**Solution Manual**

#### to accompany

Contemporary Issues in Accounting

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CHAPTER 1

CONTEMPORARY ISSUES IN ACCOUNTING

**Contemporary issue 1.1 *Abstracts from critical accounting research***

**1. In each of these abstracts the notion of true or fair accounting or financial statements is considered. Identify any requirements in accounting standards or corporations legislation that relate to the truth or fairness of financial statements or reports. (K)**

The accounting standards require that the financial statements provide a fair presentation and state:

 Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation. (IAS 1/AASB 101, para 15).

(It should be noted that the concept of faithful presentation and whether there can be a true and fair view is contested and this is discussed in Chapter 2).

In Australia Corporations Law, S297, requires that :

The [financial statements](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) and notes for a [financial year](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_year) must give a true and fair view of:

 (a)  the financial position and performance of the [company](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#company), [registered](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s1276.html#registered) scheme or [disclosing entity](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#disclosing_entity); and

 (b)  if consolidated [financial](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) [statements](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) are required--the financial position and performance of the [consolidated entity](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#consolidated_entity).

This section does not affect the obligation under [section 296](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s296.html) for a [financial report](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_report) to comply with [accounting standards](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#accounting_standard).

Note: If the [financial statements](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) and notes prepared in compliance with the [accounting standards](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#accounting_standard) would not give a true and fair view, additional [information](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#information) must be [included](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#included) in the notes to the [financial statements](http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s9.html#financial_statements) under paragraph 295(3)(c).

 There is similar legislation in many countries.

**2. Can you think of reasons why there could be claims that financial statements that are prepared in accordance with accounting standards are not true or fair? (J, K, SM)**

The assumption made in the standards is that compliance with accounting standards will, expect in rare cases, result in a true and fair view. Reasons for considering that financial statements prepared in accordance with accounting standards may not present a true and fair view could include:

* Some accounting standards do not allow professional judgment and have set rules, regardless of whether these rules reflect the substance. For example, in current leasing standards treat no assets or liabilities are disclosed for operating leases despite the fact that most of these leases would meet the definition and recognition criteria for such elements under the conceptual framework (Note: this deficiency is acknowledged and it is intended that this standard be revised). Another example is that internally generated intangible assets (such as goodwill, brands) are not permitted to be recognised under current standards, yet these may be valuable assets to an entity.
* From a critical perspective, the limitations of information provided by accounting render these statements incomplete and biased, toward financially measurable elements, and so would not be considered true and fair (see answer to 3 below)

Students may identify further reasons.

**3. The first extract states that current accounting “may disenfranchise those parties to the dispute whose issues are not readily expressed in the common vocabulary of business’. What do you think the author means by ‘the common vocabulary of business’? Given this, what type of issues may not be included in accounting reports/statements and how could their exclusion impact on decision making? (J, AS)**

* The common vocabulary of business here would refer to monetary or dollars values (so financially measurable elements). This is also normally restricted to ‘direct’ and measurable costs and benefits (so other factors, eg: externalities such as pollution or employee satisfaction/morale are not included unless directs costs associated with these). Further, the prime objective of business is ‘profit’ and this profit orientation is reflected in what is included and how measured and gives primacy to economic factors/issues and often short term outcomes.
* A few of the issues not included would be social justice, environmental concerns, and social equity issues. Typically decision making frameworks suggest that decision makers should take into account both qualitative and quantitative factors. However if the variable /factors considered are restricted to those in the financial statements this will effectively exclude most qualitative factors. A quote by John F Kennedy (although this is in the context of gross national product, this illustrates the limitations of quantitative information and hence can be extrapolated to accounting issues)

[Gross National Product](http://en.wikipedia.org/wiki/Measures_of_national_income_and_output) counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. It counts special locks for our doors and the jails for the people who break them. It counts the destruction of the redwood and the loss of our natural wonder in chaotic sprawl. It counts napalm and counts nuclear warheads and armoured cars for the police to fight the riots in our cities. It counts Whitman's rifle and Speck's knife, and the television programs which glorify violence in order to sell toys to our children. Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country, it measures everything in short, except that which makes life worthwhile. (Robert F. Kennedy, University of Kansas, March 18, 1968)

**Review questions**

**1. Define what is meant by ‘theory’ and explain how theory is useful. Do you think theory needs to be considered in financial accounting?**

There is no simple definition of ‘theory’ and in usage it is simply an opinion or explanation. Macquarie dictionary definition states that ‘theory’ is:

1. a coherent group of general propositions used as principles of explanation for a class of phenomena
2. a proposed explanation whose status is still conjectural, in contrast to well-established propositions that are regarded as reporting matters of actual fact
3. a body of principles, theorems, or the like, belonging to one subject
4. distinguished from the practice of it
5. a particular conception or view something to be done or of the method of doing it; a systems of rules or principles
6. conjecture or opinion.

