



FINANCIAL ACCOUNTING THEORY SEVENTH EDITION

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PEARSON

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To Mary Ann, Julie, Martha, Kathy, Paul, and Cary

Contents

Preface xiii

Acknowledgments xvii

1 Introduction 1

- 1.1 The Objective of This Book 1
- 1.2 Some Historical Perspective 1
- 1.3 The 2007–2008 Market Meltdowns 10
- 1.4 Efficient Contracting 16
- 1.5 A Note on Ethical Behaviour 18
- 1.6 Rules-Based versus Principles-Based Accounting Standards 20
- 1.7 The Complexity of Information in Financial Accounting and Reporting 21
- 1.8 The Role of Accounting Research 21
- 1.9 The Importance of Information Asymmetry 22
- 1.10 The Fundamental Problem of Financial Accounting Theory 24
- 1.11 Regulation as a Reaction to the Fundamental Problem 26
- 1.12 The Organization of This Book 27
 - 1.12.1 Ideal Conditions 27
 - 1.12.2 Adverse Selection 27
 - 1.12.3 Moral Hazard 28
 - 1.12.4 Standard Setting 28
 - 1.12.5 The Process of Standard Setting 29
- 1.13 Relevance of Financial Accounting Theory to Accounting Practice 32

2 Accounting Under Ideal Conditions 37

- 2.1 Overview 37
- 2.2 The Present Value Model Under Certainty 38
 - 2.2.1 Summary 41
- 2.3 The Present Value Model Under Uncertainty 41
 - 2.3.1 Summary 47
- 2.4 Examples of Present Value Accounting 48
 - 2.4.1 Embedded Value 48
 - 2.4.2 Reserve Recognition Accounting 48
 - 2.4.3 Critique of RRA 52
 - 2.4.4 Summary of RRA 56
- 2.5 Historical Cost Accounting Revisited 56
 - 2.5.1 Comparison of Different Measurement Bases 56
 - 2.5.2 Conclusion 58
- 2.6 The Non-Existence of True Net Income 58
- 2.7 Conclusion to Accounting Under Ideal Conditions 59

3 The Decision Usefulness Approach to Financial Reporting 72

- 3.1 Overview 72
- 3.2 The Decision Usefulness Approach 73
 - 3.2.1 Summary 74

3.3	Single-Person Decision Theory	74	4.3	Implications of Efficient Securities Markets for Financial Reporting	127
3.3.1	Decision Theory Applied	74	4.3.1	Implications	127
3.3.2	The Information System	78	4.3.2	Summary	128
3.3.3	Information Defined	82	4.4	The Informativeness of Price	129
3.3.4	Summary	83	4.4.1	A Logical Inconsistency	129
3.4	The Rational, Risk-Averse Investor	83	4.4.2	Summary	132
3.5	The Principle of Portfolio Diversification	85	4.5	A Model of Cost of Capital	132
3.6	Increasing the Decision Usefulness of Financial Reporting	87	4.5.1	A Capital Asset Pricing Model	132
3.6.1	Introduction	87	4.5.2	Critique of the Capital Asset Pricing Model	135
3.6.2	Objectives of Management Discussion and Analysis	88	4.5.3	Summary	137
3.6.3	An Example of MD&A Disclosure	89	4.6	Information Asymmetry	137
3.6.4	Is MD&A Decision Useful?	99	4.6.1	A Closer Look at Information Asymmetry	137
3.6.5	Conclusion	101	4.6.2	Fundamental Value	140
3.7	The Reaction of Professional Accounting Bodies to the Decision Usefulness Approach	102	4.6.3	Summary	142
3.7.1	The Conceptual Framework	102	4.7	The Social Significance of Securities Markets that Work Well	143
3.7.2	Summary	107	4.8	Conclusions on Efficient Securities Markets	145
3.8	Conclusions on Decision Usefulness	107	5	The Value Relevance of Accounting Information	153
4	Efficient Securities Markets	120	5.1	Overview	153
4.1	Overview	120	5.2	Outline of the Research Problem	154
4.2	Efficient Securities Markets	121	5.2.1	Reasons for Market Response	154
4.2.1	The Meaning of Efficiency	121	5.2.2	Finding the Market Response	156
4.2.2	How Do Market Prices Fully Reflect All Available Information?	124	5.2.3	Separating Market-Wide and Firm-Specific Factors	156
4.2.3	Summary	126	5.2.4	Comparing Returns and Income	157

