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**ADM4342N**
**Accounting Theory**
**Mid-Term Exam**
**February 24, 2016**

**Instructor:** **B. La Rochelle, Ph.D., C.P.A**
**Duration:** **75 minutes**
**Value:** **25% of your final grade**

**Note to students:** This is a closed-book exam, containing 3 questions, worth 45 marks in total. Apart from sundry writing materials (pens, pencils and the like), no examination aids are permitted

**NAME:** ______________________________

**STUDENT #:** ____________________

**Statement of Academic Integrity**
The School of Management does not condone academic fraud, an act by a student that may result in a false academic evaluation of that student or of another student. Without limiting the generality of this definition, academic fraud occurs when a student commits any of the following offences: plagiarism or cheating of any kind, use of books, notes, mathematical tables, dictionaries or other study aid unless an explicit written note to the contrary appears on the exam, to have in his/her possession cameras, radios (radios with head sets), tape recorders, pagers, cell phones, or any other communication device which has not been previously authorized in writing.

**Statement to be signed by the student:**

I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this exam.

Signed:______________________________

Note: An exam without this signed statement will not be graded and will receive a grade of zero.

**Question 1 (15 marks)**

With reference to three of the class presentations, discuss the nature of an "accounting failure" and how, if at all, one might use stock market information to assess whether such has or has not occurred.

**Question 2**

An extract from "[Local Authority Pension Fund Forum] claims IFRS adviser misapplied EU law" (Stephen Bouvier, *Investment & Pensions Europe*, September 28, 2015) is as follows:

> *The UK Local Authority Pension Fund Forum (LAPFF) has upped the stakes in its bid to persuade the European Union to block the introduction of International Financial Reporting Standard 9, Financial Instruments (IFRS 9) across the bloc.*
>
> *From 1 January 2018, IFRS 9 will become the new accounting rule that EU banks will have to follow as the basis for their reporting….*
>
> *The IASB launched its bid to replace its existing financial instruments accounting standard, IAS 39, in 2009.*
>
> *Critics of IAS 39, the standard it replaces, argue that its incurred-loss impairment model has caused banks to recognise losses too late.*
>
> *Although the IFRS 9 project started out life as a joint effort with the US FASB, the US standard setter largely walked away from the effort.*
>
> *That move on the part of the FASB has complicated the IASB's bid to become the world's single global accounting standard setter.*
>
> *In a further twist, critics of the IFRS 9 have jumped on the fact the FASB has adopted a more forward-looking model that requires banks to recognise full upfront lifetime losses.*
>
> *Meanwhile, the LAPFF, together with a growing investor coalition, has turned into a vocal critic of the IASB's efforts.*
>
> *The LAPFF is an umbrella body for some 65 UK public sector pension fund members, with approximately €235bn in total assets under management.*
>
> *In June 2013, the LAPFF, Threadneedle Investment and USS Investment Management released a legal Opinion from George Bompas QC.*

> *This move emboldened those investors who believe IFRS puts too little focus on protecting the interests of capital providers as required under UK company law.*
>
> *That row was reignited earlier this month when the LAPFF sought a second Opinion from Mr Bompas, who again concluded that company accounts prepared using IFRS fail to provide a true and fair view of its financial position.*
>
> *Nor, he added, do they allow companies to assess how much of their profit each year is available for distribution to shareholders.*
>
> *The FRC, however, has long rejected these claims, dismissing them as "misconceived".*
>
> *Instead, it has urged investors to engage with the IASB's conceptual framework project and the debate over the role of prudence in accounting…*
>
> *In the past, MEPs have highlighted the potential scope for a conflict of interest within Europe's accounting institutions.*
>
> *In a statement last year, former ECON Committee chairman Sharon Bowles warned that funding for the IFRS Foundation had strings attached…*

**Required (15 marks):**

With reference to the course material to date, discuss the foregoing.

**Question 3**

The following is extracted from Zsuzsanna Ilona Kovács and István Deák, "Accounting—Profession vs. Science", *Public Finance Quarterly* (2012) [State Audit Office of Hungary]:

> *Defining accounting as a scientific field is not self-evident to everyone. Some view accounting as a practical activity aimed at creating a report that describes the financial, income and earnings position of an economic entity. However, the methodology providing the framework for financial reporting inevitably relies on scientific research, given that its subject – the assets and the business activity of economic agents– is subject to continuous change, which the methods describing them are bound to follow. Accordingly, the definition of accounting should include both science and practice. According to Sterling (1975), the most important question is how one defines accounting. The definition he quotes includes*

*the word "art". This definition is based on the argument that no trend can be called scientific unless it relies on eternal laws and absolute truths and obviously, accounting does not fit the bill. Sterling, however, points out that scientific claims are not infallible truths but generalisations which must be put to test continuously. Other disciplines also involve changes, uncertainties and unresolved issues; this is no reason in and of itself to exclude accounting from this category:*

"There is nothing intrinsically unscientific
about accounting; our approach is unscientific"
(Sterling, 1975, p. 29).

