FINANCIAL ACCOUNTING THEORY

SEVENTH EDITION

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PEARSON

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

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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.

- **PowerPoint® Lecture Slides** PowerPoint presentations offer a comprehensive selection of slides covering theories and examples presented in the text. They are designed to organize the delivery of content to students and stimulate classroom discussion. The PowerPoint® Lecture Slides are 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.

I am grateful to Carolyn Holden for skilful, timely, and cheerful typing of the original manuscript in the face of numerous revisions, and to Jill Nucci for research assistance.

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William Scott