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BOOK REVIEWS

Stephen A. Zeff, Editor

Editor's note: Two copies of books for review should be sent to the Book Review Editor: Stephen A. Zeff, Rice University, Jesse H. Jones Graduate School of Business, 6100 Main St., Houston, TX 77005. The policy of *The Accounting Review* is to publish only those reviews solicited by the Book Review Editor. Unsolicited reviews will not be accepted.

CHANDRA KANODIA, *Accounting Disclosure and Real Effects*, Foundations and Trends® in Accounting (Hanover, MA: now Publishers Inc., 2007, ISBN 978-1-60198-062-5, vol. 1, no. 3, pp. ix, 95).

The third installment of the Foundations and Trends® in Accounting, edited by Professor Stefan Reichelstein, brings us a 95-page volume by Professor Chandra Kanodia, a career-long champion of accounting research based on real (production) economies, as opposed to financial (pure-exchange) economies. The monograph centers on the fundamental idea underlying the real effect approach and advocates its central importance for understanding accounting disclosure in comparison with the importance of other, competing approaches in contemporary accounting research.

The monograph is accessible to Ph.D. students with basic modern economics and information economics training. Chapter 2 contains a carefully argued and expertly articulated exposition of the contrast between the real effect approach and the pure exchange approach to the study of accounting disclosure. It should be appreciated, even if not adopted, by scholars who are interested in the role of external accounting disclosure in capital markets as well as its role in the real activities of the firm. For those needing a more in-depth treatment, Professor Kanodia offers four opportunities to showcase the intellectual power and subtle insights which the approach brings to specific accounting problems at hand, ranging from intangible assets, derivatives, measurement imprecision, and periodicity. While these four chapters essentially summarize key results from four previously published studies co-authored by Professor Kanodia, the monograph describes their links to the fundamental premise laid out in Chapter 2. Such connections are crucial for a holistic understanding of the approach, which can be easily missed when reading the four individual papers separately. Readers of earlier writings by Professor Kanodia would recognize the familiar ways in which arguments are made based on first-principles and tightly weaved together. While some parts of the monograph can be quite technical, they are supplemented with intuitive discussions. Overall, the monograph is a wonderful read and a must for any serious and curious accounting student.

It is not a coincidence that Professor Kanodia's approach carries the label "real effect." In the 1970s, Professor Kanodia was among a rare, superlative group of young economists, developed at the Graduate School of Industrial Administration (GSIA) at Carnegie Mellon University, in Pittsburgh, Pennsylvania. With their distinctive style of economic research, much new ground was broken by this group, which included luminaries such as future Nobel laureates Lucas, Kydland, and Prescott. The Real Business Cycle (RBC) theory in macroeconomics, which is a major force in the macro landscape, emerges from the famous 1982 "Time to Build" *Econometrica* paper by Kydland and Prescott (cited in this monograph). As a true intellectual pioneer, Professor Kanodia, in his 1980 *Econometrica* article, formulated the first dynamic general equilibrium model of accounting disclosure (Kanodia 1980). This paper is the basis for the subsequent real effect literature in accounting and also the basis underlying the middle four chapters of the monograph.

Yet Chapter 2 is the key chapter. Instead of going over the detailed arguments in the 1980 paper (which I recommend to every Ph.D. student), Professor Kanodia discusses its essence and compares and contrasts it with alternative frameworks. At its core, the framework places the central importance on real economic activities by households and firms. That is, to understand accounting phenomena such as disclosure, one must dig beneath the surface of observable relationships such as the association between disclosed accounting signals and share returns.

To truly understand the economic substance of accounting disclosure, one must understand the processes that generate the primitives upon which measurements are taken. Accounting disclosure, in whatever variety (earnings, accruals, voluntary press releases), measures (and thus informs about) cash flow primitives, which are generated by choices made by firms in the economy, each optimizing some objectives; these choices are real activities. Financial market metrics, in whatever variety (returns, volume, etc.), measure the outcome of consumption and saving choices made by individuals in the economy, each optimizing some objectives; these choices are financial activities. The shortcoming of the pure-exchange approach, according to Professor Kanodia, is that it bypasses the underlying real activities to focus on the equilibrium condition within the financial market. For example, cash flows in a typical CAPM setup are exogenously given, and any information arrival (i.e., disclosure) effectively replaces the old, exogenously given stochastic cash flow series with a new, but still exogenously given, stochastic cash flow series.