5.3	The Ball and Brown Study	159	6.5	A Defence of Average Investor Rationality	209
5.3.1	Methodology and Findings	159	6.5.1	Dropping Rational Expectations	209
5.3.2	Causation Versus Association	160	6.5.2	Dropping Common Knowledge	211
5.3.3	Outcomes of the BB Study	162	6.6	Summary re Securities Market Inefficiencies	215
5.4	Earnings Response Coefficients	163	6.7	Conclusions About Securities Market Efficiency and Investor Rationality	216
5.4.1	Reasons for Differential Market Response	163	6.8	Other Reasons Supporting a Measurement Approach	219
5.4.2	Implications of ERC Research	169	6.9	The Value Relevance of Financial Statement Information	219
5.4.3	Measuring Investors' Earnings Expectations	170	6.10	Ohlson's Clean Surplus Theory	221
5.4.4	Summary	172	6.10.1	Three Formulae for Firm Value	221
5.5	A Caveat about the "Best" Accounting Policy	173	6.10.2	Earnings Persistence	225
5.6	The Value Relevance of Other Financial Statement Information	174	6.10.3	Estimating Firm Value	227
5.7	Conclusions on Value Relevance	176	6.10.4	Empirical Studies of the Clean Surplus Model	230
			6.10.5	Summary	233
6	The Measurement Approach to Decision Usefulness	189	6.11	Auditors' Legal Liability	233
6.1	Overview	189	6.12	Asymmetry of Investor Losses	236
6.2	Are Securities Markets Fully Efficient?	191	6.13	Conclusions on the Measurement Approach to Decision Usefulness	241
6.2.1	Introduction	191			
6.2.2	Prospect Theory	194	7	Measurement Applications	252
6.2.3	Is Beta Dead?	197	7.1	Overview	252
6.2.4	Excess Stock Market Volatility	199	7.2	Current Value Accounting	253
6.2.5	Stock Market Bubbles	200	7.2.1	Two Versions of Current Value Accounting	253
6.2.6	Discussion of Securities Market Efficiency Versus Behavioural Finance	200	7.2.2	Current Value Accounting and the Income Statement	255
6.3	Efficient Securities Market Anomalies	202	7.2.3	Summary	256
6.4	Limits to Arbitrage	206			

7.3	Longstanding Measurement Examples	256	7.11	Accounting for Intangibles	282
7.3.1	Accounts Receivable and Payable	256	7.11.1	Introduction	282
7.3.2	Cash Flows Fixed by Contract	256	7.11.2	Accounting for Purchased Goodwill	283
7.3.3	The Lower-of-Cost-or-Market Rule	257	7.11.3	Self-Developed Goodwill	287
7.3.4	Revaluation Option for Property, Plant, and Equipment	258	7.11.4	The Clean Surplus Model Revisited	289
7.3.5	Impairment Test for Property, Plant, and Equipment	258	7.11.5	Summary	289
7.3.6	Summary	259	7.12	Reporting on Risk	290
7.4	Financial Instruments Defined	259	7.12.1	Beta Risk	290
7.5	Primary Financial Instruments	259	7.12.2	Why Do Firms Manage Firm-Specific Risk?	291
7.5.1	Standard Setters Back Down Somewhat on Fair Value Accounting	259	7.12.3	Stock Market Reaction to Other Risks	292
7.5.2	Longer-Run Changes to Fair Value Accounting	261	7.12.4	A Measurement Approach to Risk Reporting	294
7.5.3	The Fair Value Option	262	7.12.5	Summary	297
7.5.4	Loan Loss Provisioning	264	7.13	Conclusions on Measurement Applications	297
7.5.5	Summary and Conclusions	266	8	The Efficient Contracting Approach to Decision Usefulness	311
7.6	Fair Value Versus Historical Cost	267	8.1	Overview	311
7.7	Liquidity Risk and Financial Reporting Quality	270	8.2	What Is Efficient Contracting Theory?	313
7.8	Derecognition and Consolidation	271	8.3	Sources of Efficient Contracting Demand for Financial Accounting Information	314
7.9	Derivative Financial Instruments	275	8.3.1	Lenders	314
7.9.1	Characteristics of Derivatives	275	8.3.2	Shareholders	314
7.9.2	Hedge Accounting	278	8.4	Accounting Policies for Efficient Contracting	315
7.10	Conclusions on Accounting for Financial Instruments	281	8.4.1	Reliability	315
			8.4.2	Conservatism	316
			8.5	Contract Rigidity	318
			8.6	Employee Stock Options	322
			8.7	Discussion and Summary of ESO Expensing	329

