

Fall 2015

ACCT 6125

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University of New Orleans
ACCT 6125.601 - Accounting Theory
Fall 2015

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Office/ E-mail: KH455/ DManry@uno.edu *Hours:* MW 1400-1515, 1700-1745,
Classes: M 1800-2045, KH227 T 1000-1100 or as announced

Text: There is no text. However, there will be Required Reading material (**RR**) available online (hopefully) through "Moodle," in .pdf format. **Do not print these out**; in most cases, you will find it easiest to merely skim the readings online. The RR sections will correspond very generally to topics in my Lecture Notes, which will be available at the University Copy Shop hopefully soon.

Prerequisites: ACCT 3121 and ACCT 3122. The material covered in this class is somewhat technical in nature, and a firm *ex ante* understanding of financial accounting is required. *A certain comfort level with economics, finance, math, and statistics is also presumed.*

Objectives: Note the title of the class at the top of the page. This is a class about *theory*, not applications, practice, or procedures. Our questions focus on "why," rather than "how to."

A. Financial economics concerns behavior under uncertainty; in particular, how rational agents make investing, financing, contracting, resource allocation, and other value-relevant decisions. You will learn how the need for accounting information arises naturally in such situations, and will develop an understanding of how economics, finance, and accounting are inextricably interrelated. This class is thus interdisciplinary.

B. Financial accounting intends to measure and report quantitative information about economic events. If stock price inculcates economic information, then accounting reports and firm value should be related. In this class, you will learn how information is reflected in stock price, how to estimate a firm's intrinsic value with accounting information, and develop an appreciation of the delimiting assumptions underlying related modeling efforts.

C. This class will help you develop an understanding of the limitations of the traditional "historical cost" accounting model and a familiarity with alternative theoretical measurement models. In particular, you will learn how theoretical disagreements about measurement lead to multiple accounting methods and the opportunity to manage earnings. You will also learn why firms seek to manage earnings, and why regulators allow firms to.

D. You will also develop an understanding of some of the theory and research in

accounting and financial economics, and how theoretical developments relate to current issues in financial reporting and regulation (standard setting).

Assignments: 4 components will determine your grade in this class: problem sets (**PS**), a valuation project (**V**), a term paper (**T**) which extends the valuation project, and a comprehensive final exam. Assignments not conforming to instructions will be marked down, and email submissions will not be accepted. Tentative due dates are on the attached schedule. Details and weight:

A. Problem Sets will (hopefully) be posted soon on Moodle. One (of 4 total) will be due every couple of weeks (see attached schedule). They will be based on the RR and my lectures. You are responsible for all material referenced, but must submit answers only for “**group C**” (@) questions. Weight: 32%.

B. The Valuation Project will require that you select a publicly-traded U.S. firm whose name begins with the same letter as your last name. This cannot be the firm you currently work for. You will obtain financial information and security analyst earnings forecasts for your firm from Value Line and the internet (yahoo.com is required for this), and estimate its stock price. I will show you how in class. On Moodle, I will provide you with hints and other important information. Weight: 18%.

C. You will write a brief term paper on the firm you have selected, providing additional information and analyses I request. On Moodle, I will post a detailed outline, which must be followed. The paper will incorporate (by reference) your valuation analysis (#B above). The paper must be turned in *at my office*, not in class. Weight: 17%.

Please *do not* buy a fancy binder for the paper. I am required by UNO regulations to keep the papers for a year; after that, space constraints force me to toss 'em, binder included.

D. The comprehensive final exam will resemble the PS questions and will thus be based on the RR and my lectures. Weight: 33%.

Attendance: Not required, but highly recommended. Although the readings are substantial, much of the material I present in class is not found in the readings. Given the readings and the technical nature of the lecture material, a satisfactory outcome will be less likely if classes are missed. I may also say something interesting without warning.

Drop date: **10/14** is the last day to drop/withdraw.

Grading: The assignment of grades will be based on your weighted average component percentage score, as follows: 90-100%, A; 80-89%, B; 70-79%, C; 60-69%, D.

This assumed distribution may be perturbed in your favor at my discretion.

Cell Phones: No cell phone usage allowed. If you bring one to class, have it turned completely off and stowed. If you are expecting an important call, do not come to class; arrange to get notes from a colleague. Also: No text messaging, and no photos. If you want copies of the overhead solutions, no problem; ask to borrow the overheads from me after class. This policy has been recommended by Student Affairs. Failure to follow these guidelines constitutes a violation of UNO Judicial Code item #19 concerning annoyances and disrupting class. Violations will be dealt with as indicated by the Code.