As a result, the only meaningful information asymmetry available to study is among traders in the financial market, not between the firm and the collection of financial market traders. Professor Kanodia sees the latter information asymmetry as of first-order importance. Such recognition leads, naturally, to the real effect approach. In contrast to the pure-exchange approach, disclosure in a real effect setup not only feeds into the financial valuation of future cash flows but also feeds back to real activities of the firm, which alters the future cash flows at the beginning. This two-way interaction is the hallmark of the real effect study. This is, indeed, a Carnegie message: pay attention to the structural relations underlying the empirically observable relations.

The table is set. The question is how to operationalize the approach with a nontrivial accounting problem. Here Professor Kanodia serves up four illustrative studies, common in their underlying approach but different in their topical considerations as well as analytic techniques. It is in these examples where Professor Kanodia advocates a separate and more methodological point: a piece-meal, specialized route to implement the real effect approach, against a comprehensive model of disclosure.

I will not detail each argument in the four chapters (3 to 6); readers are directed to the monograph as well as the four source papers, each of which focuses on entirely different accounting topics. Some shared features/ingredients are noteworthy.

First, the timing of the economic events is similar. A single firm makes a real economic investment decision. Before the full cash flow series produced by the investment is realized, the firm makes an information disclosure which feeds into a market valuation of future cash flows. With this setup, the real effect refers to how the *ex ante* investment is affected by the subsequent, anticipated disclosure. The key is that the eventual market evaluation of cash flows matters to the decision maker. Second, alternative accounting disclosure rules are represented by the alternative informational (statistical) properties. Finally, all four chapters noticeably use a partial equilibrium analysis specifically designed for the particular accounting problem at hand. This is by choice; as Professor Kanodia concludes, in Chapter 7, that any attempts "to formulate a *comprehensive* theory of disclosure would, like a search for the 'Holy Grail,' be either futile or sterile" (p. 88).

The monograph is not intended to be a comprehensive review of the real effect literature, but it is worth noting Professors Ron Dye and Sri Sridhar of the Kellogg School at Northwestern University, among others, have also published important works that focus on production economies. Further, while Professor Kanodia explicitly rules out discussing the production of new information to focus on the disclosure of existing information (p. 10), I believe more can be learned by expanding the real effect approach to include information acquisition activities of the firm, especially from the marketplace (see Dye and Sridhar 2002). This would allow a return to the Hayekian idea of price conveying information for resource allocation (beyond simply resource distribution). Lastly, one of the true splendors of the Carnegie economics tradition was the eventual development of theory-based estimation to study structural relations underlying observed economic phenomena. Wouldn't it be nice if the real effect approach to study in accounting were to lead eventually to theory-based structural empirical studies in accounting?

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NAHUM D. MELUMAD and DORON NISSIM, *Line-Item Analysis of Earnings Quality*, Foundations and Trends® in Accounting (Hanover, MA: now Publishers Inc., 2009, ISBN 978-1-60198-212-4, vol. 3, no. 2–3, pp. ix, 148).

In their monograph, *Line-Item Analysis of Earnings Quality*, Nahum D. Melumad and Doron Nissim provide a comprehensive yet refreshingly succinct summary of 15 key line-items from the financial statements, with the purpose of allowing practitioners and researchers to better identify the quality of each individual line-item, whereas prior monographs in this genre focus on the quality of aggregate financial statements (Dechow and Schrand 2004; Francis et al. 2008).

The authors begin with an overview of the concept of earnings quality and earnings management, including a summary of the key incentives and implications of earnings management. In the remaining 15 chapters, they systematically discuss key line-items. Beginning in Chapter 4 with revenue, the authors introduce each line-item chapter with an overview of the accounting rule(s), including required estimations or judgments ("Accounting Principles"). They then discuss how these required estimates or judgments allow for potential malfeasance ("Accounting Quality"). Finally, the authors end each chapter with a discussion of specific ratios or other red flags that would allow a diligent financial statement user to identify potential manipulation ("Red Flags and Other Analyses").

Each chapter offers a veritable fountain of information. First, the authors provide a concise yet complete summary of the main measurement issues. For example, within inventory, they summarize lower of cost or market, cost flow assumptions, and inventory accounting systems. Second, the authors frequently offer statistics on the use of different measurement approaches based on the AICPA's annual survey, *Accounting Trends & Techniques*; for example, in 2005, about 64 percent of firms used FIFO, and 9 percent of firms experienced an inventory revaluation (i.e., write-down).

Third, the authors provide examples of specific firms that managed earnings by using this specific line-item. In Chapter 6 on inventory, the authors highlight Nicor Inc.'s misuse of LIFO layers and Suprema's fraudulent re-labeling of imitation cheese and noncheese products as premium cheese to inflate the value of ending inventory. These anecdotes are both informative and entertaining, and they aid in the absorption of the material.

