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ADM4342B
Accounting Theory
First Quiz
October 5, 2017

Instructor: **B. La Rochelle, Ph.D., C.P.A**
Duration: **70 minutes**
Value: **15% of your final grade**

Note to students: This is a closed-book quiz, containing 4 questions, worth 35 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 quiz, 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 quiz.

Signed:______________________________________

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

Question 1

"A research paradigm is restrictive, but necessary, if knowledge is to develop. A particular difficulty occurs when first principles remain unquestioned."

Required (8 marks)

Discuss the foregoing sentiment.

Question 2

In March, 2004, the FASB issued an exposure draft of a standard, by which it was proposed that the value of employee stock options would need to be expensed. An exposure draft is a proposal for a new standard, circulated to the public beforehand, The proposal faced powerful opponents. These included large corporations like Texas Instruments, Cisco Systems, Intel Corporation and Sun Microsystems. All used employee stock options extensively as a form of executive compensation.

Responding to industry concerns, various bills, or legislative initiatives, were proposed by various members of the U.S. Congress, with a view to either overriding or limiting the effect of the proposed standard. For example, under one such bill, the expensing of employee stock options would have been limited to the five more senior officers of a corporation.

By early 2004, around the same time as the FASB proposal, the Boards of Directors of almost 500 U.S. corporations had voluntarily decided to immediately expense the value of employee stock options.

Required (10 marks):

Based on the course material to date, discuss the issues raised by the foregoing.

Question 3

In March, 2004, Canadian Superior Energy Inc. held a conference call concerning the abandonment of a major exploration well off the coast of Nova Scotia. Previously, the company had issued favourable news releases about the well.

The company's Chief Executive Officer explained that the well was a success, but that the corporate business partner of Canadian Superior Energy, El Paso Corp., had decided not to invest more money into it. The Chief Executive Officer advised that he was optimistic that a new partner could be found, but declined to answer any questions from participants in the conference call.

Immediately following these events, the shares of Canadian Superior Energy lost half their value.

Required (7 marks):

Based on the course material to date, discuss the issues raised by the foregoing.

Question 4

Management of a foreign company plans to crosslist the company's shares on a U.S. securities exchange. The company currently uses local GAAP. Before applying for crosslisting, management plans to switch its current and future financial statements to IASB GAAP for reporting in both its home country and in the United States The company is based in a country with strong institutional structures.

Required (10 marks):

Based on the course material to date, discuss the issues raised by the foregoing.

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REGI-31

8/8 Superb response

1. Under Popper's view, we operate in a research paradigm of the scientific method, where the method is defined by trial and error, as well as conjecture and refutation. In respect to the development Knowledge, Poppers uses the concepts of falsifiability and criticism as a means by which to generate a cumulative nature, allowing Knowledge to progress. Falsifiabi is the idea that any hypotheses a scientist may have is open to the testing by others, an example being the law of gravity may be tested at any point and be refuted if the result does not agree with the hypothesis. Through this process the theories within this paradigm are able to develop as they grow to encompass a wider variety of considerations, ensuring objectivity through the openness to critique by the community. However, Kuhn's view is such that there is no development of Knowledge o than within a dominant paradigm. He believes that mature sciences can only progress through a strict adherence to the system in place, and that due to the open-ended nature of the research paaradigm, dogmatic approaches are the only way to yiel progress of a mature science. Outside of the paradigm Kuhn believes that mature sciences can only come into place through a scientific revolution, where the new ideas completely replace the old rather than build upon them, thus creating the distinction that Kuhn believes in a non-cumulative nature of Knowledge. Furthermore, he objects to objectivity outside of what is relative within the paradigm (paradigm defined objectivity), through the basis of incommensurability, that we have no common measure all as individuals as to a completely objective standard or basis for which to use as a comparison. Issues that arise from restrictive and dominant research paradigms is that results or

the Knowledge that is produced may be inherently subject to the bias or influence of the paradigm, inhibiting the progress of Knowledge. An example being that for a long period of time, there was the assumption that women were to blame for the poor health or developmental disorders of their children, where we Know now today that some disorders are actually attributed to factors relating to the father. Lastly, these dominant paradigms may put pressures on research to yield results, but that in itself weakens the integrity of the research in turn, weakening or even halting the true progress of Knowledge.

what is a paradigm?

