Contemporary Issues in Accounting 3rd edition Rankin Solutions Manual

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Solutions manual

to accompany

Contemporary issues in accounting

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by

Rankin et al.

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Chapter 1: Contemporary issues in accounting

Contemporary issue 1.1

Dick Smith hearings reveal questionable accounting of rebates

Questions

1. **This article states 'accounting standards are currently unclear' with regard to how to account for rebates. Given these rebates seem to be quite common, can you think of any reasons the accounting for these could be unclear and why there may not be an accounting standard that specifies exactly how to account for these particular transactions?**
2. **This article claims that profits were overstated by Tesco 'because it had booked rebates from suppliers before receiving them'. Do accounting principles require cash to be received before recognising items in the accounting? If not, why should accounting be implicated in these profit overstatements?**
3. **A note prepared by PricewaterhouseCoopers claims that supplier rebates are complex and as accounting requirements are unclear.**

   Ultimately, getting rebate accounting correct relies on a culture and leadership that encourages accounting for the commercial substance of rebate arrangements and discourages short-term profit maximisation.

What do you think is meant by 'getting the accounting correct'? Can you identify any factors that would influence the exercise of professional judgement in this context?

1. The key reason would be that rebates vary significantly and are often complex. These can involve for example:
   - Rebates related to inventory (e.g. retrospective volume rebates)
   - Other rebates (e.g. involving contributions to marketing and promotional costs or activities).

These rebates will be tailored to the particular circumstances (as the PWC notes states these vary widely "reflecting the different elements of the goods and services exchanged between suppliers and retailers".)

Given the complexities and variations in these rebates, it would not be feasible for the accounting standards to specify exactly how to account for every possible rebate in every particular context/circumstance. The principles in the standards should be applied to reflect the substance of the particular rebate contract/arrangement. For example, if the rebate related to volume rebates we would need to apply the principles relating to cost of inventory in IAS 2/AASB 102 *Inventories.*

Students should also consider if the accounting standards were to specify exactly how such rebates were to be accounted for:

- Is it likely such prescriptions would take a conservative approach (e.g. not allow these rebates to be recognised/factored into costing of inventory until virtually certain)? If this occurred would it necessarily result in faithful representation.

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- This would amount to a 'rules' based approach. If this were to occur, could the contracts be drawn so they do not fall within the types of rebate contracts specified in the standards?

2. A key accounting principle is the accrual basis: that the effects of transactions and events are recognised in accounting records when they occur, not when the cash is received or paid. Therefore accounting principles do not require cash to be received before recognising an item. For example, we do not defer recognition of revenue when sales are made on credit.

However, the accounting standards do specify recognition criteria. For example:
- For assets it is expected that future economic benefits will be received.
- For revenue, the amount of any variable consideration can only be recognised to the extent that highly likely it will not reverse.

Given that these rebates often are contingent on/linked to future events/circumstances – such as the sale of a particular volume/amount of inventory – this requires estimation and judgment. For example, in the article it states that "Dick Smith breached accounting standards by booking its rebates as profit before these were actually sold". The argument here is based on the circumstances of Dick Smith where the inventory was not able to be sold. However, if a company has a history of easily selling and forecasts indicate that it will sell at least the amount of inventory required to receive the rebate, then it would be expected to be entitled to this rebate (and thus would reduce the cost of inventory by the rebate expected to be received).

It could be argued that accounting is implicated as:
- It does not require certainty (or is not conservative enough), and./or
- In these cases there were inappropriate estimations/judgments made.

3. 'Getting the accounting correct' would mean that the accounting reflects the substance of the arrangements and applies the principles of the standards to reflect a true and fair view. Remember that the objective of financial accounting is to provide useful information to users, that is relevant and faithfully represents what it purports to represent.

Factors that could influence professional judgment in this context would be:
- Complexity and variation in arrangements, which leads to more possible alternative accounting treatments.
- The continent nature of these rebates involves uncertainties which need to be assessed and evaluated and this can make these more problematic and ambiguous.
- Given the above, pressure from clients/companies to exercise professional judgment 'favourably' for the company.
- In addition, the apparent widespread 'early' booking of such rebates would seemingly further justify that this may be 'acceptable practice'.

