. (2013). How do accounting standards and insiders' incentives affect earnings management? Evidence from China.

Presentation 9 : Wang, X. (2011). The quality of financial reporting in China: An examination from an accounting restatement perspective.

what’s in it for me ?

- accounting = recording transactions, by who and for whom ?
  - market value or historical cost ? why ?
- internal use = management accounting
  - costing, CVP, working capital management, strategic ma
- external use = financial accounting
  - audited by accounting firm, for various users, per accounting standards
- later on, you will be the person who needs to decide what to do
  - if you are deciding on a number on a client’s financials, you need good reason to support your point(s), more of these as you become more senior
  - if you become the accounting industry’s standard setter, then you would need to understand all the angles for your decisions

3 big topics

- big topic 1 – chapter 2 to 6
  - if you are the one to set the accounting standards (law maker versus policemen)
  - what numbers to use to record / show transactions
  - purpose of financial statements is to satisfy user needs
  - but users want financial numbers for different reasons
  - reliability numbers vs relevant numbers, dependent on user needs
  - spectrum from all historical to all current
  - how would you decide ?
  - mid-term test up to and including chapter 4

3 big topics

- big topic 2 – chapter 8 to 11
  - if we are shareholders, are management and company evil ? can we trust the numbers that they report to us ?
  - will management change numbers for their own benefits ?
  - will companies prefer certain methods for their own benefits ?
- big topic 3 - chapters 12 and 13
  - if problems exist, let’s set standards for everyone to follow
  - setting of accounting standards

chapter by chapter main points

- chapter 1
  - many financial disasters accounting related
  - conflict of interest leading to adverse selection and moral hazard problems, how to reduce these problems with accounting policies
- chapter 2
  - under ideal conditions, current value accounting should be used
  - however, not proper otherwise
  - trade-off between relevance and reliability
  - no true net income

chapter by chapter main points

- chapter 3
  - per chapter 2 current value accounting only under ideal conditions
  - let’s use all historical value accounting, BUT can we provide better information if we know how the users think and use the information
  - two theories on how users think and use the information
  - theory of decision making
- chapter 4
  - wait a minute, IF the market is efficient, why need all these
  - market not perfectly efficient
  - estimation risk

chapter by chapter main points

- chapter 5
  - Ball and Brown study, method and findings, stock price moves before announcement
  - ERC – stock price move differently dependent on the nature of information and nature of firm
- chapter 6
  - other reasons for better financial information
  - low correlation between financial information and share price = lower relevance and importance
  - clean surplus theory
  - auditor liabilities

chapter by chapter main points

- chapter 8
  - contract efficiency
  - contract rigidity
  - contract efficiency versus opportunism
- chapter 9
  - game theory
  - interactive decisions between parties and not with market
  - managers might slack off or cheat for their own benefits

chapter by chapter main points

- chapter 10
  - can we set up a better executive compensation system ?
- chapter 11
  - do managers manage earnings ?
  - is earnings management always bad ?
  - is there good earnings management ?

chapter by chapter main points

- chapter 12 and chapter 13
  - setting accounting standards
  - provide useful information to users
  - economic issues
  - political issues

research papers

how to understand them quickly

how to understand research papers QUICKLY

- Sections in research papers and what they do
  - Summary and conclusion (short)
  - Literature review
  - Methodology
    - Data source
    - How to structure the test (formula, etc)
  - Summary of results – tables, etc
  - Conclusion (long)

How To Understand Research Papers QUICKLY

- my example research paper
  - Lily says that she does not lie
  - I do research to see if it is true and then write paper on what I have found
  - these are my sections and what I would say in my research paper
  - like hypothesis testing, I cannot proof something beyond doubt, all I can do is provide strong evidence that ALL other alternatives are not likely, hence the only choice left (my choice) is most likely correct