(8/87) more

Question 1

~~[illegible]~~ A concept perpetuated by Kuhn, it speaks of scientific advancement and the nature in which science (he believes) is developed. Paradigms are somewhat restrictive because it is an immediate limitation of the scope of a theory or research topic. It stipulates that progress can only occur within a paradigm and that scientific revolution represents the evolution and complete overhaul of previous paradigms. Kuhn ~~discusses between~~ identifies mature/normal paradigmatic theories as those that require a dogmatic and predisposed view in order to develop a theory or concept. That means that researchers must already understand the scope of their paradigm and work to prove concepts not through rationality, but in confirmation of a predisposed view. Kuhn champions the notion that objectivity can exist only within the paradigm and that progress is shown through scientific revolution; coined because it relates to how a smaller and less accepted idea overthrows the dominant and current standing paradigm. ~~[illegible]~~ • An unquestioned first principle speaks to the basis by which a paradigm a developed upon. Without the initial principle, there is no direction or logical progression to the study. Such is true in a paradigmatic theory. As opposed to Popper who sees science as a progression ~~[illegible]~~ based on trial and error, refutability and objective ~~[illegible]~~ and rational reasoning. Popper contends that scientific theories are by nature fallible and must be ~~a~~ subject to testing. Should an existing theory be proven wrong, 3 outcomes occur. ~~The theory~~ A new theory is used, the theory is discarded, or the theory is amended. Popper's view is that the progression of research and science does not require ~~extra~~ scientific forces and that there are inherent rules and principles that exist. The goal of science is to reveal, learn and understand them.

7.5

Relate to disclosure theory

Q2

how does this work

This issue relates to the interest group theory, where several constituencies compete against each other for their best personal outcome. In this case, several large corporations lobbied to the government to not expense employee stock options as they were being used to compensate executives; therefore it was in their best interest to not have this standard go through as it would reveal information that they otherwise would not need ~~to~~ disclose as explicitely. The government, through the form of legislation, attempted to override the effects of the standard, which they can do as accounting standards are in effect legislation. However, this raises concerns about working in the public interest, which is supposed to be the interest group that should be served first.

We then see that nearly 500 corporations were already voluntarily expensing the value of the employee stock options; the voluntary nature of disclosing and accounting for the employee stock options in this way shows that the Board of Directors for these companies wanted transparency and due process to the market on this issue to provide high quality disclosures of management compensation.

Signalling

This level of high quality disclosure reduces information asymmetry in which adverse selection gets diminished with this new standard by allowing the market to see at what price the executives receive the stock option and when they execute their option. It also reduces moral hazard as how is this shirking

executives cannot shirk by opportunistic sales of their shares.

Finally, the 500 corporations who voluntered to accept this exposure draft increase its reliability to represent their accounting information truthfully and agree to take on ~~conservative~~ accounting standards for complete transparency.

7 ~~7~~ 8 [illegible]

QUESTION 2:

What we witness in the provided text is a real-life application of the interest Group Theory. This theory describes the role that various interest groups (constituents), holding different priorities/goals/incentives, in regulation, whether the source of such regulation is professional accting bodies, standard setters, securities commissions, or GAAP.

compare public interest

For example, in the Manufacturing industry, firm managers, organized labour, consumers, and environmentalists will have varying interests. Consumers may want better labelling + quality minimums, while environmentalists may want more sustainable production process. The various interest groups exert pressure on the regulator through lobbying, political donations, media appearances, etc.

Effectively, the interest group who most successfully applies pressure has the greatest influence on the regulator + the outcome.

lobbying / lobbying by management

As we can see in the provided scenario, Texas Instruments, Intel, etc. were lobbying against the new ESO standard, as it conflicted with their interests. They then had to change their practice to adopt the new standard.

Well, someone has to compromise, if not everybody. That's what Arrow says in his Possibility Theorem: there is no one objective optimum. There is no such thing as a perfect accting standard, and so, the Interest Group Theory will prevail, where constituencies compete for a social ordering of priorities which benefit them most.

In acctng standards more complicated, there is actually the need for more influence on the regulator by the regulated. We see this in the case of derivative regulation, and in disciplines such as medical drug testing. The regulated is the most knowledgable about the issue at hand, and therefore often ends up heavily influencing the regulator (we see this on acctng standard setting boards, where many members are CPAs or even industry members).

What about voluntary disclosure here

Q3

Restoration ~~Relevan~~ Relevance COSTS do not need to be expensed right away; they affect profit over a period of time. Contrast

Discuss theory and evidence re forecasts

By releasing favorable information but then announcing the loss of their investment partner, the market would be concerned. Therefore, by the CEO of Canadian Superior Energy maintaining silence, the market punished the company as it perceived the silence as bad news. The market also perceives that the CEO has information that he is not willing to disclose which creates a loss in investor confidence and the share price dropped significantly. The lack of quality in information denied the investors of any confidence that the company would find another investment partner.