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Contemporary issue 1.2

Blockchain technology: everything you need to know

Questions

1. **This article explains that blockchain is both transparent and secure. Would the adoption of a technology such as blockchain mean that accountants would no longer need to use professional judgement in determining how to account for or report transactions and events?**
2. **Identify any technologies or programs that are currently used in accounting firms or for undertaking accounting tasks in businesses. Using the internet to research, are there any developments or available alternatives for these technologies?**

1. The simple answer is no; the introduction of blockchain does not mean that professional judgment would no longer be required. This is because:

- The nature of blockchain is that it is essentially a database that is an alternative to the traditional ledger. The advantage is in processing and also verification. However a transaction would still need to be added to the database and determining how to record the transaction would still require professional judgment. Further, financial reporting requires the determination of what information to present (e.g. application of materiality) and how, and such decisions would still require professional judgement.

2. A simple internet search reveals that a range of programs and technologies are used in accounting firms or to undertake accounting tasks. These range from:

- general programs (such as excel, word, email)
- accounting packages (such as MYOB, XERO, QuickBooks) which are also now cloud based
- audit software (such as eAudit: IDEA Data Analysis)
- tax preparation software
- document management software for client files
- project management programs.

Answers re developments or alternatives will vary depending on what students find in their searches. However predictions are that:

- There will be development of intelligent automated (smart) software that will replace routine tasks and automate complex and multifaceted processes.
- Use of Cloud based programs will further increase.

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Contemporary issue 1.3

Some answers, more questions over Dick Smith failure

Questions

1. **This article explicitly refers to earnings management research. How has this research been used in this article to assist in explaining the Dick Smith failure?**
2. **The article states 'If one subscribes to the conclusions within accounting research'. This proviso implies that others may question the conclusions of the research used in this article. Can you think of reasons why particular theories or research would not be accepted?**
3. **This article states that the auditors, Deloitte, questioned the rebates, realised that inventory values were too high, yet certified that the company was a going concern. A review of the 2015 annual report indicates that inventory represented almost 60% of total assets and was twice the net asset amount. However, in this report there is no mention of these rebates or their impact on profit and the audit report does not suggest any issues of concern. Referring to the previous definition of professional judgement in this chapter, in your opinion what elements in that definition may not have adequately been practiced?**

1. Earnings management is defined there as "a manger's use of accounting discretion through accounting policy choices to portray a desired level of earnings in a particular reporting period". However as the article discusses, earnings can also be managed by not simply manipulating accounting but by manipulating actual transactions or activities. This article has used the research relating to 'real activities management' to analyse the actions of Dick Smith to determine if the transactions (activities) entered into by the company have been chosen, not on the basis of the 'good business', but because these transactions enabled the company to improve their reported financial position. Further the research has been used to explain:
   - Why Dick Smith used such earnings management strategies (as needed to 'support' expectation of growing business).
   - That such earnings management strategies assist in short term and ultimately have a negative effect in longer term (and so exacerbate issues for companies in financial distress).

2. The conclusions referred to in the article are essentially that incentives for managers to make decisions, not on basis of sustaining business but rather on managing earnings figures, would increase and therefore, given that decisions not made to promote long term profitability it was dangerous (in terms of the company's survival).

However, the article notes research that indicates that 80% of CFOs surveyed indicated that they would undertake some form of earnings management. Yet there is no indication that such earnings management would result in such companies necessarily failing.

There may also be other theories that could explain the demise of Dick Smith or the actions that were taken. For example, in the Enron scandal the corporate culture was implicated.

