Theory of Accounting and Control:
Exercises and Problems*

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Chapter 1: Contract Theory of the Firm

1. In what sense is a lunch date with a friend a "contract?" Explain by analyzing the sacrifices of and gains to each participant, and the consequences of not fulfilling the contract for each.
2. Explain the difference between control *of* and control *in* an organization.
3. What is the difference between the following two statements: (1) each member of my church group knows that rain is forecast for Labor Day afternoon; and (2) a forecast of rain for the Labor Day afternoon is *common knowledge* among the members of my group? What is the effect of this difference on the number of people who will turn up for the church picnic?
4. List three metaphors used to understand organizations. How do they differ from the contract view of organizations?
5. "People are rational in the sense that they do not deliberately choose actions with outcomes that are less desirable to them." Write your own definition of rationality and compare it to the idea expressed in this sentence.
6. List the five important functions of accounting that help maintain control in organizations. Give an example of each. List any additional functions that you consider important.
7. Pick an organization you are familiar with. List three important classes of participants in this organization. Identify the resources each contributes to and receives from the organization.
8. If all participants in an organization contribute as well as receive resources, why don't they all have similar relationships to accounting? Explain.
9. What is the role of income in a business corporation?
10. What is special about shareholders? How does their participation in the firm differ from the participation of employees or customers?
11. What is the difference between conventions and economic features of accounting? Give an example of each.
12. How would you determine whether a proposed accounting standard is desirable for society?

13. How are accounting standards set in your country? What attempts are made to ensure that these standards do more good than harm? How successful are these attempts? Can you suggest any improvements in the current process?
14. What roles do governments play in accounting?
15. How is government, as an organization, different from a business firm? How do the accounting and control systems differ for government and business organizations? Why

Chapter 2: Accounting and Contract Model of the Firm

1. What do you understand by separation of ownership and control? What are the differences between the problem faced by an owner who runs his or her own business, and an owner who hires a manager to run the business?
2. "For the purpose of understanding accounting, each firm can be seen as a set of contracts among rational agents." Analyze and critique this statement.
3. Take a business firm, identify three types of participants, their resource contributions and inducements, and state the conditions under which each agent will and will not participate in the firm.
4. Prepare a list of organizations in which you participate. For each participation, identify what you contribute to the organization, what you get from the organization, and the reason why you continue to participate in it.
5. "A promise must be in writing in order to be enforceable as a contract." Comment.
6. How would you answer the question: "What is the objective of a business firm?" Is this question consistent with the view of the firm as a set of contracts among individuals who pursue their personal objectives?
7. Consider the organization and the participants you listed in Question 3. For each agent, identify the part of the accounting and control system of the organization that measures his or her resource contributions to the organization. Can you think of ways of improving these measurement processes?
8. Consider the organization and the participants you listed in Questions 3 and 7. For each agent, identify the part of the accounting and control system of the organization that measures the resources he or she receives from the organization. Can you think of ways of improving these measurement processes?
9. Consider the organization and the participants you listed in Questions 3, 7 and 8. For each agent, identify the part of the accounting and control system of the organization that determines the degree to which each agent has fulfilled his or her contract. Which participant(s) in the organization receive this information about contract fulfillment?
10. What are the consequences for others when a participant in the organization decides to quit his or her contractual slot in the organization? What do organizations do to protect themselves in such events?
11. What is "common knowledge?" Explain any relevance it may have for accounting.
12. What are the consequences of a bargaining deadlock among participants of an organization? What is the role of accounting in reducing the chances of such deadlocks?

13. What is the form of accounting that serves the control function in a small grocery store run by a family?
14. What is the form of accounting that serves the control function in a large multinational corporation? How does this accounting and control system differ from the system used by the small grocery store?
15. "Expecting a single accounting and control system to serve the needs of all kinds of organizations is no more reasonable than to expect a single plumbing system or electrical wiring to serve the needs of all kinds of buildings." Comment.

Chapter 3: Contracting for Managerial Skills

1. What is special about managers as a contracting agent in an organization?
2. What special features are induced into managerial contracts by the inability of organizations to enforce employment contracts on the employees (employees can always resign from a job)?
3. What is managerial human capital? Does it increase or decrease when managers work? What are the consequences of this change in how contracts of managers are designed?
4. "My knowledge is my greatest asset." However, unlike other assets, it is difficult to sell the knowledge asset in one lump sum and convert it into cash. What are the consequences of this feature for how managers behave?
5. In order to induce managers to work hard, their salary, bonus, stock options, savings, and continuation of employment are often tied to various measures of financial performance (e.g., income, rate of return or stock price) of the firm. What is the effect of this lack of diversification on congruence between the goals of managers and shareholders?
6. Get a proxy statement of a publicly-held corporation and examine the compensation contract of its chief executive officer. What are the variables that determine CEO's compensation? Who measures these variables and how? Identify each variable as an input (from the manager) or output variable. How many input variables do you see? Why?
7. "Managers stand at the procedural but not the economic hub of the organization." Explain this statement with examples. Do you agree?
8. Competing organizations may share customers, vendors, even employees but they rarely share senior managers. Why?
9. Design three different managerial contracts that link compensation to performance. Predict and compare the behavior of the manager under each of the three contracts and a fourth—flat salary—contract.