- compare to the research papers for presentation

How To Understand Research Papers QUICKLY

Section	What I would say
Short Summary	Lily says that she does not lie, but I found that it is not true.
Literature Review “Why do it?”	(Introduction) What research was done before, what was found, how this paper adds new information.
	• Introduction to key concepts. E.g. how is lying defined • What was done before, what was found, etc. E.g. Chan found UIC students do not lie in October, Lee found UIC female students do not lie in the afternoon, Davis found UIC students cannot tell the truth ..... • This paper tries to determine if Lily, a female UIC student, will lie in an October afternoon (new information).
Methodology “How to do it?”	I will ask 40 of her friends in UIC. I will ask them if Lily had lied; if yes, which month and what time of day. Regression analysis, sample size, formula used, ...
Results “Found what?”	Information collected – tables of data on friends asked, e.g. gender, age, know how well, ... Results of analysis, significance, other factors that might explain, ...
Conclusions	Based on the finding, I conclude that Lily will only lie on Monday afternoons between 1 pm and 3 pm in September, October, March, and April to all male on UIC campus except to me. I also conclude that Lily’s finding of “all male lies and all female does not lie” cannot be supported.

for your group project

- why the research paper ?
- how does it relate to topics in our class ?
- what was the concept being tested ?
- how was the explanations excluded ?
- what was the finding ?
- quantitative important ?