*We examine the scientific grounds of accounting along the lines of Thomas S. Kuhn's work, "The Structure of Scientific Revolutions", which describes the possible foundations of specific scientific disciplines and the steps that accompany scientific progress. International literature includes a number of studies linking accounting to Kuhn's theory of scientific philosophy...*

*This study is intended to compare Kuhn's theory to the bases and evolution of the most broadly applied international accounting standards of our time, the International Financial Reporting Standards (IFRS). First, we identify the elements of the so-called disciplinary matrix within the set of rules established by the International Financial Reporting Standards; secondly, we discuss the stages of scientific revolutions by focusing on one of the biggest challenges faced by the accounting profession: the subject of new asset types (intangible assets and financial instruments). Our goal is to demonstrate, by examining a specific reporting system, that accounting is based on scientific grounds and that the stages of its evolution are similar to those of natural sciences.*

**Required (15 marks):**

With reference to the course material to date, discuss the foregoing.

1X / 15# Much care details

Question 1

An accounting failure occurs when the current accounting standards are
1. defficient. Meaning that the standards fail investors. For example, an
2. accounting failure is present when there is a topic not covered by
3. current accounting standards and it should. Another example is
4. when the accounting standards currently in place are too complex
5. and have difficult for practitioners to accuratly apply. In these cases,
6. information that is presented as a result of the inneficient standards
7. will mislead instead of perform their main purpose. Investors are improperly informed and it will often lead to financial statement misstatements.
8. As a result, you would expect to see a surprise in the market. You expect
9. to see a change in stock prices and trading volatility, because investors are discovering the standard defficiency and it's potential impacts on
10 the existing financial information offered to them that they previously believed to be accurate and reliable. ~~In~~ most, but not all cases of an accounting failure you would expect to see a significant reaction in the market, often times negative.

or delay communication

## Etisalat

This is an example we used in class showing an accounting failure. Etisalat subsidiary, Mobily, operated in Saudi Arabia and therefore was following SOPCA accounting standards. Within these standards were guidelines relating to recognizing revenue from contracts. They differed from IFRS in terms of the timing of the revenue recognition. IFRS required recognition when the obligations were performed while SOPCA allowed for complete recognition at the beginning of the contract term. The SOPCA standards also made vague references to having a global emphasis when reporting financial information. Mobily followed the Saudi Arabian standards accuratly up until they were forced to change their reporting style to IFRS. At that point, it was evident that, according to national standards anyway, the revenue recognition policies used by Mobily did not fairly represent the substance of the contracts. They had to restate their revenue significantly as a result. This was an accounting failure, at least on the part of SOCPA, because it did not accurately cover the revenue recognition concepts for contracts with customers. The market was very surprised as a result of the failure and the misstatement that followed. In fact, at the date of the misstatement, the stock price fell 30%. This supports the idea that an accounting failure often leads to market surprise.

KCAP

In this case, we are not dealing with an accounting standard deficiency, rather we are dealing with management error. Specifically, management of KCAP failed to properly account for its investments. Investments were overstated despite clear and understandable standards surrounding the matter. Here, the market did not seem to elicit a very strong response. In fact, the market, management, and the media did not make a very big deal of the restatement due to the error. Stock market prices were barely influenced. Here we can see a result of No accounting failure a weak market response. However, this does not mean that every time a market acts surprised it is because of an accounting failure...

Iconix

In this case, there is no accounting failure again. Instead we see management inaccurately recording revenues and valuing accounts receivables when there were clear and understandable accounting standards surrounding the matters. In this case, we saw a dramatic reaction by the market. On the date of the restatement announcement, stock price fell by over 57%. This reaction was not due to an accounting failure, rather it was due to investors losing confidence in the management of a relatively new company

quickly

As was illustrated, you might expect a market reaction due to a surprise a a result of an accounting failure. This is usually associated with negati stock price drops and increased volatility. However, we must note that not every market surprise is due to an accounting failure. A strong reaction can occur from management malfeasance/errors, from political/economical influences etc. Important ~~to understand~~ market reactions.