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3. The definition in the text from the American Accounting Association defines professional judgment as:

> Professional judgment is a process used to reach a well-reasoned conclusion that is based on the relevant facts and circumstances available at the time of the conclusion. A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. Professional judgment involves the [clarification of issues and objectives, and the] identification, without bias, of reasonable alternatives; therefore, careful and [unbiased] consideration of information that may seem contradictory to a conclusion is key to its application. In addition, both professional scepticism and objectivity are essential to the process and to reaching an appropriate conclusion.

Professional judgment would have been required to make decisions regarding:

- The disclosure and accounting for the rebates
- The (over) valuation of inventory
- Assessment of whether the company was a going concern.

The article states Deloittes questioned (or was aware of some of these issues), but ultimately did not exercise their professional judgment to, for example, require disclosure or changes in accounting for the rebates (or indicate going concern basis dubious).

In relation to definition could be argued that:

- Given relevant facts and circumstances at the time the conclusion reached was not 'well-reasoned"
- Failure to consider information carefully or in unbiased way
- Did not exercise professional scepticism or objectivity.

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Review questions

1.1 'Accounting is merely a technical exercise and all accountants need to do is follow the rules'. Drawing on your understanding of accounting, discuss whether this statement is correct. (LO1)

Students should disagree with this statement and note the following:

- The nature of accounting is that it is not like a 'hard science' where there is one correct answer.
- Although there are accounting standards that prescribe the accounting treatment for specific transactions/events these often do not include 'black and white' rules. The standards are primarily principles based requiring consideration of substance over form and the exercise of judgement in applying these. The text notes that even simply applications, such as choosing a depreciation method requires judgement. Further some accounting standards allow a choice. As the text states:

  > The shift to principles-based standards acknowledges that the mechanistic compliance to a set of rules may not result in the accurate portrayal of the economic substance events and transactions. Although guidance is provided in the standards, the application of the principles requires the exercise of judgement.

- As the text notes it is unlikely that the standards ('rules') will cover every possible transaction/ event or directions for the application of the principles in every potential scenario. Therefore judgment (and choices) will be required.
- The text notes that the standards often lag behind events and transactions in the real world. Therefore even if the standards contained simple rules to follow, there may not yet be standards about emerging new transactions.

1.2 What is meant by 'professional judgement'? Consider the Pathways Vision Model in figure 1.1 and explain the role of professional judgement in accounting. (LO1)

The definition in the text from the American Accounting Association defines professional judgment as:

- Professional judgment is a process used to reach a well-reasoned conclusion that is based on the relevant facts and circumstances available at the time of the conclusion.

Students may consider common definitions such as:

- Judgment is the ability to make considered decisions.
- Professional is one engaged/qualified in a particular profession.

The American Accounting Association further states in relation to professional judgment that:

- A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. Professional judgment involves the [clarification of issues and objectives, and the] identification, without bias, of reasonable alternatives; therefore, careful and [unbiased] consideration of information that may seem contradictory to a conclusion is key to its application. In addition, both professional scepticism and objectivity are essential to the process and to reaching an appropriate conclusion.

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Thus the first requirement for professional judgment is a person who has the requisite knowledge and skill set given the particular context.

If we consider the pathways model (figure 1.1) this clarifies that:

- There are no 'black and white' choices but what the model calls 'shades of grey'
- Thus judgments are required by accountants to determine the appropriate accounting treatment and the resulting information to be provided.
- Critical thinking underpins accounting (i.e. professional) judgment. This would include the need to:
  - clarify the issues
  - identify appropriate alternatives
  - analyse carefully information.

All of these would require an understanding of objectives and evaluation of potential impacts.

From the Pathways model students should see that the role of professional judgment is fundamental in accounting. This is evidenced by the fact that the American Accounting Association have identified this as the defining attribute of the accounting profession.

Students may want to consider the alterative. If there was no need for judgment in accounting, what role would an accounting professional have? If accounting was simply the application of a set of specified and immutable rules - a mechanical exercise – surely a software program could largely replace accountants.