10. Can you specify the circumstances under which a firm may want to use each of the four contracts specified in response to Question 9 above?
11. Specify three different measures of managerial performance. What would be the consequences of rewarding the manager on the basis of each measure?
12. Why is it that the conditions under which senior managers lose their jobs are often left to the discretion of their superiors? Why are they not specified in their contract?
13. "Budget is the manager's contract." Comment.
14. As a manager, what are the positive or negative attributes of your job that you care about? How do organizations use each attribute to design jobs?
15. Under what conditions does it make sense to make managerial compensation dependent on variables beyond the control of a manager?
16. Making managerial compensation contingent on performance motivates them to deliver good performance. However, it also burdens them with greater risks that they may not like. How do organizations balance these two considerations in choosing managerial compensation functions?
17. How would you distinguish those aspects of managerial compensation that are induced by tax laws from those designed as incentives for managers?
18. When does it make economic sense for two sections or divisions of a firm to be part of one firm (as opposed to being independent firms in their own right)? Analyze the organizational costs and benefits of integration.
19. What is the role of transfer prices in divisionalized organizations? Why should we not always use market prices as transfer prices?
20. "Evaluation of middle managers in an organization is most difficult." Explain why or why not.
21. Compare the advantages and disadvantages of using single versus multi-criterion measures for evaluation of managers.
22. What are the advantages and disadvantages of defining a manager’s job so it includes diverse tasks (as opposed to uniform tasks)?

Chapter 4: Managers and Accounting Decisions

1. List four major classes of managerial decisions that influence the accounting and control system of the firm.
2. "The choice of the form of organization of a firm is also its most important choice with respect to the accounting rules." Explain.

3. "I thought accounting has precise rules, and matches numbers to the last penny. Now you tell me managers have a great deal of discretion in preparing accounts. I don't understand." Explain.
4. Why don't the accountants write clear, unambiguous rules to eliminate all managerial discretion?
5. What are the factors a manager of a firm would consider in making various expensing-capitalization choices?
6. What factors constrain managers' tendency to make expensing-capitalization decisions to serve their own interests?
7. How would you mitigate the advantage managers may gain from using opportunities to make accounting estimates in their own interests?
8. Why do accounting rules permit managers to choose from a set of accounting principles, instead of eliminating all choice by specifying a single rule to be used by all?
9. What are the constraints on managers who may wish to switch back and forth among alternative accounting principles to manipulate financial performance reports?
10. What are the advantages and disadvantages of allowing managers to decide what to disclose and when? Answer this question from the point of view of (1) managers and (2) shareholders.
11. "The more leeway managers have to choose what they disclose, the more they reveal about themselves through the disclosure choices they make." Comment.
12. What are the consequences of requiring all public firms to disclose specified proprietary information? Address this question from the point of view of (1) managers, (2) shareholders, and (3) government regulators.
13. U.S. Foreign Corrupt Practices Act of 1977 requires all public firms to maintain an adequate level of internal control systems. Assess the effect of such legislation on internal control systems of the firms, and on the interests of various contracting parties in the firms.
14. Corporate managers almost always oppose new proposals for accounting standards. Why? Whose interests do they serve in doing so?
15. Given your answer to Question 14, do you think it would be better for shareholders to exclude managers from participating in the process by which accounting standards are set? Why?
16. Accounting systems often seem to have a degree of “redundancy” built into them. What might be rational reasons for such “redundancy”? If these are rational reasons, are they really redundant?
17. "Organizational design is a tug-of-war between costs and benefits of decentralization." Explain with examples.