Remarks: A. Students are expected to conduct themselves according to the principles of academic integrity as defined in the statement on Academic Dishonesty in the UNO Judicial Code. Any student or group found to have committed an act of academic dishonesty shall have their case turned over to Judicial Affairs for disciplinary action which may result in penalties as severe as indefinite suspension from the University. Academic dishonesty includes, but is not limited to: cheating, plagiarism, fabrication, or misrepresentation, and being an accessory to an act of academic dishonesty.

B. It is University policy to provide, on a flexible and individualized basis, reasonable accommodations to students who have disabilities that may affect their ability to participate in course activities or to meet course requirements. Students with disabilities should contact the Office of Disability Services as well as their instructors to discuss their individual needs for accommodations.

C. My Lecture Notes will provide the organizational center for the course. However, the Required Readings will provide much explanatory and complementary background.

D. Check Moodle periodically for announcements concerning changes in scheduling of classes or tests, assignment due dates, or the availability of course project assignments. In the event of campus closures due to hurricanes or other unforeseen events, Moodle may be our only means of communication. Make-up classes (if needed) will be held at times determined to be the most inconvenient for the largest number of persons affected.

E. I will render the concepts and material as intuitive and transparent as possible. *You are strongly advised to read the assigned material before coming to class.* Be advised that this may require some planning on your part, since the volume of readings is somewhat uneven.

Meeting	Lecture Notes Topic	RR, Assignments <i>Tentatively Due</i> (PS1-4,V,T)
M 8/24	1. Recall- brief overview 2. Questions: motivations 3. Background: measurement and reporting	RR1, RR3
M 8/31	(3. Economic rationality, the DCF model) 4. Accounting measurement and security valuation	(RR3), RR4
M 9/14	(4. Accounting measurement and security valuation) 5. Alternative measurement models, capital maintenance concepts	(RR4), RR6
M 9/21	6. Decision theory and capital markets	(RR6), <u>PS1</u>
M 9/28	(6. Market efficiency and portfolio theory)	(RR6)
M 10/5	7. Economic consequences and positive accounting theory	RR7, <u>V</u>
M 10/12	8. Earnings management	RR8, <u>PS2</u>
M 10/19	9. Capital markets research in accounting	RR9
M 10/26	(9. Capital markets research in accounting)	(RR9)
M 11/2	10. Financial statement (ratio) analysis, 11. Game theory: introduction	RR11, <u>PS3</u>
M 11/9	(11. Game theory: equilibrium concepts)	(RR11), <u>T</u>
M 11/16	(11. Game theory: refinements, 3-person games, repeated games)	(RR11)
M 11/23	(11. Principal-agent conflicts and efficient contracting)	RR12, RR13, <u>PS4</u>
M 11/30	12. Regulation (standard setting) and lobbying 13. Current issues and international harmonization	
M 12/7	Final Exam 1730-1930	

Required Readings (RR)

RR1.

Schulte, Erin. Tomorrow's Profits Matter Today. *The Wall Street Journal Sunday*, July 2004, theory1.pdf. This is a short newspaper article, easy to skim; in fact, I'll probably go over it in class. It demonstrates much of what this class is about. E.g., why is financial accounting important, and why do professional stock-pickers and the financial press obsess over earnings? Because (read title).

Basenese, Louis. The Truth about First-Quarter Earnings, *Wall Street Daily* 2012. I'll go over this in class; otherwise, it's real short so you can read it. rr-earnings-wallstreetdaily.doc.

Background on the FASB's Conceptual Framework; *just skim these* to get an idea of the arguments behind the Framework we now have:

The FASB's Conceptual Framework: Relevance and Reliability. Financial Accounting Standards Advisory Council, September 2004, theory2.pdf.

Johnson, L. Todd. The Project to Revisit the Conceptual Framework. *The FASB Report*, December 28, 2004, theory3.pdf.

Johnson, L. Todd. Understanding the Conceptual Framework. *The FASB Report*, December 28, 2004, theory4.pdf.

The FASB's Conceptual Framework: Issues Involving the Definition of Liabilities. Financial Accounting Standards Advisory Council, June 2004, theory5.pdf.

RR3.

The Rational, Risk-Averse Investor, The Principle of Portfolio Diversification, The Optimal Investment Decision, Portfolio Risk, The Reaction of Professional Accounting Bodies to the Decision-Usefulness Approach, Conclusions, SFAC1, SFAC2: Scott, William. *Financial Accounting* 5, CGA Canada, 1994, 257.pdf, 258.pdf. Read all parts *except* Topic 2.4-2.6 (skim 2.4), 257.pdf. The omitted parts should be read at the beginning of RR6.

FASB. *Understanding the Issues: Why Does the FASB Have a Conceptual Framework?* 2001, 259.pdf.

FASB. *Financial Accounting Series: Status Report #223-A*. August 31, 2001, 260.pdf.