1.3 Define what is meant by 'theory' and explain how theory is useful. Do you think theory needs to be considered in accounting? (LO2)

As the text notes there is no simple definition of 'theory' and it can mean different things in different contexts. The following are dictionary definitions of what a theory is:

- a belief or principle that guides actions or behaviour (such as behavioural theories of positive reinforcement or theories in management about motivating employees)
- an idea or set of ideas that is intended to explain something (such as Darwin's theory of evolution)
- the set of principles on which a subject is based or of ideas that are suggested to explain a fact or event (such as economic theory or the theory of relativity)
- more generally, a conjecture or an opinion.

Accountants are required to exercise professional judgment and underpinning this is critical thinking. Critical thinking requires a considered analysis of information and, identification and evaluation of alternatives. Professional judgment will also require (as outlined in the Pathways model) accountants to decide, given their analysis, what information should be provided to optimise decision making by users. Thus, students should see that theory (and related research) will be required in the exercises of professional judgment. For example, how could alternative accounting treatments or disclosures be considered without an understanding of how information is used, or impacts on investment decisions?

So for example, theory needs to be considered in financial accounting to reflect the decision-making behaviour of managers and investors, company policies, political activity or professionalism of accountants.

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Accounting theory definition means as stated by Henderson et al. 2004 p. 4 'a description, explanation or a prediction [of accounting practice based] on observations and/or logical reasoning'…'Logical reasons in the form of a set of broad principles that (1) provide a general framework of reference by which practice can be evaluated and (2) guide the development of new practice and procedures'

Students should discuss how theory can help in accounting. Theories can:

- describing and explaining current accounting practices
- predicting accounting practice
- providing principles to take into account when taking action or making decisions
- help to identify problems and deficiencies with current accounting practice and improve accounting practice.

Examples are that a theory of accounting can:

a. provide a basis for action: for example, a theory of capital budgeting helps us with choosing among investments; a theory of revenue recognition helps to determine when and how revenue should be recognised; a theory of lease accounting helps with accounting for leases
b. reveal deficiencies in practice: a theory of profit determination might reveal deficiencies in the way we presently measure profit
c. improve practice: understanding deficiencies may promote change; understanding the behaviour of decision makers may help us to supply better information
d. help with accounting standard setting; the conceptual framework is used as a basis for drafting accounting standards.

1.4 It has been stated that 'many people accept theories without justification'. Identify reasons people may accept theories. Provide examples of theories that you accept or believe although you may not have direct knowledge in the area. (LO3)

Students may identify various theories that they accept but have no expert or direct knowledge of: e.g. theories re global warming, theories on punishment (e.g. that deters crime), theories on black holes in space; theories on causes of diseases (such as genetic depositions).

For many theories that a person considers, that particular individual may not have an in-depth knowledge of the area relating to the theory. For example, I believe that the world is not flat and that in fact the theory that the world is round is true. However, I am not a scientist; I have not studied detailed evidence about this theory in any scientific or systematic manner, so what makes me accept this theory, or other theories that are not in my area of expertise. People accept theories every day that they may not fully understand (such as theories of global warming; the theory of relativity; theories about how certain diseases are spread). There are a number of reasons why we may accept theories without 'first–hand' or direct knowledge, these include:

1. The authority of the source of the theory.

If the theory comes from a source perceived as having specific knowledge and expertise then we may defer to their superior experience and wisdom. If the 'experts' in the area say it is true then we are more likely to believe it is true, particularly when the expert provides evidence to support the theory. Statements and theories from eminent scientists or researchers in an area,

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by teachers (such as university lecturers), from textbooks, even from media sources (such as television and newspapers) are often viewed as authoritative. We are willing to often accept a theory as correct due to whom or where the information about the theory comes from (they wouldn't say it if it isn't true would they?).

2. *It 'fits' with our own experience.*

We are also more willing to accept a theory if the theory matches our own experiences and observations. The theory that the earth is not flat and is in fact round agrees with my own observations of the slightly curved horizon, and the sun setting so I am willing to accept this theory.

3. *It makes sense.*

If a theory seems reasonable and sensible we will often accept it.