18. Why would a company want to charge a share of the sunk cost of facilities to its divisions who share the use of the facility?
19. There have been many experiments with a participative style of management. Some succeed, others don't. How would you choose the degree and form of participation of your subordinates in the unit you manage?
20. "The end point of the action-reaction sequence between the managers and their subordinates is difficult to predict." Why? What are its implications for how you set standards of performance and rules for investigation of performance?
21. Prepare a list of reasons why, as a rational manager, you might be reluctant to adopt LIFO method of inventory valuation, even if it holds prospects of saving taxes for the firm?
22. The Financial Accounting Standards Board in the U.S. has published detailed rules for lease accounting, often justified by the possibility that investors and lenders might be misled if obligations under long term leases do not appear on lessee balance sheets as liabilities. On the other hand, leasing subsidiaries of banks tutor their clients in new methods of bypassing FASB regulations. How would you explain the banks' role on both sides of lease accounting?
23. How would you explain the role of U.S. banks in opposing the FASB's proposal to require them to recognize losses when their troubled loans are restructured?
24. Why do managers oppose recognizing the economic value of stock options granted to employees as expense? Whose interests do they serve in the process?
25. Is it possible that all participants in a group are rational, but not everybody believes that everyone else is rational? Can you cite examples of such phenomenon? What are the consequences of such phenomenon for accounting?
26. List a set of instruments managers might use to manage income of the firm.
27. What do firms reveal about themselves through their choice of accounting methods they use?
28. Stock options are often promoted as a link between long run managerial performance and compensation. However, in the nineties the U.S. practice, when the market price of shares of the firm drops sharply, the strike price of the stock options held by managers is often adjusted downward retrospectively. Analyze the consequences of this practice for the effectiveness of stock options in achieving the goal for which they are promoted in the first place.

Chapter 5: Income and Its Management

1. What do you understand by the term income?
2. What challenges might one face in trying to measure income by Hicks' definition given in the text (p. 65)?
3. How does the Hicksian definition compare with the income measured by the financial accounting standards used in your country (e.g., Financial Accounting Standards Board in the U.S.) Point out any differences and similarities.
4. All participants in an organization seek "income" for themselves through participation. Yet, unless otherwise specified, it is customary to use the term income to refer to the share of resources to which the shareholders of the organization are entitled. What is so special about "income" to the shareholders?
5. How many "degrees of freedom" do you have when you divide a pie into n slices? Explain. Why is it necessary for at least one party to be a residual claimant in the business firm?
6. "It is not possible to define the share of resources of all parties in a firm independently by their respective contracts. At least one of the parties should be the residual claimant, in the sense that it must accept whatever is left after all others have claimed their shares." Comment on this quotation. If you agree, who is the residual claimant in a business organization? Who is the residual claimant in a charitable organization?
7. Income of all participants in a firm, except the shareholders, is transferred to the participants according to a contracted schedule. However, transfer of income to shareholders is subject to discretion of the board of directors of the firm. Why?
8. What obstacles lie in the way of precisely measuring the income to the shareholders over a given period of time?
9. What is the Law of Conservation of Income. Illustrate through a simple numerical example.
10. What is the Law of Conservation of Discounted Residual Income?
11. What is the role of income (to the shareholders) in functioning of a firm?
12. What information does the income (to the shareholders) convey to participants other than the shareholders of the firm?
13. What is the role of income (to the shareholders) in renegotiation of contracts with other participants in the firm?
14. When the income or residual claim of the shareholders takes the form of real (not monetary) assets, what problems arise in accurate translation of this claim into units of money?

15. Why would managers want to manipulate income they report to the shareholders? What can, and should, the shareholders do to prevent such manipulation?

16. Is manipulation of income by managers necessarily against the interests of shareholders? Give examples to support your answer.

17. In the Fall of 1998, Mr. Arthur Levitt, Chairman of the U.S. Securities & Exchange Commission said:

    Earnings management has evolved over the years into what can best be characterized as a game among market participants. Too many corporate managers, auditors, and analysts are participating in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. … Managing may be giving way to manipulation; integrity may be losing out to illusion. … I want to talk about why integrity in financial reporting is under stress and explore five of the more common accounting gimmicks we've been seeing. I will outline a framework for a financial community response to this situation. … This necessary response involves improving both our accounting and disclosure rules, as well as the oversight and function of outside auditors and board audit committees. I am also calling upon a broad spectrum of capital market participants, from corporate management to Wall Street analysts to investors, to stand together and re-energize the touchstone of our financial reporting system: transparency and comparability. (Excerpted from Arthur Levitt, "The Numbers Game," remarks delivered at New York University Center for Law and Business, September 28, 1998).

    Comment on Mr. Levitt's identification of the problem and proposed solution.

18. What factors determine the price of the shares of stock of a company in the market place? How do managers' actions affect these prices? Which of these actions would you label as manipulation?

19. Suppose you manage a publicly-held firm, and you are confronted with an extraordinarily and unexpectedly bad year in which you have incurred a large loss. However, you honestly believe that the firm has a bright future due to very good products and technology you have in the pipeline. You are afraid that if you report poor results for the current year to the shareholders, you may lose your job, or be forced to dump these promising new products you are nurturing in the pipeline. What is your best course of action?