The authors also bring in academic research, for example, citing Lev and Thiagarajan (1993) and Thomas and Zhang (2002) in the inventory chapter. The sole shortcoming of the monograph, in my opinion, is that the authors do not appear to have conducted a comprehensive search of published research when examining each particular line-item. For example, when discussing the grossing-up of revenue, the authors fail to cite Davis (2002), and when discussing book-tax differences, they fail to cite Hanlon (2005). As such, researchers interested in examining a particular line-item cannot use this monograph as a primary source for related literature.

Finally, within the "red flags" section of the chapters, the authors provide the mechanics to undo certain accounting methods or otherwise enhance the financial statement figures. For example, in the inventory chapter, the authors provide the equations to recast LIFO income statement and balance sheet items to a FIFO basis to facilitate comparability. While these techniques are generally also provided in standard intermediate accounting textbooks, the monograph provides the perfect amount of information to refresh the memory of the reader. Thus, the level of the monograph is well suited to an accounting practitioner or academic with accounting knowledge who wishes to revisit specific topics, and it should be especially useful for Ph.D. students wishing to ascertain the complexities of individual line-items.

In summary, Melumad and Nissim provide a clear, succinct, and informative monograph on the inherent limitations of the measurement of key line-items, which should allow both practitioners and researchers the necessary tools to evaluate the quality of these specific line-items, thereby allowing for a better overall assessment of a firm's total earnings quality.

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DAVID MOSSO, *Early Warning and Quick Response: Accounting in the Twenty-First Century* (Bingley, U.K.: Emerald Group/JAI Press, 2009, ISBN 978-1-84855-644-7, pp. viii, 86).

This is an engaging book with compelling arguments for a complete overhaul of our current set of accounting standards and of the process by which they are set.[1] David Mosso is well qualified to comment on both, having served as a member of the Financial Accounting Standards Board (FASB) from 1978 to 1987, as Vice Chair of the Board from 1986 to 1987, and as the FASB's Assistant Director of Research from 1987 to 1996. He came to the Board with extensive experience in governmental accounting and, after his work with the FASB, served as Chair of the Federal Accounting Standards Advisory Board from 1997 to 2006. He is quick to acknowledge his role in the development of our current Generally Accepted Accounting Principles (GAAP) and to express his regret for their failings.

In essence, Mosso argues that we must replace our current mixed-attribute GAAP with full fair value accounting. His proposal, which he calls the Wealth Measurement Model, would recognize all assets and liabilities, as he defines them, at their current fair value, as defined by SFAS No. 157. That fair value balance sheet would measure the entity's wealth at that date. Changes in the entity's wealth from one period to the next would act as an early warning of potential trouble to all of the entity's constituents. As to the standard-setting process, Mosso argues that the standard setter should outline the principles of the Wealth Measurement Model and then observe practice, being alert for aberrations in the way those principles are applied. New standards would mostly be interpretations of the basic principles and so could be issued quickly with a minimum of due process.

The primary line of thought in Mosso's book is a proposal to radically revise our current accounting model. On pages 11–12, he proposes six principles for his Wealth Measurement Model, quoted as follows:

- The objective of accounting is to measure an entity's economic wealth (net worth) and income (earnings) for the purpose of diagnosing the entity's financial health.
- All measurable assets and liabilities of an entity must be recognized on the entity's balance sheet, along with the owners' equity in those assets and liabilities.
- All balance sheet assets and liabilities, and changes in them, must be measured at fair value
- All issues and redemptions of owners' equity shares must be measured at fair value with gain or loss recognition in earnings for any difference between the fair value of the shares and the fair value of things received or given in exchange.
- All major nonmeasureable assets, liabilities, commitments, and contingencies of an entity must be disclosed in notes to the financial statements.
- The primary financial statements … must be segmented and supplemented in a manner to facilitate the diagnosis of an entity's financial health and future prospects.

Mosso argues that these principles must be mandatory and applicable to every entity. He observes that issuing the FASB's Concept Statements as nonauthoritative guidance was a mistake, leading them to be seen as a basis for debate rather than as a basis for decision-making.