'If a man is offered a fact that goes against his instincts, he will scrutinize it closely, and unless the evidence is overwhelming, he will refuse to believe it. If, on the other hand, he is offered something which affords a reason for acting in accordance to his instincts, he will accept it even on the slightest evidence. (Bertrand Russell).

For example, there are various debates about how much alcohol is safe to drink and that one or two drinks a day may actually be of benefit to a person's health. Many people would believe this is reasonable and further it may fit with their own preference to drink alcohol so would accept this.

4. *Perceived level of general acceptance.*

A key influence on many people's beliefs is what other people believe. If a theory appears to be accepted by many people, particularly if it is repeated. For example, if a poll shows that 82% of people believe that introducing gun controls will reduce violent crime, you may be more likely to accept this. This appeal to general acceptance is often used in advertising and political campaigns, such as '3 million Frenchmen can't be wrong. Buy a Renault'. Of course, just because most people believe something does not make it true. As we noted earlier, many people believed the world was flat but this did not mean that the world was in fact flat.

These approaches to accepting theories are intuitive rather than scientific or systematic and given that any individual's expertise is necessarily limited, provide a practical and rational way of determining whether an individual accepts a specific theory.

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1.5 Identify a theory that you have heard about (this can be about any area; e.g. global warming). Consider how you would test whether this theory was true. Do you think you could prove it? (LO4)

Think of a theory that describes what is happening or explains what is happening. The first step in testing the theory would be to evaluate its logic. Is the theory logical and gives a valid conclusion given its premises? So for example, there may be a theory about global warming that measures the hole in the ozone layer and links this to changes in average temperatures.

The next consideration would be to consider the evidence. Does the evidence 'fit' with, or perhaps contradict, the theory? For example, if the theory regarding temperature change related to global warming simply predicted that the temperature may change whatever happened, would fit with the theory and this could not really be tested. However if it made a clear prediction — for example, that in 2023 temperatures in a particular region would increase by 1% then we could test this by observing the temperatures in that region. If the observations are not consistent with the predictions of the theory we have established then the theory is incorrect. If the observations 'fit' with the theory then we can claim that the evidence supports the theory (i.e. that it has not been contradicted or falsified). It is generally accepted that theories cannot be 'proved' correct because of the problem of determining how many 'correct' observations are enough to establish the truth of a theory.

Students should recognise that even well accepted theories (such as Einstein's theory of the Big Bang) have been later proven wrong when better observations have been able to be made.

1.6 What is your understanding of the term 'research'? (LO4)

The Macquarie dictionary states that 'research' is:

- *'diligent and systematic enquiry or investigation into a subject in order to discover facts or principles'.*

A view of research taken from FASB's research and development is:

- Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service or new process or technique or in bringing about a significant improvement in an existing product or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other ongoing operations even though these alternations may represent improvements and it does not include market research or market testing activities.[1]

[1] Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 2 'Accounting for Research and Development Costs'. Stamford, C.T: FASB, 1974) par 8.

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1.7 Explain the role of research and how this relates to theory. (LO4)

Students should firstly understand that research is activity. The relationship to theory depends on the reason for the research being undertaken, the type of research and/or the results/findings of the research. Research can be undertaken before any theory has been formed or considered. The findings of such research could lead to the formation of a theory (either positive or normative). Research can also be used to test theories. For example, you could test the hypothesis of a positive theory and see if the findings match the predictions of the theory.

Below some types of research are listed – these are not discussed in the text but may be useful to provide examples to students of research. It may also be useful to have students examine abstracts of academic articles and consider how the research in these relates to theory.