20. Suppose you hold shares in a firm. The firm has reported expectedly poor results for the recently completed year, but the president's letter assures the shareholders that the firm has a bright future because it has very promising new products about to be introduced to the market place. What does this information do to your assessment of the value of the shares you hold? What, if any, action would you take?

21. What is the role of income in evaluating and rewarding the performance of managers at various levels of corporate hierarchy?

22. What are managerial motives for smoothing income and taking a "big-bath?"
23. If you are given a historical series of income reported by a company, how would you determine whether the managers of the company have smoothed out the income series before reporting it to the public?
24. What instruments for managing income are available to the corporate managers? Which of these instruments are accounting instruments? What are the advantages and disadvantages of using each instrument from the managers' point of view?
25. Why is it so difficult to determine from the published data whether managers smooth out earnings before reporting it to the public?

Chapter 6: Investors and Accounting

1. What are the special features of shareholders as a class of contracting agents in business firms?
2. Some people think that it is not fair to the shareowners not to be able to have a say in the day-to-day operations of the firms they own. Is being relieved from such involvement in the firm a denial of their rights, or relief from the unwanted burden of responsibility? Explain your answer.
3. Should the return on investment in shares of publicly held companies that are run by those who own a substantial proportion of the equity be higher than the return on shares of firms run by hired managers with no ownership interest? Explain the reasons for your answer.
4. Contractual rights to shareownership in firms are tradable, and the markets in which such trades take place are fairly liquid, while other contractual rights in the firm are either not traded, or traded in markets with high frictional costs. Explain why.
5. It is said that capital markets help resolve professional managers’ problem of deciding how to operate the firm whose multiple owners have diverse preferences. Do you agree? Why and to what extent?
6. What is the primary rationale for laws that make it illegal to engage in insider trading? What is the link between this rationale and the efficient market theory?
7. What are the sources of demand for the services of the information intermediaries in capital markets? Would it not be better and easier for each investor to become a producer or analyst of information?
8. How are professional portfolio managers evaluated? How are the evaluation functions of portfolio and firm managers, and their behavior, linked to one another?

9. When corporate managers blame the "short-term oriented' portfolio managers for their own short-run orientation in corporate decision making, do you agree with them? Why or why not?
10. Given a choice between two kinds of financial reporting standards—simplified, highly aggregated statements versus detailed disclosures—which would the professional analysts who sell information favor. Explain why.
11. Why do professional portfolio managers in mutual funds remain passive with respect to financial standards setting process? Analyze their interests with respect to "better' financial reporting standards.
12. Explain any differences between the interests of equity holders and debt holders of the firm in financial reporting.
13. Explain why most debt covenants rely on Generally Accepted Accounting Principles to define various conditions, knowing full well that a change in accounting methods or standards may shift the threshold of behavior to which the borrower is intended to be constrained. Why don't they make covenants contingent on GAAP or accounting methods used at the time the covenant is signed?
14. Explain why shareholders are interested in making sure that all other contracting parties in the firm fulfil their contract. How does accounting assist in fulfilling this demand?
15. What is the role of accounting in solving the problem of lack of observability of the input of top managers in the firm?
16. Does aggregation of data necessarily result in loss of information? Can you give a few examples where aggregation may also add information.
17. List the various ways in which shareholders can influence the accounting and control system of the firm even without taking on managerial responsibilities in the firm.
18. What are the accounting consequences of choosing the form in which the promoters organize a firm?
19. Voting and proxy rights are the direct and most visible form of shareholder rights in the firm. Yet, this right is rarely exercised to choose accounting methods. Explain why.
20. To what extent is it possible for the shareholders to indicate their prefrences among alternative financial reporting practices through their actions in the stock market? Explain your answer.
21. What is the role of the social and political institutions in choosing financial reporting practices of business firms? What contributions, if any, do the shareholders make to this process?
22. While the current shareholders pay for the cost of producing financial reports, the information is shared by the general public. This would seem to be an unfair transfer of wealth from shareholders to others. Do you agree? Explain.

23. Explain whether and how financial reports are public goods.
24. In what sense can public accounting reports and advertising be regarded as parallel activities?
25. In efficient capital markets, any information in the hands of anyone is quickly supposed to become incorporated in the prices, and thus shared with everyone else. Under these conditions, why would anyone want to spend precious time and effort on digging up information? Explain the economic rationale for the existence of the financial analysis and information industry in which real resources are expanded on production of information.