8.8	Distinguishing Efficiency and Opportunism in Contracting	330	9.7	Reconciliation of Efficient Securities Market Theory with Economic Consequences	388
8.9	Summary of Efficient Contracting for Debt and Stewardship	334	9.8	Conclusions on the Analysis of Conflict	389
8.10	Implicit Contracts	335	10	Executive Compensation	403
8.10.1	Definition and Empirical Evidence	335	10.1	Overview	403
8.10.2	A Single-Period Non-Cooperative Game	336	10.2	Are Incentive Contracts Necessary?	404
8.10.3	A Trust-Based Multi-Period Game	340	10.3	A Managerial Compensation Plan	407
8.10.4	Summary of Implicit Contracting	344	10.4	The Theory of Executive Compensation	409
8.11	Summary of Efficient Contracting	344	10.4.1	The Relative Proportions of Net Income and Share Price in Evaluating Manager Performance	409
9	An Analysis of Conflict	357	10.4.2	Short-Run Effort and Long-Run Effort	412
9.1	Overview	357	10.4.3	The Role of Risk in Executive Compensation	415
9.2	Agency Theory	358	10.5	Empirical Compensation Research	420
9.2.1	Introduction	358	10.6	The Politics of Executive Compensation	422
9.2.2	Agency Contracts Between Firm Owner and Manager	359	10.7	The Power Theory of Executive Compensation	428
9.3	Manager's Information Advantage	369	10.8	The Social Significance of Managerial Labour Markets that Work Well	431
9.3.1	Earnings Management	369	10.9	Conclusions on Executive Compensation	432
9.3.2	The Revelation Principle	371	11	Earnings Management	444
9.3.3	Controlling Earnings Management	373	11.1	Overview	444
9.3.4	Agency Theory with Psychological Norms	375	11.2	Patterns of Earnings Management	447
9.4	Discussion and Summary	378			
9.5	Protecting Lenders from Manager Information Advantage	379			
9.6	Implications of Agency Theory for Accounting	383			
9.6.1	Is Two Better Than One?	383			
9.6.2	Rigidity of Contracts	387			

11.3 Evidence of Earnings Management for Bonus Purposes	448	12.5 Market Failures in the Production of Information	492
11.4 Other Motivations for Earnings Management	454	12.5.1 Externalities and Free-Riding	492
11.4.1 Other Contracting Motivations	454	12.5.2 The Adverse Selection Problem	493
11.4.2 To Meet Investors' Earnings Expectations	455	12.5.3 The Moral Hazard Problem	493
11.4.3 Stock Offerings	457	12.5.4 Unanimity	493
11.5 The Good Side of Earnings Management	458	12.6 Contractual Incentives for Information Production	494
11.5.1 Blocked Communication	459	12.6.1 Examples of Contractual Incentives	494
11.5.2 Empirical Evidence of Good Earnings Management	461	12.6.2 The Coase Theorem	495
11.6 The Bad Side of Earnings Management	465	12.7 Market-Based Incentives for Information Production	497
11.6.1 Opportunistic Earnings Management	465	12.8 A Closer Look at Market-Based Incentives	497
11.6.2 Do Managers Accept Securities Market Efficiency?	469	12.8.1 The Disclosure Principle	497
11.6.3 Analyzing Managers' Speech to Detect Bad Earnings Management	471	12.8.2 Empirical Disclosure Principle Research	499
11.6.4 Implications for Accountants	472	12.8.3 Signalling	503
11.7 Conclusions on Earnings Management	472	12.8.4 Private Information Search	505
12 Standard Setting: Economic Issues	487	12.9 Are Firms Rewarded for Superior Disclosure?	506
12.1 Overview	487	12.9.1 Theory	506
12.2 Regulation of Economic Activity	489	12.9.2 Empirical Tests of Measures of Reporting Quality	509
12.3 Ways to Characterize Information Production	490	12.9.3 Is Estimation Risk Diversifiable?	511
12.4 First-Best Information Production	491	12.9.4 Conclusions	513
		12.10 Decentralized Regulation	514
		12.11 How Much Information Is Enough?	516
		12.12 Conclusions on Standard Setting Related to Economic Issues	519