Question 1:

15+

well and insight

An accounting failure is "a situation where the market is surprised and the cause of the surprise is a deficiency in the accounting standard-setting processes." There are three examples of when an accounting failure can occur. The first example is when there is an issue in how an accounting standard is interpreted but the standard has not addressed this issue. This occurred with Enron in regards to the accounting treatment of special purpose entities. The standard-setters did not intervene and there was a delay in the amendment of the standard. The second example is when there is a clear need for an accounting standard but a standard has not been developed. In this case, there will be differences in accounting practices and a formalized accounting standard is needed. The third example is when the accounting standard exists but it is too complex to interpret in a matter that results in the fair presentation.

In terms of how stock market information can be used to assess whether an accounting failure has occurred, this relates to the level of market surprise. The stock market information can display the level of surprise and whether it appears as though the investors have lost confidence in management. This occurs when there is a stock price decline because investors see a restatement as a "signal" or message from management about the future of the company. The stock market reaction during the restatement is important but an accounting failure cannot be based on this information alone. Three class presentations can be used to further understand an accounting failure. For, Etisalat, its subsidiary Mobily restated its earnings due to issues with revenue recognition. Mobily was recognizing revenue on contracts that have yet been realized which overstated earnings. Mobily did comply with the applicable Saudi Arabia standards that were in effect before it switched over to IFRS. In terms of the market reaction, the stock price declined by 30% after the restatement. In this case, it was an accounting failure due to an issue with the standard itself and whether it showed ~~Mobily was~~ a fair presentation of Mobily's earnings.

For, KCAP, the company failed to properly record the fair value of assets to comply with the relevant accounting standard. The company overstated assets during the financial crisis. In this case there was not a significant market reaction and it appears the investor's did not lose confidence in KCAP. The applicable standard existed and was simple to understand. This was an issue of management integrity rather than an accounting failure.

For, EZCORP, the company restated earnings due to issues with the revenue recognition of asset sales and the improper accounting and classification of out-of-payroll loans. There was a significant market reaction after the restatement. In terms of relevant standards, they ~~were~~ existed and were not too complex. This case shows us the lack of professional judgment of the accountant rather than an accounting failure.

DIR

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DEST

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Question 2 IFRS

This extract is one of many examples of the difficulties in adopting IFRS. Starting with the International Accounting Standards Board as the standards setters of IFRS. The chairman of the board is Hans Hooverorst who is essentially a politician. Despite his position, he has zero profession in accounting. Contrast to the former chairman, Tweedie, who was very active in the profession. The IASB also lacks representation from appropriate bodies. For example, there is no representative for Canada but instead, there are threei members representing the North American continent. Some of these members are also no longer active in the accounting profession. Another example is that the representative of the whole African continent is not exactly of African descent. These factors points to the problem that the members of the IASB are not experts on accounting, so what value do they add and how can we trust their commitment to their position?

Accounting standard setters are the same as legislators. ~~Unf~~ Unfortunately, legislators do not necessarily need to have expertise on what is to be legislated. We need to keep in mind that accounting is like the law, and the law is to act in the best interest of the general public. Therefore, legislators have to seek valid expertise on the subject matter in order to act in the interest of the public. This leads to the matter of the public interest perspective and regulatory capture regarding standard setting.

The European Union is unhappy with IFRS because it is not able to see its public interest. The IASB are not experts, and so to have a perspective on the public interest of European Union is to seek one with expertise. They should seek one with expertise on the European Union banks, the industry, and their economy. This is also to avoid regulatory capture, which is to advance concerns of only for a particular party. We need to remember that the regulated is often the one with more knowledge on what is being regulated than do the regulators.

Another problem are the nuances in the translation of IFRS. The IASB needs to be mindful of the fact that the European Union is a collection of other countries with cultural differences. The same with China and how full convergence with IFRS in China is highly impossible because of the differences between the capitalist and socialist parties. This proves that IFRS is difficult to adopt due to the fundamental differences.

The other problem with IFRS is the government consent. The European Union has made it so that the IFRS needs to get approval from the European Union before doing anything. However, in Canada, the CICA delegated their authority to IASB without consent from the federal or provincial government. They violated the principal of delegated authority. The holder of that authority must obtain approval from the original delegator before further delegating. With CICA's situation in mind, it is questionable whether IASB will actively obtain approval from the European Union or not.

more on specific articles

Question 3 →

12 on the right track

Q2 First issue

The fact that the IFRS is able to infinge upon soveriegn rights of EU members is baffling. The maxim for majority of standard setting is Pareto efficiency ie. no one is worse off when there are clearly those ending up worse off, it is hard to see how the FRC could be so dismissive

Absolute?