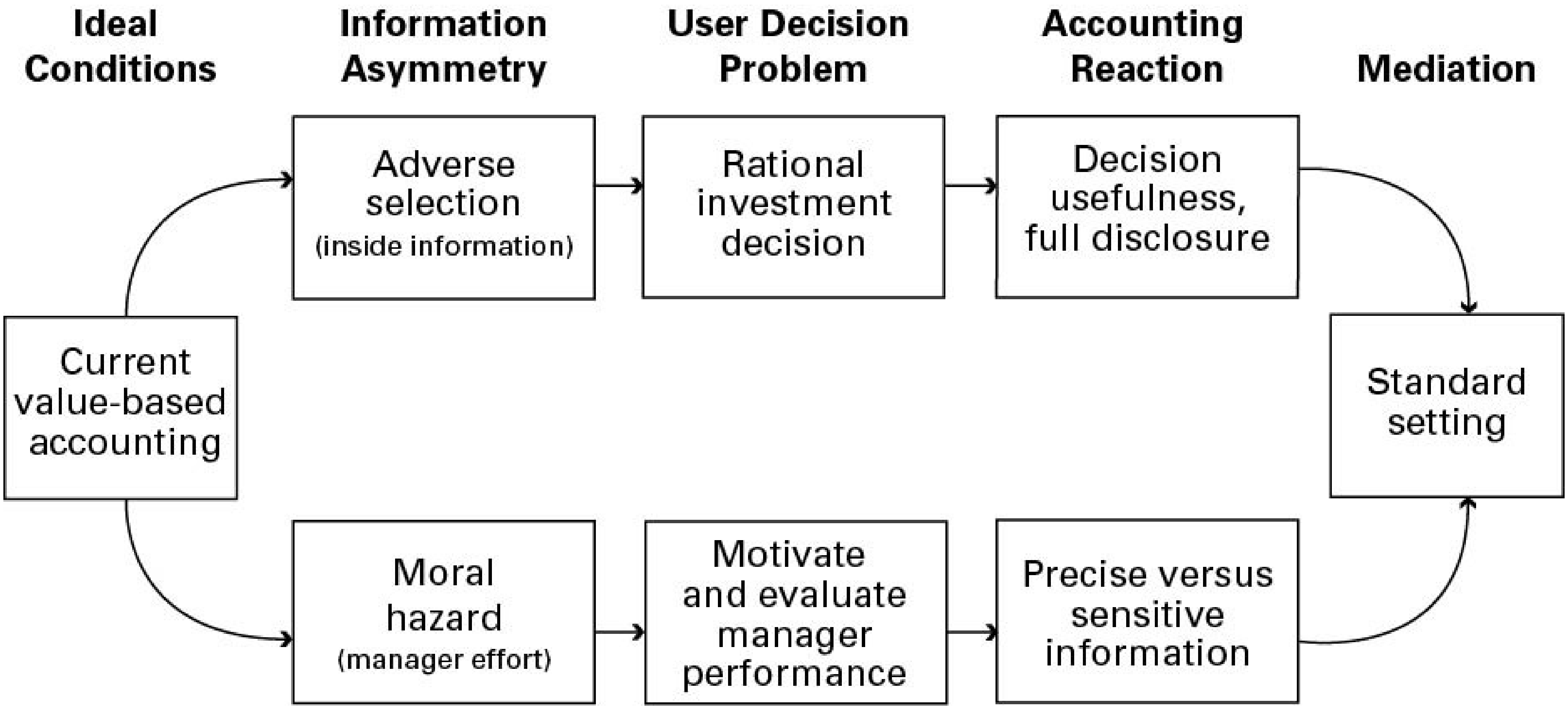
chapter 1 two main points

- main point #1 - historical perspective
  - many financial disasters were caused by intentional or non-intentional recording of incorrect / incomplete financial information
  - Enron, Worldcom, many hedge fund and financial firm blow ups
- conclusion: how the financial information are recorded and reported are important

chapter 1 two main points

- main point #2 – potential conflict of interest
  - management report firm performance to shareholders (eg. earnings for the year) but potential conflict of interest because of asymmetrical information
  - two problems are adverse selection and moral hazard
  - can we set accounting standards to reduce / eliminate these two problems ?
  - IF we have IDEAL condition, then we can use current value accounting
- conclusion: current value accounting should be used IF under IDEAL condition
  - in chapter 2, we will see what happens IF NOT under IDEAL condition

chapter 1 Introduction



chapter 1 main point #1
historical perspective

1.2 Some historical Perspective

- **Early development**
- **Great depression of 1930s reinforced historical cost accounting**
- **Alternatives to historical cost**
  - **Current value accounting**
    - **Value-in-use**
    - **Fair value (exit price, opportunity cost)**
  - **Mixed measurement model**

Early Developments In Accounting

- Complete description of double entry system – 1494
  - Translated into English – 1543
- England – 18th Century
  - Development of limited companies in England
  - Separation of owners and managers
  - Industrial revolution
  - Specialization
- US – 20th Century
  - Market crash – 1929 and Great Depression
  - SEC
  - Financial reporting
- Two Observations

Early Developments In Accounting

- Two observations from historical developments
- Market crash / blow up => more regulations
  - Minsky moments
  - Changes between more and less regulations
  - Glass-Steagall Act in US of 1933 - separation of banking and investment banking due to 1929 crash
- The major financial accounting developments happen in where the major economic developments were
  - UK in 18th Century, US in 20th Century
  - Reason - amount of influence in the market of the companies
  - Now Asia / China starting 21st Century?
- Conclusion for us?

Historical Perspectives

- Great depression of 1930s reinforced historical cost accounting
- Frequent appraisal of capital assets before 1929
  - More market-based valuation
  - Encouraged development of a bubble
    - e.g. US housing market
  - Historical cost accounting afterwards
- Income statement becomes the focus
  - More short term focused

- Moore’s Law of processing power – double every 2 years
- Law of financial accounting development
- Conclusion for us?

What It Means For Us

- **Observations**
- **Financial accounting developments occur in geographical location of fastest growth**
- **Changes in financial accounting developments becoming faster and faster**
  - **IAS**
- **The development of the accounting standard depends on the actions of the regulatory body (SEC in the US) and the accounting profession**
  - **How will this interaction work out in China?**

What It Means For Us

- More interactivity between financial accounting and the financial market development
- Previously assumed user of financial statements are rational
  - But recent financial theories found otherwise
  - Contradictions found from efficient market hypothesis
  - Probability Theory
  - Behavioral finance
  - Conflict of interest – adverse selection, moral hazard
  - Different goals of users recognized
- Conclusion for us?

What It Means For Us

- More conflicts will appear
  - Recording of hedge accounting in financial statements
  - Valuation of intangible assets
  - Valuation of intellectual rights
- Accounting professions => body with many skills

- Conclusion for us?