Research may be *exploratory, descriptive, investigative, causal* or some combination of these (Kent, 2001). *Exploratory* research aims at finding out whether or not something exists (Dane, 1990, p. 8). As such it is about generating ideas, insights or hypotheses rather than measuring, testing or evaluating those ideas, insights or hypotheses. For example, early research in environmental accounting was aimed at finding out *if* companies were providing environmental information in their annual reports. *Descriptive* research is concerned with providing more detail (a more complete picture) about something, and so may involve measuring the sizes, quantities or frequencies of characteristics, but not investigating the relationships between them. For example, research in environmental accounting has investigated the exact nature of the environmental disclosures made by companies by recording the quantities of words included in reports about the environment and the nature and type of environmental information provided. When the research focuses on the extent of association or correlation between two or more variables, the research is *investigative*. This may often involve predictions (i.e. if one event occurs can predict that another event will occur) although it may not explain the cause of this link or correlation. For example, researchers have investigated the question of what factors are associated with companies that report environmental information and others that do not. Findings in this area have indicated that there appears to be a correlation between the size of a company and the type of industry, and whether it reports environmental information (e.g. that larger companies or companies in more environmentally sensitive industries, such as mining, are more likely to include this type of information in their annual reports).

Causal research extends the investigation by distinguishing between dependent and independent variables, and examines the degree of, and reasons for, the influence of one or more independent variables upon the one or more dependent variables. For example, this may investigate the question as to *why* (what causes) companies that are large include environmental information in their annual reports more often? Researchers have considered that one reason could be to manage the relationships and expectations with stakeholders.

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1.8 Outline the different classifications of research. (LO5)

The answer to 1.7 provides types/classifications of research in general. In accounting research, there are 2 broad classifications. These are:

- research of or about accounting. This considers the broader role of accounting
- research in accounting which focuses more on the actual practice of accounting.

In addition research in accounting can be classified into particular areas (although these overlap). The text identifies:

- *Capital markets research.* Capital-market research was undertaken by Ball & Brown (1968) and Beaver (1968) that began the positive research stream. Their studies *investigated the use and impact of accounting information by capital markets.*
- *Accounting Policy choice research.* Accounting policy choice research is commonly known as positive accounting theory for its domination of research which began with Watts & Zimmerman (1978). This research attempted to explain the motivation.
- *Accounting Information Processing Research.* Accounting information processing research investigates the use and users of information in the decision-making process and uses theories and models from psychology.
- *Critical Accounting Research.* Critical accounting research considers the role of accounting in society and the social content.
- *International Accounting Research.* International accounting research considers the call for uniform accounting standards worldwide and to harmonise financial accounting.

1.9 Explain why case studies are used and outline the suggested steps in answering case studies. (LO6)

Case studies are trying to portray a 'real life' problem but often in simplified form. This allows students to:

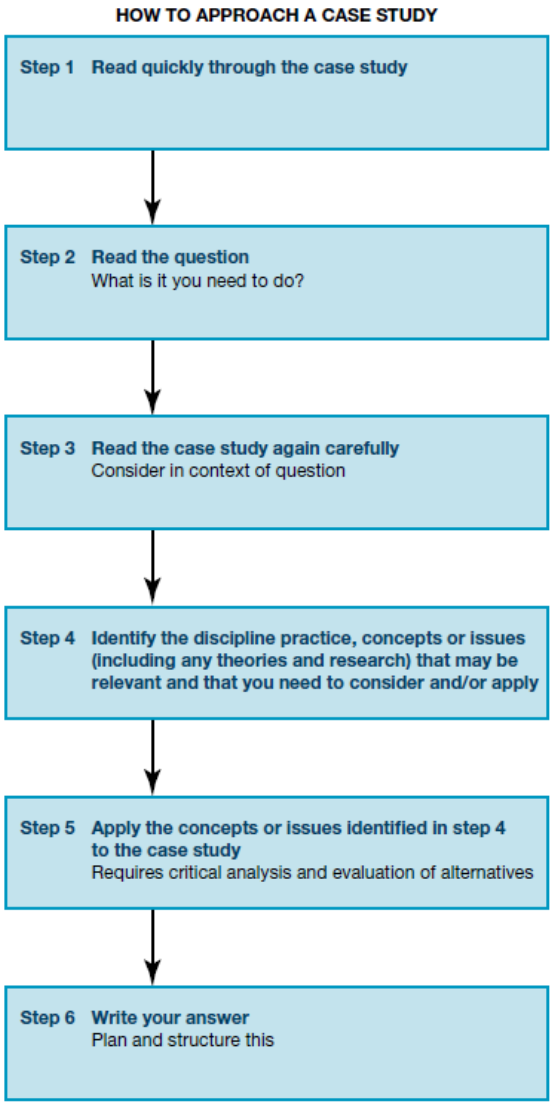
- be exposed to some of the complexities of 'real life' problems
- practice integrating and applying discipline knowledge and theory
- develops analytical and critical thinking skills
- develops communication skills
- practice decision making and judgement, especially where alterative solutions are possible.

