

# INSTRUCTOR'S SOLUTIONS MANUAL

*for*

## Financial Accounting Theory Seventh Edition

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**PEARSON**

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## **CHAPTER 1**

### **INTRODUCTION**

- 1.1 The Objective of This Book
- 1.2 Some Historical Perspective
- 1.3 The 2007-2008 Market Meltdowns
- 1.4 Efficient Contracting
- 1.5 A Note on Ethical Behaviour
- 1.6 Rules-Based v. Principles-Based Accounting Standards
- 1.7 The Complexity of Information in Financial Accounting and Reporting
- 1.8 The Role of Accounting Research
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- 1.13 Relevance of Financial Accounting Theory to Accounting Practice

payoff of \$225 for sure, is only 5.0625. Thus, for the same prior probabilities and payoffs, the risk-taking investor prefers the risky investment whereas Bill Cautious, who is risk averse, prefers the risk-free investment.

A risk-taking investor will *specialize* (that is, buy only one security) — the one with the highest risk for a given expected return. There is no incentive to diversify for an investor who *likes* risk.

A risk-taking investor needs the same information as any other investor — information that will be useful in assessing expected returns and risks of securities. However, risk-taking investors will use the information differently. They will seek to find the securities that, for a given return, have the highest risk.

3. For  $a_2$  to yield the same utility as  $a_1$ , we must have:

$$3\bar{x}_{a_2} - 1/2\sigma_x^2 = 2.384$$

$$3 \times 0.80 - 1/2\sigma_x^2 = 2.384$$

Solving for  $\sigma_x^2$ :

$$1/2\sigma_x^2 = 2.400 - 2.384$$

$$= 0.016$$

$$\sigma_x^2 = 0.032$$

Thus act  $a_2$  would require  $\sigma_x^2$  of 0.032 to yield the same utility as act  $a_1$ .

A risk-averse investor trades off risk and expected return. An investment act with a lower expected return must also have lower risk if it is to give the same expected utility. As shown in the calculation, the risk of  $a_2$  (0.032) is less than

current values in the accounts will better enable the market to anticipate financial distress, thereby reducing the number of auditor lawsuits.

I have gone out on a bit of a limb in suggesting these reasons for increased attention by standard setters to measurement issues, since they are speculative on my part. Instructors are urged to challenge them if they do not agree. Certainly, as will be documented in Chapter 7, accounting practice has moved in a measurement direction, although events during the 2007-2008 market meltdowns have resulted in some movement by the IASB from fair value to value-in-use (i.e., amortized cost accounting) accounting for financial instruments—see Chapter 7, Section 7.5.2. The FASB seems somewhat more committed to fair values than the IASB. For example, it is not clear that the FASB will accept the business model concept that the IASB uses to justify amortized cost accounting. Also, the FASB allows more general use of the fair value option than the IASB (Section 7.5.3). However, both bodies are working on a new standard to recognize loan losses sooner than at present. When completed, the new standard will represent a major step in the measurement direction (Section 7.5.4).

### **3. To Review Theory and Evidence that Securities Markets May Not be Fully Efficient.**

The 2007-2008 market meltdowns have raised serious questions about the efficient market hypothesis. Instructors should discuss at least some, and possibly more, of the behavioural finance theories and evidence underlying these criticisms outlined in Section 6.2.

The post-announcement drift and accruals anomalies are some of the strongest evidence questioning investor rationality and market efficiency. My reading of the research on these anomalies is that while we still do not fully understand them, they are slowly yielding to cost- and risk-based explanations (see discussion of limits to arbitrage in Section 6.4 (optional section)). Note that while these anomalies suggest that markets are not fully efficient, they do not necessarily conflict with average investor rationality.

### **4. To Defend Market Efficiency Theory and Average Investor Rationality**

6. Conditionally conservative accounting (i.e., impairment testing) contributes to efficient debt contracting by providing an early warning system of financial distress. This increases the trust of lenders that any operating policies that have led to impairment will be corrected by management and/or the Board of Directors. Also, conditional conservatism, by creating a systematic understatement of net asset value, provides lenders with a lower bound on net assets to help them evaluate their loan security. Impairment tests also lower debt covenant ratios, providing additional security and protection for lenders. For example, tighter covenant constraints reduce the likelihood of excessive dividend and manager compensation payments and lower the likelihood of additional borrowing by the firm, all of which dilute the security of existing lenders. As a result of this increased protection and trust, lenders accept lower interest rates.

Conditionally conservative accounting increases the efficiency of managerial compensation contracts by meeting a shareholder demand for reporting on manager stewardship. It makes it more difficult for managers to record unrealized income-increasing gains to enhance their reputations and compensation. Also, recording unrealized losses may motivate early manager action to correct operating policies that have led to such losses and, if they do not, alerting Boards of Directors to take timely steps to correct management's lack of action.