1.2 Collapse of the Stock Market Boom of Late 1990s

- Enron
- WorldCom
- Collapse of public confidence in capital markets
- Effects on financial reporting
  - Increased regulation and corporate governance
    - Sarbanes-Oxley Act
  - Tighten rules re off-balance sheet entities

1.3 Market Meltdowns, 2007-2008

- **Terminology**
  - Securitization
  - Financial instruments
    - Asset-backed securities
    - Collateralized debt obligations
    - Asset-backed commercial paper
    - Credit default swaps
    - Expected loss notes
  - Liquidity risk
    - Liquidity pricing
  - Counterparty risk

>> Continued

Market Meltdowns, 2007-2008

(continued)

- **Financial accounting issues leading up to the market meltdowns**
  - Fair value accounting for financial instruments
  - Liquidity pricing
    - Fair value less than value-in-use
    - Severe criticism of fair value accounting
  - High leverage of financial institutions
    - Off-balance sheet financing liabilities
    - Use of expected loss notes to avoid consolidation of structured investment vehicles
    - Was disclosure of off-balance sheet liabilities adequate?

>> Continued

Market Meltdowns, 2007-2008 (continued)

- Response of standard setters
  - Stopgap measures in response to government pressure
    - Fair value accounting guidance during liquidity pricing
    - Increased use of internal estimates (value-in-use)
    - Increased use of cost-based valuation
  - New accounting standards
    - Consolidation
    - Derecognition
  - Increased disclosure
  - Response of standard setters considered in greater detail in Chapter 7

>> Continued

Market Meltdowns, 2007-2008 (continued)

- Response of other regulators
  - Increased disclosure of managerial compensation
  - Move transactions to security exchanges from shadow banking system
  - Increased capital reserves for financial institutions

>> Continued

Market Meltdowns, 2007-2008

(continued)

- **Implications for accountants**
  - **Need for transparency**
  - **Value-in-use v. fair value accounting**
  - **Full disclosure of off-balance sheet activities**
  - **New accounting standards to prevent future abuses?**

1.4 Efficient Contracting

- A different view of the purpose of financial reporting than the current value orientation of standard setters
- Basic characteristics of efficient contracting view
  - Emphasis on contracts. A firm can be defined by the contracts it enters into
    - E.g., debt contracts, compensation contracts…
  - Emphasis on corporate governance
    - Those firm policies that align the firm's activities with the interests of investors and society

Efficient Contracts

– For good corporate governance, contracts should be efficient
  - Contracting parties must trust each other
    – E.g., a firm can generate lenders' trust by incorporating a covenant into a borrowing contract. Covenants are a cost of contracting
    – Lenders reward firm with lower interest rate. This is a benefit of contracting
  - An efficient contract is the best tradeoff between contracting costs and benefits

>> Continued

Efficient Contracts (continued)

- Efficient contracting emphasizes manager stewardship
  - Compensation contracts should motivate managers to work in the best interests of firm owners
  - An efficient compensation contract does so at lowest compensation cost.

Accounting Policy Implications of Efficient Contracting

- **Financial reporting should be reliable**
  - Reliable reporting generates investor trust
- **Financial reporting should be conservative**
  - E.g., write assets down if current value less than book value. But, write assets up only if can be done reliably.
  - Rationale: encourages stewardship
    - Prevents managers from increasing reputation and compensation by increasing reported profits through non-reliable asset writeups
- **These policies often conflict with current value accounting**
  - Current value accounting sacrifices reliability for relevance

1.5 Ethical Behaviour by Accountants/Auditors

- Was accountant/auditor behaviour leading up to Enron, WorldCom, and 2007-2008 market meltdowns episodes ethical?
  - Serve the client or serve society?
- Why would you behave ethically in similar circumstances?
  - Ethical principles to do the right thing?
  - Long run interests of profession require you to do the right thing
    - But mindset differs

1.6 Rules-Based v. Principles-Based Accounting Standards

- **Do rules-based accounting standards work?**
  - **Enron, WorldCom**
  - **Expected loss notes**
- **Will more rules in new accounting standards work to prevent abuse?**
- **Principles-based standards**
  - **Important role of Conceptual Framework**
  - **Relies on ethical accounting/auditing profession**