The suggested steps in answering a case study are outlined in figure 1.2 of the chapter.

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FIGURE 1.2 Steps in attempting a case study question



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Application question

1.10 (a) Search (either on the internet or via your library database) for academic journals that publish research in accounting. Some examples of journals are:

- ***The International Journal of Accounting*** **https://www.journals.elsevier.com/the-international-journal-of-accounting/**
- ***Accounting, Auditing & Accountability Journal*** **http://www.emeraldgrouppublishing.com/products/journals/journals.htm?id=aaaj**
- ***Journal of Accounting Research*** **http://onlinelibrary.wiley.com/journal/10.1111/(ISSN)1475-679X**
- **Abacus** **http://onlinelibrary.wiley.com/journal/10.1111/(ISSN)1467-6281**

(b) Read the abstracts for three articles in the latest issue of two of the journals you have located and for each abstract:

- **identify the purpose of the research undertaken**
- **explain how this research could assist in improving accounting.**

(LO4 and LO5)

(a) The answers here will depend on the articles chosen. To illustrate one example is included below:

- *Xingqiang Du, Wei Jian, Shaojuan Lai (2017) Do Foreign Directors Mitigate Earnings Management? Evidence from China, The International Journal of Accounting, Vol 52, Issue 2, pp. 142-177.*

Abstract:

- In this study, we use a sample of Chinese companies to examine the monitoring role of foreign directors in deterring earnings management. Our findings show that earnings management is significantly negatively associated with the presence and ratio of foreign directors on corporate boards. We further find that, under these conditions, earnings management is less pronounced in state-owned enterprises as compared to others. These findings are robust to various specifications of earnings management as well as to the approach used in matching the treatment and control samples. Interestingly, the negative impact of board membership of foreign directors on earnings management varies with audit quality, IFRS convergence, investor protection and the similarity or difference of the time zones of the foreign directors and China.

(b)

(i) The aim of this research is to determine whether the inclusion of foreign directors impact on earnings management (Earnings management is defined there as "a manger's use of accounting discretion through accounting policy choices to portray a desired level of earnings in a particular reporting period").

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(b)
(ii) Earnings management is undesirable as this undermines the core aim for financial reporting to faithfully represent the performance of a company. As this research has found that the presence where there are foreign board members there is less earnings management. Prima facie students could argue that this could improve accounting by, for example, leading to corporate governance requirements for foreign board members to reduce earnings management. However care needs to be taken in interpreting any research findings. An association found between 2 factors does not necessarily imply a causal link (Think of the rooster crowing in the morning just before the sun rising). For example, in this instance it may be that the culture of the companies with foreign directors mitigates earnings management overall, rather than simply the presence of foreign directors.

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Case study questions

Case study 1.1

Economic theories that have changed us: efficient markets and behavioural finance

Questions

1. **Briefly outline the two theories that are explained in this article.**
2. **The article states that these theories prescribe opposite actions for investors. If you were considering investing in the share market, which theory would you follow? How did you decide?**
3. **Do you believe that these theories have any relevance to, or implications for, accounting or accountants? Explain your answer.**
4. **The article states 'there are two things that never makes any sense: investing in a stock because you think it's a good company . . . or picking an industry that you think is going to do well'. Does this mean that you should invest in bad companies, or if the industry is doing poorly? Explain your answer.**

(LO2, LO3 and LO6)

1. The first theory is the efficient market. This essentially argues that stock (share) prices reflect all available information.