Chapter 7: Accounting and the Stock Market

1. Why is the information part of the firms' contracts asymmetric with respect to shareholders (they get summary information about contract performance by other agents but most other agents do not get periodic information about what shareholders do)?
2. What is the role of accounting valuation rules (that convert real assets into units of money) in defining the contractual property rights of shareholders in an organization?
3. Explain the three levels of markets in which shares of stock of business firms are transacted. Identify the transacting parties at each level, and any role that the accounting system of the firm, whose securities are traded, may play in the transaction.
4. How do the individual shareholders, who may buy securities from investment bankers in the secondary market, protect themselves from misrepresentations about the prospects of the firm by the investment bankers.
5. When an IPO (initial public offering) goes sour (stock price drops sharply after the security is sold to the public in the secondary market by investment bankers), how can the shareholder tell if the investment bankers misled the buyers, or the price dropped due to events beyond their knowledge or control?
6. Smaller audit firms often claim that the larger firms steal their best and most successful clients when small firms decide to go public. Can you give an economic explanation for this phenomenon?
7. Is it possible to make money in the stock market using accounting numbers? Refer to any theory or data that may be relevant to your answer.
8. Is it possible for all relevant publicly available information to be analyzed and used for trading purposes in the stock markets? Why?
9. What are the determinants of how much resources (mostly the time of analysts, and purchased access to databases) an individual, brokerage, investment

banking or mutual fund stock analyst may devote to a given security? What are the consequences of your answers for the speed of adjustment of stock prices to new information?

10. One often learns about research reports that some publicly available accounting information can be used to generate high returns in the stock market. Some people may discount such reports (why don't they use what they have learned to make money instead of publishing a paper about it?) while others may rush to start investing on the basis of such results. What is your own attitude when you read about such reports. Explain with reasons.
11. The paradox of information in stock markets is: If the market is efficient, digging up information about firms is not worth the effort; if everybody reaches this conclusion and stops digging, there will be no information in the market, and digging for information will become a remunerative use of one's time. How is this paradox resolved in the real world of frictions and imperfections?
12. Is it possible to make money from advance access to accounting information? Explain your answer.
13. Empirical studies of the value of advance access to accounting data are carried out using hypothetical portfolios formed on the assumption that some information was available on the date for portfolio formation, even though the information itself may not have existed at that date. Evaluate the validity of such studies for the purpose of assessing the value of advance access to accounting information.
14. Value of shares of the firm is said to depend on the investor expectations of future cash flows the firm may generate. What is the role of accounting and accounting methods in creation of these expectations?
15. Explain the mechanisms firms use to preserve the real resources of the firm. What is the role of accounting in this process?
16. Explain how accounting methods chosen by the firm may influence motivations of managers in making their operating decisions.
17. If a change in an accounting method causes the stock price of the firm to change, does it necessarily mean that the markets are fooled by accounting changes. Explain.
18. "Allowing managers to choose from a set of alternative accounting methods enables shareholders to learn more, not less, about the firm." Do you agree? Explain your answer.
19. Explain the difference between the effect of changes in accounting methods on the private information of the individual decision makers, and on the common knowledge available in the system.
20. How do the existence and operation of stock markets influence accounting?
21. What are the key differences between accounting of firms which are, and are not, traded on the stock exchanges? Aside from simple imposition of stock

exchange regulations against the will of the firm's managers, can you give any economic rationale for any differences you find?

22. The "Small GAAP, Large GAAP" debate in the U.S. has been centered around the idea that the optimum accounting standards for firms of various sizes can be different. Analyze and explain the relevant issues.
23. How would the absence of financial reports about the firms whose shares are traded in the stock market affect the stock market?
24. "Most studies of specific accounting changes, and stock returns reveal little reliable correlation between them. It seems fair to conclude that in an efficient market, the choice of specific methods of accounting is not particularly important for determination of stock prices." Analyze the validity of the inference.
25. Explain the relationship between the sample size in an event study and the size of stock return that may have a reasonable chance of being detected in such a study.
26. Explain the nature of the expectation problem in using the stock market event studies to guide financial accounting standard setting.
27. How does the self-selection of samples influence the studies that use data from the field to examine accounting, business and other social phenomena?

Chapter 8: Auditing and the Firm

1. What is the role of auditors in the contract set of a publicly held business organization?
2. Which of the following two views of auditors are you more comfortable with, and why? (a) Auditors do their professional duty to report the facts as best as possible within the constraints of time and resources available to them. (b) Auditors are like all other participating agents in the firm, seeking to advance their own interests through their actions in the firm. Don't expect them to always tell the full story unless it is in their own interests to do so.
3. What are the difficulties associated with using the accounting system of the firm (that the auditors are hired to scrutinize) to determine the compensation of the auditors?
4. In the U.S. practice at the end of the nineties, auditors' responsibilities with respect to the accuracy of financial statements and adequacy of disclosure are defined by the law. Suppose, instead, individual firms were allowed to negotiate with their respective auditors to the extent of the auditors' responsibility and to pay them accordingly. Analyze the consequences of such an alternative regime.