He acknowledges that any attempt to establish these principles would provoke outrage from some in the financial community. In his book, however, he deals with the usual complaints that have been laid against fair value accounting, and he outlines its advantages both for the users of financial statements and for entity managers. Most importantly, he acknowledges that the use of fair values will introduce volatility into reported results, but on page 30 he argues that (1) volatility is a fact of economic life which should be measured and reported, and (2) the

[1] Mosso made a presentation with much of this material at the luncheon session of the Financial Accounting and Reporting Section during the AAA Annual Meeting in August 2009.

concern about the impact of volatile market changes can be minimized by careful segmentation in the statements by "keeping operating revenues and expenses separate from uncontrollable price changes and other events." In the context of this operating items/price change segmentation, he references both the current FASB/IASB project on statement presentation and the report/proposal from the CFA Institute, *A Comprehensive Business Reporting Model* (CFA Institute 2007).

In Chapters 9 and 10, Mosso redefines assets, liabilities, and equity in the context of his six wealth measurement principles. An asset is an economic resource that is controlled by an entity (p. 46). That definition clarifies the FASB's current definition in that it leaves out the criteria "probable" and "future economic benefit," both of which he argues have been confusing in practice. A liability is an unfulfilled binding promise made by an entity to transfer specified economic benefits in determinable amounts at determinable times or on demand (p. 47).That definition differs from the current FASB definition in that it uses a broader "promise" criterion in lieu of the difficult-to-apply idea of a "probable future sacrifice." Interestingly, Mosso argues that, by using these definitions, receivables and payables will be reciprocal—there will be a mutual understanding of the claim between the two parties to the transaction. That understanding will be established by a triggering act as, for example, the performance of an earnings event. We have not insisted on mutuality in our current accounting for assets and liabilities, allowing for different assessments of "probability" by the holder of the asset and the obligor.

In our current GAAP, equity is understood to be simply the difference between assets and liabilities. Mosso's wealth measurement model defines equity as the wealth that belongs to and is controlled by the entity's shareholders: their capital contributions and retained earnings (p. 53). Given that definition, preferred stock, warrants, and options would be liabilities and not equity. Transactions in the real equity securities would be recorded at market prices, with any dilution (or gains) reported in earnings. He points out that the FASB has had a large-scale equity project on its agenda since 1990 but has not been able to move it very far; and he observes that, when the Board does develop a proposed standard, it will enter the due process grinder.[2]

The second line of thought in this book deals with the standard-setting process. Mosso concludes that the FASB is not really independent and as a result must depend on extended due process to assure the acceptance of its pronouncements.[3] He proposes a very different approach to the setting of accounting standards, both to assure a quick response to emerging issues—such as the Special Purpose Entities issue—and to delineate responsibility more appropriately, focusing preparers and auditors on their responsibility to find the best answer.

Naturally, his approach to standard setting assumes the adoption of the Wealth Measurement Model as the base. Once the six principles are established, the standard setter would no longer need to expend energy on allocation issues such as the valuation of inventory or financial instruments. Instead, the standard setter could focus on implementation issues such as the refinement of the fair valuation process and questions of disclosure and display.

On pages 41 and 42, he outlines six levels of issues that would need to be addressed in his vision of a quick response standard-setting process, paraphrased as follows:

1. Preparers and auditors would be responsible for applying the six principles, with the straightforward goal of measuring the entity's wealth.
2. In highly unusual circumstances, the preparer or auditor could ask for guidance from the standard setter within the time frame of the preparer's reporting deadline. Little due process would be required to provide that guidance.
3. Decisions made at levels 1 and 2 could be challenged by a user, and the standard setter would act as a hearing officer to let the decision stand or to change it. In either event, a decision by the standard setter would result in a reinforcement of the principles in the context of that set of case facts.
4. If dubious practices develop without an outside challenge, the standard setter would issue stopgap pronouncements, with limited due process.
5. Based on its experience with issues addressed at the prior levels, the standard setter would issue pronouncements refining the Wealth Measurement Model. Since they would only be refinements of the basic principles, presumably only limited due process would be required.
6. Larger issues would be deliberated by the standard setter, with a more extensive, but expedited, due process.

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2 In 2003, the FASB issued SFAS No. 150, the first of a planned series of statements on the liability/equity question. Reading the Board's record on this project, it seems clear that the Board's experience with what was to be a straightforward exposition in SFAS No. 150 has raised unanticipated, complex theoretical issues, and, as a result, the entire project has gone back to the drawing board.

3 When Mosso concludes that the FASB is not "independent," I think he means that it does not have sufficient authority always to act as it thinks is best in the face of constituent opposition: it is not clear to me how the Board would obtain that level of authority.