13 Standard Setting: Political Issues 530

13.1 Overview 530

13.2 Two Theories of Regulation 532

13.2.1 The Public Interest Theory 532

13.2.2 The Interest Group Theory 532

13.2.3 Which Theory of Regulation Applies to Standard Setting? 535

13.3 Conflict and Compromise: an Example of Constituency Conflict 535

13.4 Distribution of the Benefits of Information, Regulation FD 536

13.5 Criteria for Standard Setting 538

13.5.1 Decision Usefulness 538

13.5.2 Reduction of Information Asymmetry 539

13.5.3 Economic Consequences of New Standards 540

13.5.4 Consensus 540

13.5.5 Summary 541

13.6 The Regulator's Information Asymmetry 541

13.7 International Integration of Capital Markets 546

13.7.1 Convergence of Accounting Standards 546

13.7.2 Effects of Customs and Institutions on Financial Reporting 548

13.7.3 Enforcement of Accounting Standards 550

13.7.4 Benefits of Adopting High-Quality Accounting Standards 551

13.7.5 The Relative Quality of IASB and FASB GAAP 554

13.7.6 Should Standard Setters Compete? 555

13.7.7 Should the United States Adopt IASB Standards? 556

13.7.8 Summary of Accounting for International Capital Markets Integration 558

13.8 Conclusions and Summing Up 558

Bibliography 573

Index 596

Preface

This book began as a series of lesson notes for a financial accounting theory course of the Certified General Accountants' Association of Canada (CGA). The lesson notes grew out of a conviction that we have learned a great deal about the role of financial accounting and reporting in our society from securities markets and information economics-based research conducted over many years, and that financial accounting theory comes into its own when we formally recognize the information asymmetries that pervade business relationships.

The challenge was to organize this large body of research into a unifying framework and to explain it in such a manner that professionally oriented students would both understand and accept it as relevant to the financial accounting environment and ultimately to their own professional careers.

This book seems to have achieved its goals. In addition to being part of the CGA program of professional studies for a number of years, it has been extensively used in financial accounting theory courses at the University of Waterloo, Queen's University, and numerous other universities, both at the senior undergraduate and professional master's levels. I am encouraged by the fact that, by and large, students comprehend the material and, indeed, are likely to object if the instructor follows it too closely in class. This frees up class time to expand coverage of areas of interest to individual instructors and/or to motivate particular topics by means of articles from the financial press and professional and academic literature.

Despite its theoretical orientation, the book does not ignore the institutional structure of financial accounting and standard setting. It features considerable coverage of financial accounting standards. Many important standards, such as fair value accounting, financial instruments, reserve recognition accounting, management discussion and analysis, employee stock options, impairment tests, hedge accounting, derecognition, consolidation, and comprehensive income, are described and critically evaluated. The structure of standard-setting bodies is also described, and the role of structure in helping to engineer the consent necessary for a successful standard is evaluated. While the text discussion concentrates on relating standards to the theoretical framework of the book, the coverage provides students with exposure to the contents of the standards themselves.

I have also used this material in Ph.D. seminars. Here, I concentrate on the research articles that underlie the text discussion. Nevertheless, the students appreciate the framework of the book as a way of putting specific research papers into perspective. Indeed, the book proceeds in large part by selecting important research papers for description and commentary, and provides extensive references to other research papers underlying the text discussion. Assignment of the research papers themselves could be especially useful for instructors who wish to dig into methodological issues that, with some exceptions, are downplayed in the book itself.

This edition continues to orient the coverage of accounting standards to those of the International Accounting Standards Board (IASB). As in previous editions, some coverage of major U.S. accounting standards is also included.

I have retained the outline of the events leading up to the 2007–2008 securities market meltdowns, since these events have raised significant questions about the validity of many economic models, and continue to have significant accounting implications. Ramifications of these events are interwoven throughout the book. For example, one outcome of the meltdowns is severe criticisms of the efficient market hypothesis. Nevertheless, I continue to maintain that investors are, on average, rational and that securities markets, while not fully (semi-strong) efficient, are sufficiently close to efficiency (except during periods of bubble and subsequent liquidity pricing) that the implications of the theory continue to be relevant to financial reporting. Critical evaluation of these various criticisms and arguments is given. Nevertheless, I have moved from Chapter 3 to the Instructor's Manual the lengthy outline of the diversified portfolio investment decision that was included in previous editions, replacing it with a much abbreviated discussion.