5. What, if any, are the differences between the structure (contract set) of an audit firm, and commercial or industrial firms they may audit?
6. Publicly held firms in the U.S. are required, by the securities laws, to publish audited financial statements. Is the cost of these audits justified by any benefits? Do these laws enrich or impoverish the society?
7. "Agency costs are the cost of organizing." Comment.
8. Did auditing exist before laws required auditing for certain types of firms? Will auditing survive if these laws were scrapped? If so, how will it change?
9. Why is it so difficult to reduce or eliminate agency costs in organizations?
10. What are the hurdles that must be overcome to make hiring of an auditor an advantageous proposition for shareholders and managers? In light of your answer, review the kinds of organizations that do and do not hire auditors.
11. How do shareholders protect themselves against collusion between managers and auditors?
12. Prepare a list of the important classes of decisions auditors make, and organize them in a short run to long run hierarchy.
13. Formulate the auditor's decision making problems in planning a given audit assignment, and identify the objective(s), constraints and decision variables for the auditor.
14. Identify the contribution of statistical sampling to improvement in the quality of audit decisions.
15. How do auditors handle the problem of assessing probabilities subjectively, and the well known inability of most individuals to be correct in intuitive use of such data in their decisions?
16. Formulate the auditor's decision problem in deciding what positions should be taken during negotiations with the client, and what opinion should be rendered to a given client. List various costs and benefits the auditors must balance in making these decisions.
17. Identify the important characteristics of the service market in which auditors bid for engagements of new potential clients. Comment on your assessment of how competitive this market is with supporting evidence.
18. After considering your assessment of competitive conditions in the market for audit services, formulate the auditors' decision in preparing the bid for a new engagement.
19. What is the role, if any, of services other than the audit, in bidding for new audit engagements? Explain, considering the relevant available evidence.
20. What are auditors' incentives to invest in development of specialized services for their clients?

21. At the time of a new engagement, both auditors and clients incur additional costs. Can you tell whether the existence of such costs will result in "low-balling" or "high-balling" of initial quotations of audit fees? Explain.
22. Do auditors have incentives to invest in their long term reputation for high quality work? If so, what are the internal control problems of an audit firm to induce its members to help build such reputation through periodic evaluation of their individual performance?
23. Do client firms have incentives to invest in their long term reputation to be perceived as a low audit risk? What are the internal control problems of a client firm in inducing its managers to engage in such reputation building while evaluating their periodic performance?
24. Examine an audit firm itself as a set of contracts, and analyze how it solves the problem of defining, implementing and enforcing the set of contracts for its employees and partners.
25. Reputation of audit firms has an industry-wide component. Explain how the audit industry addresses the consequences of this externality for incentives of the individual firms in the industry.
26. It has sometimes been argued that the auditing of business firms is better handled by those who are not motivated by profit for themselves, say auditors hired by government. What would be the consequences of entrusting such audits for development of audit technology and efficiency of resource use in the audit function?
27. What are the consequences of having audit standards (Generally Accepted Auditing Standards in U.S.), as opposed to allowing each firm or auditor to use its own best judgment?
28. In contrast to accounting standards, auditing standards are developed within the auditing profession, with little involvement of nonauditors. Why?
29. Does the legal requirement of an independent audit of publicly held firms mean that the demand for audits is inelastic to price? Are there any significant substitutes for outside audit in such an environment?
30. What are the costs and benefits of standardization of audit practice for audit firms?
31. What is the auditors' role in setting of financial reporting standards?
32. "The existence of the Financial Accounting Standards Board (the financial accounting standard setting body in the U.S.) has helped weaken the role of accounting judgment, and induced auditors to run to the Board to request increasingly case-specific accounting rules to avoid having to argue with their clients" Comment, and support your remarks with evidence.
33. During the second half of the century, the responsibility of setting accounting standards has gradually slipped out of the hands of the professional auditors to a broader class of decision makers. Explain why, and its consequences.

34. What would be the effect of increasing or decreasing the extent of the auditors' responsibility for fraud on the welfare of auditors?
35. How competitive are the conditions in the market for audit services? Explain why.
36. What is the evidence on whether the regulation of entry into the audit professions has served as an effective barrier to entry to the CPA labor market?
37. What is the economic role of the peer review system in the audit industry?
38. What is the economic role of the CPA's Code of Ethics?
39. What do we know about the profitability of various services accounting firms provide to their clients? What are the difficulties in assessing the profitability of various lines of business for them? What are the internal consequences of the measurement problems?
40. "There is a trade-off between competition and independence in the audit industry. Larger audit firms are less dependent on a given audit client and therefore can better withstand client pressures. As audit firms get larger, for a given economy, their numbers must shrink through consolidation." Comment, and explain with evidence if you agree.