The second theory is behavioural science. This essentially argues that decision makers (in this instance investors) do not act in rational or unbiased fashion but base investment decisions often on cognitive biases.

2. As the article states:
   - If accept efficient market hypothesis, then investors cannot 'pick' or identify good or bad buys by analysing information and as such should diversify their investments.
   - If accept behavioural science view then you can potentially (although as article states this is difficult) identify mispriced stocks (these are mispriced due to cognitive biases) and therefore earn profit (above overall market returns).

In deciding which theory to follow students should consider:

- Evidence for each theory. The article argues that evidence confirms behavioural science view, but that in long run stock prices conform to efficient market hypothesis. Further evidence supports the 'random walk' of stock prices.
- Personal factors such as:
  - are you investing for short or long term?
  - do you have the requisite knowledge or skills to take advantage of the potential profits to be made accepting behavioural science view?
  - what level of risk are you willing to accept?

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3. These theories are used in capital market research which is an important research area in accounting. Given that a key role for financial reporting is that accounting information should be useful to investors there is an assumption that accounting informs investment decisions, including those relating to stock/share transactions. Cleary these 2 theories have implications for accounting as these propose different ways investors use information in their decision making.

4. The statement in the article is not suggesting that you should invest in a bad company or an industry that is doing poorly. What it is saying is that the fact that a company is 'good' (or industry doing well) – by this we assume for example, profitable or has high returns – is not on its own a valid reason for purchasing shares in that company or industry. The decision to invest in a stock/share should be based on the expected return and risk (this will be by considering such issues as dividends and changes in share prices) given the investment timeframe. For example:

- Evidence suggests that a company's stock price may be temporarily higher following a unexpectedly good earnings announcement. Further, according to the efficient market hypothesis the fact that a company is 'good' would already be factored into the stock price.
- The stock prices of companies in an industry doing poorly may offer more opportunity for higher expected returns, especially if prices have fallen and, if accepting the behavioural science view, investors may have overreacted to unexpected bad news.

Case study 1.2

Abstracts from fair value disclosure research

Questions

1. **In the above abstract the notion of fair value accounting disclosures in financial statements is considered. Summarise any requirements in accounting standards that relate to the requirement to present fair-value related disclosures in financial statements.**
2. **The abstract states that 'large quantities of information appear to overload investors, thereby obscuring high quality disclosures'; while managers regard quantity and quality of information to be complementary. What issues do you think this inconsistent view will have for the usefulness and relevance of fair value information for investors?**

(LO1 and LO6)

1. According to paragraph 91 of AASB 13/IFRS 13 an entity shall disclose information that helps users of its financial statements assess both of the following:

   - for assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements.
   - for recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

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For assets and liabilities measured at fair value, the amount shown in the statement of financial position will be the fair value. The standard then requires a note (or notes) that provide additional information about how the valuation was determined. The amount of information is dependent on the level of input to the valuation (remembering that the lowest 'significant' level defines the overall level for that item class), with particularly extensive requirements for items based on unobservable Level 3 inputs.

Examples of disclosures are provided in AASB 13/IFRS 13.

2. The assumption made in the accounting standards is that compliance with fair value disclosure requirements will result in provision of information that is both useful and relevant for investor decision making. In reality this may not be the case. It could in fact lead to inappropriate decision making on the part of the investor. Students may identify the following issues:

- An increase in the quantity of information around how values are determined may not necessarily lead to a better understanding as investors may not read and/or fully comprehend all the information. Although managers may be interested in this level of detail, the average user/investor is not likely to be interested in reading lengthy disclosures and may skip over important details.
- More complex information associated with increased disclosure requirements may actually confuse investors and hinder decision making. Although useful for managers, information that is too complex may decrease the usefulness of these disclosures for investors.
- Investors may not fully understand the extent of subjectivity involved in calculations and estimates that form part of the fair value disclosures.

Students may also identify other issues.

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