A theory may well be born in the human mind, and for it to be useful it must relate to the ‘real’ world. 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.

Accounting theory definition therefore 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:

1. 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
2. reveal deficiencies in practice: a theory of profit determination might reveal deficiencies in the way we presently measure profit
3. 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.

**2. Explain what is meant by positive theory.**

Positive accounting theory can:

* Describe what is actually happening
* Explain what is happening

Positive theories are concerned with ‘what is’ and should relate to the facts or the real world through hypotheses. For example, there may be a theory about how individuals or groups actually use accounting information and this would result in predictions (hypothesis) about how we would expect information to be used by particular individuals/groups. The hypothesis is usually to test the theory. Many positive theories are generally concerned with predicting how accounting information is used in economic decision-making and often referred to as ‘empirical’ theories. In the main positive theories are developed from observation through the process of induction and deduction.

**3. Explain what is meant by normative theory.**

Normative accounting theory is concerned with ‘what should’ be done or ‘what ought to be’ as they prescribe. Prescriptions or recommendations of these theories aim to achieve some goal or objective. The normative theories deal essentially with measurement and are based on classic economic concepts, especially those of income, wealth and rational decision-making.

The conceptual framework is a normative theory. It prescribes the basic principles that are to be followed in preparing financial statements. Hence an accounting conceptual framework can be described as ‘A coherent system of concepts that underlie financial reporting’.

Please note that normative does not mean devoid of any empirical base — normative theories will use empirical theories/observations as assumptions from which prescriptions are deduced.

**4. Explain what is meant by induction and deduction.**

**Induction** is the process of inferring general principles from particular instances; it is the process of moving from the specific observations (particular instances) to a general theory or conclusion.

Deduction is from the general to specific statement; it is the process of reaching a conclusion about particular instances from general principles.

The illustration explains:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Inductive |  | Theory |  | Deductive |
| (specific > general) |  | (general > specific) |

The inductive–deductive cycle is a common way in which researchers work and in which positive theories emerge. This is often referred to as the **scientific method** and is the common way in which positive theories emerge.

An example of the inductive-deductive cycle is below:

1. \*Identify the research problem by observation (induction)

Theory development

1. Develop theoretical framework to resolve the problem (deduction).
2. Specific hypothesis to be tested
3. Construct the research design

Use of Observation

Observe via sampling and gathering data

1. Analyse the observations
2. Evaluate the results — are these consistent with the hypothesis of the theoretical framework that has been developed
3. Assess any limitations

3. State Hypothesis

2. Develop

(deduction)

4. Research design

5. Observe

6. Analyse

7. Evaluate

1. Identify (induction)

8. Limitations

**5. 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.**

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 everyday 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, 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 who or where the information about the theory comes from (they wouldn’t say it if it isn’t true would they?).

1. 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.

1. 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 persons health. Many people would believe this is reasonable and further it may fit with their own preference to drink alcohol so would accept this.

1. 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.

**6. Identify a positive theory (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?**

Recall that a positive theory 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 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.

For a positive theory to be able to be tested by observation it must then make a predication that can be tested. 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 2008 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 theory has not been 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.

**7. What is your understanding of the term ‘research’?**

The Macquarie dictionary states that ‘research’ is:

1. diligent and systematic enquiry or investigation into a subject in order to discover facts or principles
2. to make researches; investigate carefully.
3. to investigate carefully; to research a subject exhaustively
4. of or pertaining to research

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]](#footnote-1)

**8. Explain the role of research and how this relates to theory.**

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.

**9. Is the following statement correct: ‘Empirical research is only related to positive theories.’?**

This statement is incorrect. Recall that ‘empirical research’ is defined as ‘research based on observation and experience’. As the text states, this can also be associated with normative theories. As normative theories do not make predictions about what is happening we cannot use observations of the real world (what is happening) to test these theories — normative theories are making recommendations and stating what should happen, not what is happening. However empirical research is often a catalyst for normative theories. For examples, empirical research that identifies the impact that companies have on the environment may lead to a normative theory about requirements for companies to include information about their environmental performance in their annual reports.

**10. Research can be classified in several ways. Outline them.**

There are 2 broad classifications of accounting research. 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. Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 2 ‘Accounting for Research and Development Costs’. Stamford, C.T: FASB, 1974).par 8. [↑](#footnote-ref-1)