Chapter 9: Conventions and Classification

1. What are the necessary conditions for a pattern of behavior to be called a convention. Provide three examples of conventions and show that each fulfills the given conditions.
2. What are the essential features of an accounting convention? How would you distinguish an accounting convention from an economic feature of accounting?
3. "Other things being the same, society has a bias toward maintaining its conventions, instead of changing them." Comment.
4. How does the attitude of standard setters toward conventions differ from their attitude toward economic features of accounting? Why?
5. Give three examples each of accounting conventions and economic features with an explanation why you characterize them so.
6. Conservatism is often labeled as an accounting convention. Provide your analysis of the nature of conservatism, and why it should or should not be considered an accounting convention.
7. What is an accounting entity? What are the determinants of defining an entity in a given accounting context?

8. What are the economic consequences of the going concern assumption in preparing financial statements of a firm?
9. What are the determinants of the periodicity of public financial reports? In what sense can we or can we not refer to the annual period of reports as an accounting convention?
10. What are the reasons for aggregating a firm's resources into a homogenous unit of measurement through valuation? Can you think of organization contexts in which valuation is not necessary?
11. " Accrual is anticipation of cash. Cash-basis accounting is refusal to anticipate cash." Do you agree? Under what conditions do you think accrual may help implement and enforce contracts? Under what conditions would it not?
12. Explain and differentiate between the causal and classificational interpretations of double entry.
13. "In any set of contracts, definition of what resources belong to the firm at any given time is inherently ambiguous and indeterminate. This is the primary attraction of cash basis accounting because it cuts off all anticipation." Comment.
14. In classifying objects with two or more attributes into a number of categories less than the number of objects, what are the possible definitions of a good classification scheme?
15. Explain what the uniformity principle in accounting is. Give two examples of accounting standards that help make financial reports more uniform. Be careful to define what you mean by uniformity.

Chapter 10: Decision Criteria and Mechanisms

1. Distinguish individual from collective decision making in accounting, using an example of each.
2. Explain what is technological efficiency criterion?
3. What is the difference between simple economic and technological efficiency?
4. What is Pareto efficiency criterion? Explain using an example of conditions under which it is more appropriate criterion than simple economic efficiency.
5. When the resource flows associated with a decision are spread over many periods, how do we use the technological, simple economic and Pareto criteria?
6. What is social cost-benefit analysis? What is the appropriate discount rate to use in multi-period social cost-benefit analysis problems?

7. How is the technological efficiency criterion implemented in presence of uncertainty?
8. What is expected utility criterion?
9. What is the difference between expected value and actual after-the-fact consequences of a decision as a criterion for choice under uncertain environments? Which criterion would you prefer and why?
10. "Pareto criterion for social choice does not yield a complete ranking of options." Explain and comment on this statement.
11. What are the advantages of using social cost-benefit instead of Pareto criterion for making social choices?
12. Explain the complications that arise in social cost-benefit analysis due to partial equilibrium assumption and non-linear utilities.
13. Consider an organization you are familiar with, and identify five distinct types of contracting agents in the organization. Identify the efficiency criterion used by each party to decide if its participation in the organization has been a success.
14. "It is easier to implement social choice mechanisms than social choice criteria." Do you agree? Explain.
15. What are the key differences between price and voting mechanisms? What, if any, are the overlaps between the two kinds of mechanisms?
16. What is Arrow's Paradox? Explain using an example.
17. " Outcomes of all voting mechanisms are subject to manipulation through rules and agenda." Do you agree? Explain your answer.
18. Is it possible for a society to choose its standards through a market or price mechanism? If so, explain how such a mechanism would function.
19. "In the extreme case when there are no transaction costs, assignment of property rights has no effect on allocation of resources among alternative uses. Therefore, standards could be defended, and understood, only in the context of transaction costs." Explain.