Fellingham, John and Rick Young. *Accounting in Perfect and Complete Markets*. 2002, 261.pdf. I go over this in class, so you may skip it, unless you get lost or have questions.

Kinney Jr., William R. Empirical Accounting Research Design for Ph.D. Students. *The Accounting Review* 61, 1986, pp. 338-341 only, 262.pdf.

Ingberman, Monroe and George Sorter. The Role of Financial Statements in an Efficient Market. *Journal of Accounting, Auditing, and Finance*, Fall 1978, pp. 19-23, 263.pdf.
You may just skim this one.

RR4.

Lee, Charles. Measuring Wealth. *CA Magazine*, April 1996, pp. 32-37, 264.pdf.
You may just skip this one; I'll go over it in depth in class.

RR6.

(Review RR3, file 257.pdf, especially topics 2.4-2.6 which were skipped earlier.)

The Decision-Usefulness Approach, Single-Person Decision Theory. Scott, William. *Financial Accounting 5*, CGA Canada, 1994, 265.pdf.

Dyckman, Thomas R. and Dale Morse. *Efficient Capital Markets and Accounting: A Critical Analysis*, Chps. 1-6. Prentice-Hall, Inc., 1983, pp. 1-67, 266-273.pdf. You should read the first 4 chapters (266-269.pdf), skim chapters 5 and 6 (270-271.pdf), forget the Bibliography (272.pdf), and only look at the Appendices (273.pdf) if you want to review expected values, variance, covariance, and the math behind calculating Beta and CAPM (the Capital Asset Pricing Model), which are used in the Valuation Project (V).

Rubinstein, Mark. Rational Markets: Yes or No? The Affirmative Case. *Financial Analysts Journal*, May/June 2001, pp. 15-29, 274.pdf. You can probably just skim this one.

The Money Store. *News Release*. July 28, 1993, 275.pdf. This is just an example (I refer to it in class) of a quarterly earnings release; have a look, but there's nothing to read here.

Stern, Marc D. Reducing Investment Risk by Capturing Volatility. *The CPA Journal*, May 2002, 70-72, 276.pdf.

RR7.

The Rise of Economic Consequences, The Relationship Between Efficient Market Theory and Economic Consequences, The Positive Theory of Accounting. Scott, William. *Financial Accounting 5*, CGA Canada, 1994, 277.pdf.

Zeff, Stephen. The Rise of "Economic Consequences." *The Journal of Accountancy*, December 1978, pp. 56-63, 278.pdf.

Watts, Ross L. and Jerold L. Zimmerman. "Positive Accounting Theory: A Ten Year Perspective." *The Accounting Review* (1990), Vol. 65, No. 1, pp. 131-156, 279.pdf. Skimming this one is probably sufficient.

Kinney Jr., William. *Letter to Accounting Faculty and Ph.D. Students, Re.: FASB and Market Value Accounting*. January 30, 1991, 280.pdf. Read the first part, but just skim the rest; this is

actually just a class example I will refer to and comment on.

Hakansson, Nils H. *On the Interaction of Accounting, Economics, and Finance and the Economic Consequences of Accounting*. Plenary Address given at the AAA annual meeting, Hawaii August 21-25 1979, 281.pdf. Skimming this one is probably sufficient.

RR8.

Schipper, Katherine. Commentary on Earnings Management. *Accounting Horizons*, December 1989, pp. 91-102, 282.pdf.

Gainey IV, Phillip H. and Paul M. Beland. *The Accounting Cookbook*. SalomonSmithBarney Equity Research: United States Valuation and Accounting, 2002, 1-20, 283.pdf.

RR9.

Outline of the Research Problem, The Ball and Brown Study, Earnings Response Coefficients. Scott, William. *Financial Accounting 5*, CGA Canada, 1994, 284.pdf.

Ball, Ray and Philip Brown. An Empirical Evaluation of Accounting Income Numbers. *Journal of Accounting Research* (1968), Vol. 6, No. 2, pp. 159-178, 285.pdf. Don't freak out. Just read the intro & conclusion, and skim the rest; I'll explain it and tell you what you need to know about this in class.

Lev, Baruch. On the Usefulness of Earnings and Earnings Research: Lessons and Directions from Two Decades of Empirical Research. *Journal of Accounting Research* (1989), Vol. 27 Supplement, pp. 153-192, 286.pdf. Skimming this one is probably sufficient.

Clarkson, Peter and Richard Mattessich. A Review of Market Research in Financial Accounting. *Modern Accounting Research: History, Survey and Guide*. The Canadian Certified General Accountants' Research Foundation, 1992, 287.pdf. Just read to p. 366, and skim the rest.

The Valuation Perspective, The Explanatory Power of Net Income, Efficient Security Market Anomalies. Scott, William. *Financial Accounting 5*, CGA Canada, 1994, 288.pdf.