Second issue

Even though the CICA delegated their authority to IFRS, it is hard to see how this specific standard would benefit canadian investors further putting the initial delegation to question

Third issue

With the stewardship aspect of Acct in mind, why is IAS causing banks to recognize losses too late? There is no real reason to push the entire system from current value and economic reality to future oriented recognition of full upfront lifetime losses. There is a huge leap of logic that isn't filled

Fourth issue

There is no evidence, even by virtue of experience, to argue that IFRS 9 is an improvement. The logic of falsification is not there to isolate variables that are affecting IAS39. The reasoning seems to be that of Kuhn where they choose to simply replace one standard with another by the virtue of the ideas it stands for. This isn't science, it is religion.

Fifth Issue

not necessarily

There shouldn't be a debate on prudence like lawyers, an Accountant's job is to follow the rules of the profession, legal or other wise, while acting in an ethical manner. Thus, what is up for debate is rules of the profession, not prudence.

Question 3.

14

The view that accounting is a science, as well as mention of Kuhn's theory brings about how either accounting changes are due to revolution or gradual acceptances of new methods of doing things.

According to Kuhn, science is absolute in the sense that those that know it make sure their ideas prevail over all others. There are no gradual changes, no evolution of ideas. The only way a new idea can take over as a new way of thinking is by completely replacing the old ideas. It will be as if these new ideas have been written on a blank slate.

This idea is known as a scientific revolution. Before a revolution occurs, there are no challenges to the prevailing theory, because it is declared as fact. Compared to a standard like IFRS, it would stand that the accounting under that standard is correct and there can not be any recourse due to its effects.

On the other end of the spectrum is Popper, who believes that science can evolve. Instead of abrupt, violent change, science involves a steady accumulation of information over time. Previous ideas can be used to assimilate new ones in the field.

Also unlike Kuhn's theory, Popper argues that criticism is necessary for scientific progress. A scientist's idea can be challenged by anyone, and if proven to be false, the theory can be dropped. If there is an error in the theory, it can be fixed and expounded upon.

In this day to day accounting, it appears that the approach most applicable to the field is that of Popper. As shown in the readings, accounting standards are open to change as well as criticism. It is one of the many similarities that Popper's idea of scientific progress has with accounting.

For example, accounting bodies as well as Chairman Hoogervorst admitted that due to those understatements of bad loans, they would work towards change. The same type of critizism an forward thinking that Popper pushed in his argument for scientific progress

It is important to conduct continuous tests and experiments to see what works and what doesn't. In a non-mathemati environment like this, not every suggestion will be effective in all situations.

(3) Thomas Kuhn discusses the concept of a paradigm shift in his book, "The Structure of Scientific Revolutions". The paradigm shift is a concept that states that a new change of thinking is revolutionary, and not evolutionary. and that people are reactive rather than proactive. People, businesses, etc only react when a problem occurs. A paradigm shift occurs when there is a new chang and a new way of thinking that is established to replace an old paradigm. He also said that Sometimes an ~~new paradigm repla~~ old paradigm is replaced by a newer incompatible one. and

- ignoring shift & valuable info

that individuals who have vested interests in the old paradigm will strongly resist change. This can relate to ~~aca~~ the adoption of IFRS accounting standards in the European Union. For example, the European Union believed that changing their accounting standards will not focus on protecting interests of capital providers. The new standard that the IASB wanted to adopt was IFRS 9 Financial Instruments to replace the old standa IAS 39. When EU heard this, they were dissappoint and wanted to resist the change. They did not want to accept the ~~a~~ fact that their banks are losing money and that they appear to be overvalued. The European Union does not believe that the implementa of an ~~a~~ international accounting standard will be success As compared to having an international language for all countries to speak, will never happen because each country is unique. The EU believes that IASB was prejudice on their countries' losses and that accounting standards should be set by a country's laws and government.

Kuhn's paradigm shift concept also states that individuals are willing to resist a new change because they found that the old one was more compatible. as seen by the EU. However, Kuhn also talks about that ignoring a paradigm shift is like ignoring valuable information. It is important to realize the benefits of implementing a newer and more corrective accounting standards than to have an old detriment standard that does not fairly represent the EU's ~~[illegible]~~ financial position. Applying IFRS in the EU can help correct losses that were not recognized when they were incurred in the banks, this prevents risks of debtness and allows healthy appearance for capital providers.

Although IFRS can be flawed, (its improving) and EU believes that accounting standards should be set by a country's laws and governe IFRS should not be ignored because the standard can be useful in improving a states economic situatn and fairly representing their financial positions.

~~[illegible]~~

Finally, Accounting standards should be clear, consige ~~in the~~ when used in reporting systems and used to aid a union (EU) or a firm's financial position IFRS can be used to modify weak standards to help governments have successful accounting ~~[illegible]~~ framework.