The Conceptual Framework retains its role as an important component of this book. As it is further developed, this framework will be an important aspect of the financial accounting environment. Its relationships to the theory developed here are critically evaluated. While extensive discussion of alternate theories of investor behaviour is retained, this book continues to regard the theory of rational investors as important to helping accountants prepare useful financial statement information.

The book continues to maintain that motivating responsible manager behaviour and improving the working of managerial labour markets is an equally important role for financial reporting in a markets-oriented economy as for enabling good investment decisions and improving the working of securities markets.

I have updated references and discussion of recent research articles, revised the exposition as a result of comments received and experience in teaching from earlier editions, and added new problem material. I also continue to suggest optional sections for those who do not wish to delve too deeply into certain topics.

Summary of Major Changes

Below is a comprehensive list of major changes made to the seventh edition of *Financial Accounting Theory*:

- Thorough review of recent academic accounting research, with updated explanations and discussion of important papers added throughout the text. The text represents the current state of academic accounting theory as published in major research journals up to about mid-2013.
- Increased attention to contract theory (replacing positive accounting theory), with Chapter 8 rewritten to fully explain the roles of reliability and conservatism of accounting information in securing efficient corporate governance, borrowing, and stewardship.
- Extensive discussion and evaluation of criticisms of securities market efficiency and investor rationality following the 2007–2008 securities market meltdowns. Much accounting research relies on these concepts. The important assumptions of rational expectations, common knowledge, and market liquidity that underlie market

efficiency theory are explained and discussed. The text concludes that relaxation of these assumptions is needed if accountants are to better understand the working of securities markets and the information needs of investors. The text also concludes that accounting-related securities anomalies, typically claimed to result from investor non-rationality, can also be consistent with investor rationality once these assumptions are relaxed. Theoretical and empirical papers supporting these conclusions are outlined (Chapters 4 and 6).

- New and proposed accounting standards, including for financial instruments, derecognition, consolidation, leases, and loan loss provisioning, are described and evaluated. Discussion of the Conceptual Framework is updated throughout the book.
- Discussion of standards convergence and the possibility of U.S. adoption of International Accounting Standards is updated to take recent developments into account (Chapter 13).
- Recent research using sophisticated computer software to evaluate the information content of the written and spoken word is explained and evaluated. The text includes coverage of research papers using this methodology to study the informativeness of Management Discussion and Analysis (Chapter 3) and of executive conference calls (Chapter 11).
- New problem material is added throughout the text, including numerical problems of present value accounting, decision theory, and agency. Other new problems are based on embedded value, earnout contracts, outside directors, bail-in bonds, delegated monitoring, ESO repricing, and Sarbanes-Oxley Act. Discussions and problem materials derived from recent accounting scandals (Groupon, Olympus Corp., and Satyam Computer Services) are also added.
- Discussion of whether information risk is diversifiable, and thus of the extent to which firms benefit from superior accounting disclosure, is updated in the light of recent research (Chapter 12).
- The lengthy explanation of portfolio theory, included in all previous editions, is moved to the Instructor's Manual, replaced by a much shorter explanation of portfolio diversification (Chapter 3).
- Discussion and illustration of Management Discussion and Analysis (Chapter 3) and of Reserve Recognition Accounting (Chapter 2) are updated.

SUPPLEMENTS

Instructor's Solutions Manual

The Instructor's Solutions Manual includes suggested solutions to all the end-of-chapter Questions and Problems. It also offers learning objectives for each chapter and suggests teaching approaches that could be used. In addition, it comments on other issues for consideration, suggests supplementary references, and contains some additional problem

material taken from previous text editions. The Instructor's Manual is available in print format and also available for downloading from a password-protected section of Pearson Education Canada's online catalogue (www.pearsoned.ca/highered). Navigate to your book's catalogue page to view a list of supplements that are available. See your local sales representative for details and access.

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I thank the large number of researchers whose work underlies this book. As previously mentioned, numerous research papers are described and referenced. However, there are many other worthy papers that I have not referenced. This implies no disrespect or lack of appreciation for the contributions of these authors to financial accounting theory. Rather, it has been simply impossible to include them all, both for reasons of space and the boundaries of my own knowledge.

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