Discuss theory and evidence

According to the Dye Model, there is a disclosure threshold at which if the costs outweigh the benefits, a manager will not disclose. Also, the market needs to perceive if a manager is informed or uninformed about relevant information. In this case, the market has reasonable assurance that the CEO is informed and is withholding information because it doesn't meet the disclosure threshold and therefore the disclosure principle fails. Also, the knowledge that the investment partner decided to not invest any more money but the CEO

Evidence

gave the reason as to why can lead the market to be skeptical of the actual success of the well. The role of accounting information in decision making attempts to improve the operations of the capital markets and managerial labour markets, but in this case, it fails both with the lack of disclosures.
Silence equates to negative market consequences and as the CEO is viewed as a high-type, informed manager, the market will punish excessively.

and

SP 6

3. The issues raised in this case relate primarily to the costs of non-disclosure. In particular, one may consider the disclosure principle, which states that the market knows that management has information that is not known to investors, leading to a circumstance of information asymmetry, and due to the lack of disclosure the market assumes the worst case scenario, weakening investor confidence in the company and realizing itself through a share price reduction which in this case was extremely drastic, cutting the value of the shares in half. The principle states that this assumed response is to act as a deterrent for companies relating to non-disclosure and is meant to incentivize companies to increase disclosure through negative reinforcement. Additionally, when considering information asymmetry, this case seems to present a lack of "high-quality information", which we may define as information that reduces information asymmetry. A primary issue of this situation is that the information provided did serve to bridge the gap of knowledge between management and investors. Lastly, we consider the aspect of risk, typically the benefit of disclosure is increased investor confidence and lowered cost of capital as they feel more security in their investment, so it follows that the cost of non-disclosure is loss of investor confidence and an increase in cost of capital as investors now view this opportunity as higher risk

Expand

~~Q3~~ Q4

9/10 nice and tight

The issue here is whether or not the move to IASB GAAP is a good idea for the firm or not. Taking into account the added cost and likelihood of success and adheerence to IASB GAAP. What we know, thanks to a DHSV study presented in Scott, is that it seems "serious" adopters of IASB GAAP do incur benefits of lower capital rates, higher stock price, etc. "Label" adopters whom do it simply for prestige will not receive the same benefits potentially. This is assumming the validity of the DHSV study which had to use qualitative markers for ~~...~~ strong adherence to IASB GAAP, which may be hard to measure well. Given that it is true, though, the company could consider adoption if it's "serious". Since it has strong institutional structures this gives it an advantage. Issues found here are that countries without these strong structures are known to not adhere as well. For example, a Code Law country as China ~~would~~ might be instructed on how

Q4 cntd

to account by the government, hurting it's adherence to GAAP. There is also no conclusive evidence that IASB GAAP is the best. It really depends on their situation. If their local GAAP is a great fit then they must weigh some of the costs. Is losing in comparability worth the costs to move to IFRS? Or will lack of comparability be beneficial overall?

They should not blindly move to IFRS and must take into account the foregoing points.

missing much

Question 4. 8/9 Dontrach

Switching from the current standard of GAAP to IASB has some benefits and costs to it. The costs are both indirect and direct. Direct costs include the actual creation of the new financial statements to meet the new standard. Indirectly, potential costs of releasing proprietary and non proprietary information as a result of the new standards. Releasing this information may decrease information asymmetry, but at a potential economic disadvantage to the company. It could cause the value of shares to decrease because the new regulation causes it to show unrealized gains/losses that it previously didn't have to, as an example.

There are also benefits such as once the initial costs have been incurred of creating the new financial statements, it will now be less costly to produce financial statements since IASB is internationally recognized, so they won't have to adapt their financial statements in the future.

We should note that switching to a new standard is most beneficial to countries with currently very different standards. This is because the standards vary so much..

For example, countries with code law have less information asymmetry and less conservatism on their financial statements as opposed to common law countries such as Canada. This is because since there is less information asymmetry, investors already know a lot, so they don't need to be conservative on their statements.

Is this the case here?

Since GAAP and IASB are so similar, there will be a minimal impact, since the standards required are about the same. This being noted, the management of this foreign company needs to determine if the potential benefits of switching exceed both indirect and direct costs.