7. a. From an efficient securities market perspective, the EnCana manager need not be concerned. Given full disclosure, an efficient market will look through the increased earnings volatility and realize that there is no effect on cash flows. Furthermore, prior to the accounting standard change, the market would have known the amounts of foreign exchange gains and losses from financial statement information about U.S. denominated debt outstanding and knowledge about exchange rates—the 2002 changes did not add to what the market already knew in this regard. Consequently, there should be no effect on share prices or the firm's cost of capital. Thus, if markets are efficient, then there should be no effect on its ability to lock in new financing at favourable rates.

more it will use non-financial measures of product quality relative to net income as a quality incentive device.

(iv) Regulation. A major reason for regulation is that firms have a monopoly in their product markets. The profits of regulated firms are limited by the regulatory process. This reduces sensitivity of net income as a performance measure. That is, even very high manager effort is constrained in its effect on the bottom line. However, by maintaining customer satisfaction with performance, courtesy, responsiveness, etc., the firm can help to sustain its monopoly position. As a result, non-financial performance measures such as these will be emphasized more strongly than net income in the compensation plans of such firms.

b. Firm strategy. The personal goals included in the RBC plan seem mostly strategic in nature (e.g., development of U.S. operations). Thus RBC seems to regard itself as a prospector type firm. Since these strategies likely take some time to show up in net income, personal goal attainment is a more sensitive performance measure.

To the extent that executives are directly responsible for product quality, courtesy, etc., the product quality hypothesis is also an explanation. Measures of product quality are likely sensitive to manager effort and measurable with reasonable precision, whereas with so many factors affecting net income, earnings may not be a precise measure of product quality performance.

17. a. A company awards ESOs as compensation for the following efficient contracting reasons:

- To lengthen the manager's decision horizon. ESOs, being stock-based compensation, may motivate the manager to increase longer-term effort. Since an efficient stock market will look to the longer term expected payoffs of the manager's actions, the manager's compensation is not penalized for adopting longer-term projects that

company stock. See the study of Jagolinzer, Larcker, and Taylor (2011) in Section 4.6.1.

6. a. Managers may withhold bad news:

- To conceal evidence of shirking, if the bad news results from low manager effort.
- To delay a fall in share price, which would increase cost of capital and possibly affect manager compensation.
- To enable insider trading profits.
- To postpone damage to reputation.

b. The disclosure principle will motivate the manager to report bad news if the following conditions hold:

- The information can be ranked from good to bad in terms of its implications for firm value.
- Investors know that the manager has the information.
- There is no cost to the firm of releasing the information.
- Market forces and/or penalties ensure that the information released is truthful (i.e., credible).

Then, the market will interpret failure to disclose as indicating the worst possible information. To avoid the resulting impact on share price and manager reputation, all but the lowest-type manager will disclose.

If one or more of the above requirements is violated, the disclosure principle may not completely eliminate the withholding of bad news. This will be the case when:

- The information is proprietary, so that there is a cost to disclosure. Then, there is a threshold level of disclosure. If the news is

about manager effort to some extent, and so should be included in income for bonus purposes.

10. a. According to the public interest theory of regulation, OSFI would approve the direct charge to retained earnings if it was concerned about Scotiabank's loan quality. OSFI knows that the failure of a major bank, or even public concern about a bank's financial condition, would cause significant economic and social harm, and wishes to minimize the probability of this happening. Consequently, it encouraged Scotiabank to provide a "generous safety cushion" for loan losses. Obviously, Scotiabank was concerned about reporting a lower net income for 1999 than for the two previous years, and may not have planned to provide as large an amount for loan losses as OSFI felt was needed. To encourage Scotiabank to provide a larger amount, OSFI granted the special permission.
- b. Under the interest group theory of regulation, OSFI wants to maximize its power and influence, and will thus respond to the most effective lobbying constituency. Presumably, this is the banking industry, and Scotiabank in particular. By, in effect, setting accounting standards for the banking industry, OSFI is increasing its sphere of influence relative to competing constituencies (CICA and OSC), increasing its influence over the banks, and increasing its visibility in the eyes of investors.
- c. Three arguments are possible here. First, the securities market would not respond, since the direct charge to retained earnings does not affect cash flows, and is fully disclosed.

Second, the market might respond negatively. The direct charge in addition to specific loan loss provisions may reveal new information that Scotiabank's loan quality was less than previously expected. Furthermore, the direct charge may reveal inside information that Scotiabank's management was concerned that net income would not "stand" the full amount of the needed provision. Indeed, if one deducts the after-tax amount of the direct charge from 1999 reported net income, the result of \$1,237 suggests a declining earnings trend over the three years.