

Solutions Manual

to accompany

Accounting Theory 7e

By

Victoria Wise

**Chapter 1
Introduction**



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Chapter 1 - Accounting Theory

THEORY IN ACTION

Theory in Action 1.1 Theory implementation and politics

- 1. The article describes how a particular theoretical approach has been replaced by another. Explain why one theory replaces another, and who, or what, determines whether an existing theory survives.**

A theory is primarily meant to explain or predict an event, behaviour or outcome. Proponents of a theory look for evidence to support the theory. This evidence should be independently observed and consistent after repeated observations. Some theories are speculative or ideas or guesses floated to encourage researchers to undertake the observations required to prove or disprove the theory. The question often debated is what comes first — the theory or the observation? For example, did Darwin start thinking about different species and the idea of natural selection or did evolution enter his thoughts? Did he detail these thoughts as a testable proposition and then set out to observe? Or did he observe aspects of nature which led him to formulate a theory of evolution? The latter is much more likely and for most theoretical development, observations result in development of propositions which are tested over time.

Where the body of evidence in support of the underlying theory appears to be supported by observations, then the theory is accepted. But not necessarily by everyone. Why not? Some may not be satisfied with the methods adopted to test the propositions; others simply may not believe the theory explains or defines reality and propose alternative theories.

In the specific case of Bernanke's theoretical choices based upon his detailed knowledge of the Great Depression, a similar process would be required and if the weight of evidence supported Bernanke's propositions in explaining economic outcomes, then his theoretical perspective would supplant other theoretical perspectives. In the social sciences it is even more complicated than the physical sciences. The interpretations of outcomes and behaviours are subject to individual research interpretations and the full range of factors impacting on the economy, for example, are much more difficult to control or isolate.

- 2. Does the reintroduction of a theory mean that it should not have been replaced in the first place?**

Theories about how the economy works and what will happen in the economy where there is monetary policy or fiscal policy intervention are appropriate in assisting policy-makers understand the possible implications of decisions they make or are under consideration. However, they are rarely complete models and often outcomes cannot be predicted. Reintroduction of a theory suggests that new evidence in support of the theory has been reported.

3. Should a theory be discarded if it does not specify the means of achieving a stated objective? Explain your answer.

The theory itself doesn't have to specify the means of achieving a stated objective; however, it has to provide a sound basis for explaining, defining and predicting behaviour. The application of the theory can have many elements and it is in the interpretation of what will induce the predicted effects in the economy predicted by the theory which will result in predicted or other stated outcomes.

Instructors should ask the students to discuss how we would know whether a reduction of corporate interest rates resulted in an increase in the inflation rate?

Theory in Action 1.2 Out of Control

1. **'Rogue' is defined in the Oxford dictionary as 'that which lacks appropriate control; something which is irresponsible or undisciplined'. Given this definition, who is ultimately responsible for the rogue trading outlined in the Societe Generale scandal: the trader directly involved; management, who are responsible for the high-risk, high-reward framework in which the trader operated; or a combination of both?**

Obviously all parties are responsible for their actions. The weak risk-management controls in place at Societe Generale allowed behaviour which ultimately could not be controlled by the employer. Why? Because Societe Generale created an environment where traders could become 'rogues'. It is important to appreciate that the emergence of 'rogue' behaviour can be a function of environment and in particular the embedded controls designed to detect and inhibit such behaviour. In addition, if management was pushing for outcomes, in a way the 'rogue' was seeking to meet management's performance expectations. Actions, demands, and also incentives, create and/or reinforce behaviour. The impact of financial performance benchmarks should not be underestimated. Students should discuss how controls, monitoring, and incentives can discourage/create behaviours and what types of factors are more likely to stimulate 'rogue' behaviour.

2. **Discuss the role played in the SocGen case by each of the three elements: personality, institutional framework, opportunity.**

- (1) Personality — in a competitive environment people will either compete or leave. In the competition itself behaviours will have to change and adapt, risk preferences will shift and consideration of the downside possibilities discounted. Research shows that a group environment often results in different behaviour to individual or isolated thinking.
- (2) Institutional framework — SocGen was not controlling its risk associated with trading and this allowed the individual involved to operate outside the accepted parameters. Also, the individual's knowledge of back-room trading operations and processes meant that significant 'positions' and losses could be hidden and offset against the upside, this gave the institution the result required and basically shifted the trader into rogue trades (possibly to 'make budget').
- (3) Opportunity — this relates to the first two points. The opportunity was created by the position and background experience and knowledge the trader held and the environment encouraging an unregulated approach.

The three elements are inter-related. Students should discuss which factor was the most critical in creating the behaviours documented, and the alternative view that the elements are equally important.

3. How could Societe Generale have been unaware of the activity of its trader and of the environment that it had created for the trader to operate within?

The types of environments that might create such rogue behaviour may be predictable. Students should consider what the role of theory is; is it to predict and explain behaviour? Then a good theory of rogue behaviour should do just that. However, most theories in accounting are usually better at explaining the elements of behaviour after they have occurred, rather than predict them. The problem is access to observable data. Positive theories are based on predicting behaviour based on past observations. Would this approach work in the case of behaviour which the traders did not want observed?

4. Do you think that the actions of 'rogue' traders are predictable under particular theories (such as agency theory)? Explain your answer.

Knowledge of appropriate behavioural theories will not stop behaviour of the type outlined. However, knowledge does empower management: the embedding of appropriate bonding and monitoring mechanisms and other relevant incentives and disincentives are predicted (under agency theory) to have a particular influence on an individual's behaviour. Such a theoretical approach to risk-management could be used to identify the environmental factors that could lead to rogue behaviour. But we will not know whether applying the elements of the theories to register the existence of such environments and then action is taken to change the environment, actually changes/ed behaviour. Why? Because the rogue behaviour may exist undetected; or may never occur. This is a concern with positive research, particularly in the behavioural area, we just never have a complete set of observations.