Beaver, William H. Perspectives on Recent Capital Market Research. *The Accounting Review* 77, 2002, 453-474, 289.pdf. Not too bad, but a bit gnarly. Have a bash at it.

Beating the Market: Yes, It Can Be Done. *The Economist*, December 5, 1992, 290.pdf.

Bernstein, Richard. Reported Earnings: The Ultimate Driver of Stock Performance. *Equity Research and Valuation Techniques*, Association for Investment Management and Research (AIMR), 2002, 49-56, 291.pdf.

Kimelman, John. Can Computers Do a Better Job Rating Stocks? *The New York Times*, August 25, 2002, BU 6, 292.pdf.

Not RR10.

Investment.pdf. This class is not about investing, but if it were, then these articles (mostly from the popular financial press) might be required. You may skip this entirely. However, someday you may have some money to invest. You might wonder whether all our discussions about portfolio theory, efficient markets, and valuation contain some lessons about how to invest for long-term wealth accumulation. These articles build on the financial-economic theoretical foundation we have constructed and iterate a simple, logical conclusion.

RR11.

Implications of Game Theory for Historical Cost Accounting, Implications of Game Theory for Financial Accounting, Reconciliation of Efficient Securities Market Theory with Economic Consequences. Scott, William. *Financial Accounting 5*, CGA Canada, 1994, 293.pdf.

Kreps, David M. Chp. 12: Solution Concepts for Noncooperative Games. *A Course in Microeconomic Theory*, Princeton University Press, 1990, pp. 387-410, 294.pdf.

Brams, Steven and Marek Hessel. Absorbing Outcomes in 2 X 2 Games. *Behavioral Science* 27, 1982, pp. 393-401, 295.pdf. Just skip this one, unless you're really curious and want to know more about this area.

Brams, Steven and Marek Hessel. Staying Power in Sequential Games. *Theory and Decision* 15, 1983, pp. 279-302, 296.pdf. Just skip this one, unless you're really curious and want to know more about this area.

John Mauldin, John. "Why Trade Deficits Matter." Thoughts From the Front Line, Millennium Wave Advisors, 2005, whytradedeficitsmatter.doc. You can skip this one too, if you like. It's only here to illustrate why/how game theory keeps popping up periodically among the cognoscenti. [Hopefully you are among the cognoscenti also. Look it up.]

RR12.

Watts, Ross and Jerold Zimmerman. Towards a Positive Theory of the Determination of Accounting Standards. *The Accounting Review* 53, 1978, pp. 81-102, 297.pdf, 298.pdf. Just read to p. 86 (257). Then you can skip to the conclusion, pp. 96-97 (267-268) in 298.pdf.

Healy, Paul M. and Krishna G. Palepu. "The Effect of Firms' Financial Disclosure Strategies on Stock Prices." *Accounting Horizons* (1993), Vol. 7, No. 1, pp. 1-11, 299.pdf.

Bryant, Murray and Daniel Thornton. Public Choice of Corporate Accounting Standards. *Modern Accounting Research: History, Survey and Guide*. The Canadian Certified General Accountants' Research Foundation, 1992, pp. 151-163, 300.pdf. Just read the last few sections, starting with "Why Are Public Accounting Firms Advocates of Particular Standards?" and going to the end, pp. 159-161 (315-317).

von Hayek, Friedrich. It's a short read; be sure to read the 'Note to the Reader,' Forward, and Summary first.

von Mises, Ludwig. Two Essays by Ludwig von Mises: Liberty and Property and Middle-of-the-Road Policy Leads to Socialism. 1952, 1991, The Ludwig von Mises Institute. Ludwig-von-mises-essays.pdf. Thankfully short and easy to read; read the Foreward, skim the 1st essay, and read the 2nd essay.

RR13.

Barth, Mary. Global Financial Reporting and Capital Markets. *Newsletter* 19, London Business School, Summer 2001, 301.pdf.

Review briefly 259.pdf and 260.pdf (from RR3) on FASB's Conceptual Framework.

Zeff, Stephen. The Evolution of U.S. GAAP, Part 1. *CPA Journal*, 2005, History1.pdf. This article, and part 2 below, are easy to read and even interesting. Go ahead & read 'em. See how GAAP has evolved through lobbying, market failure, poor understanding of economics and market efficiency, and competing regulatory authorities. Things have changed so little!

Zeff, Stephen. The Evolution of U.S. GAAP, Part 2. *CPA Journal*, 2005, History2.pdf.

Financial Reporting Policy Committee, Financial Accounting and Reporting Section of the American Accounting Association. 2007. Response to the SEC Release: Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP. NoIFRSreporting.pdf. Read this, but skim the technical research stuff.