

Overall Aim of FAT

- To provide a framework of broad economic principles within which contemporary financial accounting practice and issues can be critically analysed and evaluated
- Understand role of theory in explaining accounting behaviour
- Appreciate existing theories
- Financial accounting theory explains when financial accounting information will be decision useful

Information

Characteristics of Information

- Easy to create, hard to trust
- Easy to spread, hard to control

Role of Information in a Market Economy

- Valuation objective: To reduce adverse selection and therefore improve operation of capital markets
 - o Emphasis on fair value
- Stewardship objective: To reduce moral hazard problem and therefore improve operation of managerial labour – also referred to as efficient contracting view
 - o Basic characteristics
 - Firm is a collection of contracts
 - Emphasis on contracts being efficient
 - Parties must trust each other
 - o Information must be reliable
 - Emphasis on corporate governance
 - This gives rise to conservatism
 - Since we can't see the management's actions we need accounting reports to be reliable
 - Emphasis on historical cost
- Different reporting will fulfil the two objectives depending on what information is included

Financial Accounting

- Information reporting system designed to relieve information asymmetry in economics
- Role: explain when and how information asymmetry is minimised

Information Asymmetry

- Occurs when one party to a transaction is at an informational advantage/disadvantage to the other
- Formally recognises that some business transaction parties may have an advantage