CHAPTER 1
Fundamentals of Financial Accounting Theory

CPA COMPETENCIES ADDRESSED IN THIS CHAPTER

1.1.1 Evaluates financial reporting needs (Level B)
1.1.2 Evaluates the appropriateness of the basis of financial reporting (Level B)
1.1.3 Evaluates reporting processes to support reliable financial reporting (Level B)
1.2.1 Develops or evaluates appropriate accounting policies and procedures (Level B)

LEARNING OBJECTIVES

1-1. Explain the sources of demand and supply of accounting information.
1-2. Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.
1-3. Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.
1-4. Evaluate whether and what type of earnings management is more likely in a particular circumstance.
1-5. Explain how accounting information interacts with security markets.

OVERALL APPROACH

Students often say that accounting theory is boring and irrelevant. At the same time, they continuously express curiosity about why we account for particular transactions in particular ways. These sentiments reflect a separation between accounting theory and practical reality, at least in students' minds. Students want to understand "why," and accounting theory can provide many of those answers, but unfortunately students are often not exposed to theory until the end of their accounting programs.

To reconcile these two conflicting sentiments, this opening chapter introduces students to the foundations of financial accounting theory in a way that is approachable and applicable to situations with which they will be familiar. The opening vignette highlights the importance of theory in the context of a sailing trip and lays out the general approach of the textbook. This vignette augments the flowchart on the inside front cover and the imagery of the book cover.

KEY POINTS

The chapter begins with a brief discussion of the **supply and demand for information**. This is a straightforward idea that is approachable by post-secondary students. It is a threshold concept that opens up students' perspective of what accountants do, and it leads naturally to two other threshold concepts in this chapter (**decision making under uncertainty** and **information asymmetry**) and the conceptual framework in Chapter 2.

It is important to establish the idea of uncertainty at the beginning of intermediate accounting. Most students coming out of introductory accounting have the impression that accounting is very precise with only one correct answer. Indeed, many students say they choose to major in accounting as opposed to another field in business because they like the certainty in accounting. To dispel this misconception, it is important to stress that there is a considerable amount of uncertainty in accounting, thus professional judgement is needed.

First, there is inherent uncertainty in making decisions, because decisions involve the future. The need to make decisions with uncertain outcomes generates the demand for information. Second, useful accounting information is not just backward-looking, but it also includes estimates about the future. In particular, accrual accounting (to be explored in Chapter 3) includes estimates for future bad debts, the value of inventory in terms of sales in the future, useful life for equipment, etc.

The concept of information asymmetry can seem foreign to many students, so the chapter deliberately links this concept with the well understood idea of supply and demand. It is important to note that it is information asymmetry that drives the supply and demand for financial reporting. Therefore, information asymmetry is a fundamental concept that needs to be understood.

The chapter goes on to discuss two types of information asymmetry: **adverse selection** and **moral hazard**. The words in these terms are not very intuitive. To make these concepts approachable, the chapter first provides examples of these concepts before formally defining them. The financial crisis of 2008 provides a powerful illustration of moral hazard, as discussed on page 8. The two types of information asymmetry lead to two desirable characteristics (relevance and reliability), which will be explored in more detail in the conceptual framework in Chapter 2. Importantly, the presence of both adverse selection and moral hazard means that both relevance and reliability are desirable, thus trade-offs between them are a necessary consequence.

The presence of uncertainty results in a diversity of accounting choices in the form of accounting policies and estimates. Combined with information asymmetry, insiders have the opportunity to exploit their information advantage through their accounting choices. These choices have economic consequences (affecting bonuses, borrowing rates, labour relations, etc.) and this can lead into a discussion about earnings management. When students understand that **accounting choices have economic consequences**, they appreciate the importance of such accounting choices. Otherwise, accounting choices will seem to be arbitrary decisions that have no consequences outside of the accounting reports.

The final section of this chapter discusses the interaction between accounting and securities markets. Accounting not only informs the securities markets, but market prices also affect how we do accounting. The concept of **efficient securities markets** appears here, and it is important for students to recognize when this concept is applicable and when it is not.

USE OF END-OF-CHAPTER PROBLEMS AND CASES

In addition to lectures, discussion of some of the end-of-chapter problems and cases will help students apply the concepts. The following table identifies all of the problems and cases that can be used in class, and problems and cases that can be used for homework assignments. (Depending on the time allocation between lectures and examples, it may not be feasible to cover all of the suggested items.)

Table 1-1:
Summary of learning objectives, chapter content, and suggested problems and cases

L.O. number	Learning objective	Pages	Suggestions for in-class discussion	Suggestions for assignments
1-1.	Explain the sources of demand and supply of accounting information.	16	P1-2	P1-1 P1-3
1-2.	Apply concepts of information asymmetry, adverse selection, and moral hazard to a variety of accounting, management, and related situations.	16-18	P1-4 P1-8 P1-9 P1-11 P1-12	P1-5 P1-6 P1-7 P1-10 P1-14
1-3.	Describe the qualitative characteristics of accounting information that help to alleviate adverse selection and moral hazard.	18-20	P1-15 P1-19	P1-13
1-4.	Evaluate whether and what type of earnings management is more likely in a particular circumstance.	19-20	P1-16 P1-18	P1-17
1-5.	Explain how accounting information interacts with security markets.	20-21	P1-21 P1-23	P1-20 P1-22
—	Integrative		Case 3	Case 1 Case 2 Case 4

Problem P1-12 can be a fun exercise to conduct in class to illustrate adverse selection. Using a real deck of playing cards would be most helpful.

Case 3 involves in-substance defeasance of long-term debt. Being that this is a difficult case, students may not be sufficiently prepared to analyze it by themselves, so guided classroom discussion is encouraged.