1.7 The Complexity of Information

- Individual reactions to same information may differ
- Reporting to investors v. reporting on stewardship complicates reporting
  - Current value vs. efficient contracting views
- Information also affects how well markets work

linking main point #1 to main point #2

if disasters were caused by accounting recording, can we fix it ?

difficult to fix because conflict of interest AND each user is different

chapter 1 main point #2

what are the two problems caused by asymmetric information

1.9 Information Asymmetry

- Role of Information in a Market Economy
  - To improve operation of capital markets
    - Adverse selection problem
  - To improve operation of managerial labour markets
    - Moral hazard problem
  - Both roles crucial if markets are to work well
    - E.g., 2007-2008 market meltdowns
      - Lack of transparency of asset-backed securities
      - Excessive risk encouraged by off-balance-sheet activities
      - Excessive risk encouraged by manager compensation structure

>> Continued

Information Asymmetry (continued)

- Role of accounting information to control adverse selection
  - Convert inside information into outside
  - Supply useful information to investors

- Role of accounting information to control moral hazard
  - Control manager shirking
  - Improve corporate governance

Adverse Selection Problem

- Information asymmetry
- Insurance
  - Only high risk people will buy the insurance, low risk self insure
  - Buying online from Taobao – rating system
- Management not act in best interest of shareholder
  - Information advantage of insiders
  - Separation of lost from risk and benefits
  - Invest in high risk projects
  - Use of equity instead of debt to reduce scrutiny

Moral Hazard Problem

- Information asymmetry
- Insurance
  - Not as carefully after buying insurance
  - Traders take higher risk if losing money
  - Work more when boss around
- Management not act in best interest of shareholder
  - Outsiders cannot observe details of what happened
  - Separation of ownership and management
  - Unnecessary travel, not working hard

1.10 The Fundamental Problem Of Financial Accounting Theory

- **The best measure of net income to control adverse selection not the same as the best measure to motivate manager performance**
  - **Investors want information about future firm performance**
    - **Current value accounting?**
  - **Good corporate governance requires that managers “work hard”**
    - **Does more reliable information and conservatism better reflect manager effort than current value information?**

1.11 Regulation as a Reaction to the Fundamental Problem of Standard Setting

- **Standard setting is a form of regulation**
- **Is standard setting needed?**
  - **Market forces motivate firms to produce information**
  - **But market forces subject to failure**
    - **Adverse selection**
    - **Moral hazard**
  - **Regulation steps in to try to correct market failures**
    - **Regulation is costly**

» **Continued**

Regulation as a Reaction to the Fundamental Problem of Standard Setting (continued)

- **Standard setting mediates between conflicting interests of investors and managers**
  - **Investors want lots of useful information**
  - **Managers may object to releasing all the information that investors desire**
  - **Due process in standard setting mediates between investors' and managers' interests**
    - **Representation of diverse constituencies**
    - **Super-majority voting**
    - **Exposure drafts**

1.12.5 The Process of Standard Setting

- **Structure**
  - **IASB**
    - **International standards**
  - **FASB**
    - **United States standards**
  - **Securities commissions**
    - **Role in enforcing firms to follow standards**
    - **May set standards themselves**
    - **Why do they delegate most standard setting?**

Theories Relevant to Financial Accounting

- **The rational investor**
  - A model of how an investor may use new information to revise beliefs about future firm performance
  - Rationality holds *on average*, not necessarily for each individual
- **Efficient securities markets**
  - Efficiency is a matter of degree
  - Share prices reasonably reflect all publicly available information
  - Efficiency is relative to a stock of information
  - Role of financial reporting in improving/expanding the stock of information

» Continued

Theories Relevant to Financial Accounting (continued)

- **Behavioural theories**
  - **Investors do not use all the information in financial statements → securities markets not fully efficient**
- **Agency theory**
  - **Efficient contracts to motivate manager performance and achieve good corporate governance**

Chapter 1 Introduction