“Perspectives” provides a nice overview of areas where financial reporting rubs up against the constraints of the accounting system:

Historical vs Current Cost: Relevance vs. Reliability
Nature of Standards: Rules vs. Principles?
Geography of disclosure: Recognize vs. Footnote?
Completeness of the Accounting Model: What to account for? Should stock options even be on the books? Why? Why not?

Some questions to think about.
Why diversity of views on “Proper” Accounting?
   Asymmetric Information
   Incentive divergence

As an auditor:
Think through “opponent” (manager) preferences … what does the user expect from the auditor? [You have all no doubt heard the term ‘expectations gap’ that refers to the “gap” between what accountants claim an audit means vs. what investors expect auditors to do.]

As a regulator:
Is the “equilibrium” likely to be “Good”?
   Good for whom?
      Investors? Market Intermediaries?

As Congress/President:
How will it play in Peoria?
Rule-based standards vs. principles-based standards:

Accounting is a language. Like any good language, it must be as complex as the ideas we want to express. Cannot have rules for everything that can come up. But diversity (and divergence) of preferences, make discretion dangerous too!

Discretion, asymmetric information and divergent incentives are a dangerous mixture unless managers are saints.

If auditors have too much discretion, then managers can put more pressure on them. Rules-based standards are a way for auditors to “tie their own hands.” But …

Mechanics:

Exhibit 1 shows “articulation” … key to understanding how accounting works and the impact of accounting choices on your financial statements.
Financial Reporting and CMO Accounting

(all numbers made up)

With recourse:

Dr. Cash 1,000,000
Cr. NP 1,000,000

Sell the derivative (claims on the collateralized asset’s cashflows), while retaining ownership of primitive. Buyer has right to ask for additional funds in certain cases.

Effect on F/S: Debt/Equity? ROA? Current ratio? Quick ratio? Other ratios?

Without recourse:

Dr. Cash 1,000,000
Cr. Gain on Sale x00,000
Cr. NP 1,000,000

Sell the derivative while retaining primitive. Buyer has NO right to ask for additional funds.

Through a 3rd party:

Dr. Cash 1,000,000
Cr. Gain on Sale x00,000
Cr. Mortgage Loans* 1,000,000

* Recall that Mortgage Loans are an asset for a Bank.

Sell the primitive. The original asset goes off books too.

Effect on F/S: Debt/Equity? ROA? CR? QR? Other?

Who holds the risk?

Has the risk vanished or merely disappeared?

Implications …???