Chapter 11: Standardization of Accounting

1. What role do standards play in society? Explain using three examples unrelated to accounting.
2. What is the difference between the constraints and reward/punishment perspectives on accounting standards?
3. Which of these two views of accounting standards—constraints versus reward/punishment—is consistent with economic perspective? Which one is more consistent with your own personal perspective?
4. What is the difference between voluntary and mandatory behavior? What is its relevance to economic analysis of accounting?
5. What are the benefits of creating standards in society?
6. What are the costs of imposing standards in society?
7. How can we determine the distributive effects of implementing a new set of standards in a society?
8. Identify the costs of adjustment to new and changing standards.
9. " Accounting and auditing standards are a means of limiting competition in the accounting industry." Analyze the validity of this statement.
10. "Financial reports are valuable public goods, and financial reporting and auditing standards are essential for generating this social value." Analyze and explain if you agree. Why or why not?
11. Identify and explain four types of accounting standards.
12. What is the market argument against accounting standards?
13. What is the market failure argument for accounting standards?
14. What are your own conclusions about accounting standards after considering the market and market failure arguments in a world of transaction costs?
15. Prepare a list of, and explain, the variety of social institutions used to create and implement accounting standards.
16. "The reason standard X failed was because it had no teeth behind it." The statement seems to imply that effective standards require substantial punishments for those who violate the standards. What do you think?
17. Have standards making institutions in accounting been captured by those whose behavior they are supposed to regulate?
18. What is the effect of accounting standards on accounting education?

Chapter 12: Government, Law and Accounting

1. What are the various roles of government in accounting. Explain each role.
2. What does Coase mean when he refers to government as a "super firm?"
3. Give three examples of government playing the role of a contracting party in ordinary organizations.
4. What is special about the government's role as a tax collector? How does this role differ from the roles of other contracting agents?
5. What are the special features of tax accounting, as compared to financial reporting, in business firms. Can you explain these differences in terms of the role of accounting in implementing contracts?
6. How do accounting for tax and financial reporting interact with each other? Explain using some examples.
7. Compare the kinds of accounts necessary for the government to gather income and property taxes, and explain any differences between them.
8. What are the special features of accounting that is sometimes necessary when the government is a monopsony buyer of the products of competitive or monopoly manufacturers of private goods?
9. Why do most people want to be citizens of a country or members of a society that subjects them to various constraints on their behavior?
10. What is the economic distinction between voluntary and mandatory behavior? Explain your answer.
11. Explain the economic difference between voluntary and mandatory accounting standards.
12. Explain the economic difference between public and private sector accounting standards.
13. Why does the government provide limited liability laws for business organizations? What are the likely consequences of scrapping such laws?
14. What is the role of the government (e.g., the Securities and Exchange Commission in the U.S.) in the initial sale of and subsequent trading in, corporate securities? What are the likely consequences of withdrawal of government from such a role?
15. What is the role of government in certification and licensing of professional auditors? What are the economic consequences of this role?

Chapter 13: Accounting for Public Good Organizations

1. What is the difference between a private and a public good? Give three examples of each and explain why they fit the classification you have given them.
2. Consider two organizations whose ownership shares are traded in stock markets, and two organizations whose shares are not traded. Examine and compare the economic characteristics of the products of these organizations.
3. Why do some organizations have shareowners who supply capital in expectation of return from their holdings in the residual interest in the organization? Why do other organizations have no such residual interests?
4. What is the difference between the market environment for the products of a car manufacturer, and the "market" environment for the products of a city's department of streets and sanitation?
5. What is the difference between the conditions under which a car manufacturer raises money to finance its activities, and the conditions under which a city's department of streets and sanitation does?
6. Do government organizations and not-for-profit organizations necessarily produce public goods? Can you give two examples where the output of each is a private good?
7. When a charitable organization accepts a donation from a benefactor, what kinds of reciprocal obligations arise from such an action? What is the role of the accounting system in such organizations in keeping track of such obligations?
8. What are the key differences in the factor markets in which residual interest and non-residual interest organizations operate? Explain.
9. In residual interest organizations, managers' salary, bonus and continuation in the job are usually linked, either explicitly or implicitly, to the net income (residual) generated by the organization for the shareholders. Analyze the consequences of an organization that produces public goods using a similar scheme for rewarding its managers.
10. Suggest a scheme for effectively evaluating and rewarding the managers of public good producing organizations, and explain the rationale for your suggestion.
11. List three important differences between the accounting and control systems of public and private good organizations.
12. What is fund accounting? Why do the public good producing organizations tend to use fund accounting? Explain in terms of the role of accounting in defining, implementing and enforcing contracts.

13. Why does the U.S. government not present a consolidated set of financial statements?

14. What is the economic rationale behind accrual and recognition principle in accounting. Is this rationale violated by the public good organizations' practice of cash or modified cash basis accounting? Explain.

15. What is the role of depreciation in implementing contracts of private good organizations? What is its role in public good organizations?

16. Can you give some examples of organizations in which some managerial units produce public goods while others produce private goods? How is the accounting and control of such organizations designed?

