CHAPTER 1

INTRODUCTION

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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, I illustrate adverse selection by asking them 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, we are entering what is likely to be a period of increasing regulation, at least for financial institutions. Instructors may wish to discuss briefly the pros and cons of markets v. regulation (since this book tends to be market-oriented) of economic activity.

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 intangible assets, ceiling tests, financial instruments, and that they will have the opportunity to learn about 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.

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 "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 a class session 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 paper, which confines itself largely to a brief description of reporting problems leading up to the great stock market crash of 1929 and the creation of the SEC. It 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 assigning.

This edition continues its discussion of the Enron and WorldCom financial reporting disasters, since these are still relevant to accounting theory and practice. I have included (Section 1.3) a fairly detailed description of the more recent market meltdowns surrounding financial assets and institutions. In spite of the bewildering collection of acronyms, instructors may wish to discuss these events early in the course, since they pervade the book and 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. 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.

Nevertheless, for instructors who wish to discuss and/or assign problem material at this point, ceiling tests for property, plant and equipment provide a focus for many of the concepts of this book. Ceiling tests are outlined and discussed in Section 7.3.5 of the text. Issues which could usefully be considered include:

- What is the usual basis of valuation of capital assets? Why?
- Why do GAAP require ceiling tests? Conservatism in accounting can be introduced here (Section 1.4).
- Should the carrying values of capital assets be written up after having been written down?
- What is the impact of ceiling test writedowns on reported future profits?
- Why might management oppose ceiling tests?