He acknowledges that such a dramatic change in the process—and such a dramatic change in the basic accounting model—is not likely to come about without outside intervention from the Securities and Exchange Commission (SEC) or from Congress. Conversely, in the concluding chapter of the book, Mosso argues that this new approach to accounting and accounting standard setting must be adopted by the profession, or the government will take it over as it has with auditing.

It is hard to argue with Mosso's call for a move to a fair value-based accounting system. In its 2007 proposal for a new business reporting model, the CFA Institute said, "Our goal is for fair value to be the measurement attribute for assets and liabilities" (CFA Institute 2007, 8). They go on to say that the Institute has argued for fairvalue accounting since at least 1993. The use of fair values in financial reporting got further support when the SEC staff—under great contrary pressure—recommended against any suspension of "existing fair value standards" and mark-to-market accounting, although the report also said that current fair value processes should be improved (SEC 2008, 7–8). That position was based in part on the staff's own research and in part on input from users. The *Financial Times* reported that, in a recent survey of members of the CFA Institute, 74 percent of the respondents believe that fair value accounting improves market integrity (*Financial Times* 2008).

But Mosso's call for less legislation and more direct action in the process of setting accounting standards is more arguable. For more than 30 years, the Board has been operating with the understanding that "Accounting Standards are not immutable truths that can be proved scientifically. Rather they are conventions which are accepted and used by those who are involved … because they are understood to be in the best interests of all" (Financial Accounting Foundation 1977, 18).[4] By definition, a convention is a rule accepted by general consent; where the issue is contentious, the process of developing that general consent requires time, education, and some hand holding or arm twisting. No standard-setting body in the Western World, not even the Congress of the United States, has the power to impose a new rule without the general consent of its constituents.

In fact, the environment for accounting standard setting has become more constituent-oriented, rather than more action-oriented as Mosso might wish. In 2008, the SEC's Advisory Committee on Improvements to Financial Reporting (CiFR) studied the process of setting accounting standards and concluded that the Board's current open due process was "appropriate." The Committee went on to suggest that the process be expanded to include (1) the creation of a Financial Reporting Forum, where constituents could discuss pressures on the financial reporting system; (2) additional fieldwork on proposed standards, and (3) formalized post-adoption reviews of previously issued standards (Advisory Committee on Improvements to Financial Reporting 2008, 62).

Mosso is surely right that the existing process is too time-consuming and provides too many opportunities for interest groups to impede an important improvement in our standards. However, I do not believe that there is any other alternative to the messy, constituent participation process we have evolved. Given the pressures we have seen from Congress to set aside mark-to-market accounting, and similar moves in the European Union, none of us want accounting standards set by government fiat. In his conclusion, Mosso rightly calls for leadership and involvement from the analyst and academic communities in the standard-setting effort—and in the drive for fair value accounting—because both communities are unbiased in the search for truth. Interestingly, the CiFR report called for more extensive involvement by the investor community, and the Financial Accounting Foundation (FAF) has modified the qualifications for Board members to include "experience in investing and accounting education and research" (Financial Accounting Foundation 2008, 3).

Following on Mosso's challenge, and the FAF's door-opening, the academic community ought to seize on the opportunity for a larger place at the table, where we can bring our unbiased skills to bear—even beyond the work of the individual academic Board member and the contributions of the AAA Financial Accounting and Reporting Section's Financial Reporting Policy Committee. That challenge is perhaps the key message from this thought-provoking book.

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Capsule Commentary

By the Book Review Editor

FRANCESCO BELLANDI, *Accounting for Equity and Other Comprehensive Income: Dual Reporting under U.S. GAAP and IFRSs* (Rome, Italy: Casa Editrice Università La Sapienza [Sapienza State University], 2009, ISBN 978-88-95814-26-1, electronic only [available at: edizioni.sapienza@uniroma1.it], pp. xx, 631).

"This Book," writes the author, "analyzes the accounting for stockholders' equity and other comprehensive income from the point of view of the equity issuer … by means of a critical appraisal of and comparison between the U.S. GAAP and the IFRSs pronouncements and practice" (p. 11). This is verily an encyclopedic work by an author who gives executive seminars for CFOs on dual reporting under U.S. GAAP and IFRS. He holds a CPA conferred in the United States, and he has worked for a major audit firm, as a financial executive in various companies, and as a financial analyst.

The author provides extensive references to the authoritative literature for both U.S. GAAP and IFRS, and his discussion of each accounting issue contains an elaborate explanation of the principles and applications, as well as the author's interspersed observations, analyses, and suggestions. A considerable number of tables and charts complement the text. There is a detailed table of contents which makes up for the somewhat disappointing index.