



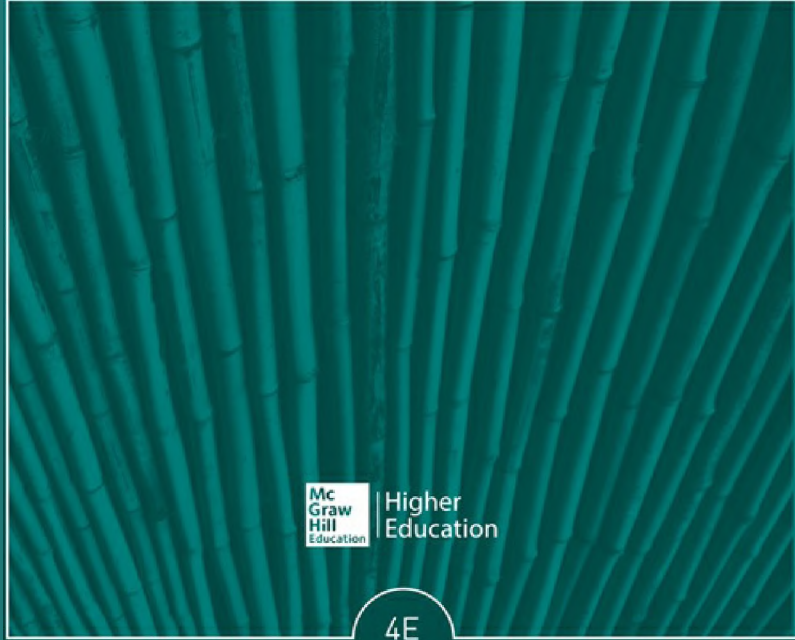
CRAIG DEEGAN

FINANCIAL ACCOUNTING THEORY

4E



FINANCIAL ACCOUNTING THEORY
CRAIG DEEGAN



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National Library of Australia Cataloguing-in-Publication Data

Author: Deegan, Craig Michael, author.
Title: Financial accounting theory / Craig Deegan.

Edition: 4th edition.
ISBN: 9780071013147 (paperback)

Notes: Includes index.
Subjects: Accounting.
Accounting—Study and teaching.

Dewey Number: 657.48

Published in Australia by

McGraw-Hill Education (Australia) Pty Ltd
Level 2, 82 Waterloo Road, North Ryde NSW 2113

Publishers: Jillian Gibbs and Rosemary Noble

Development editor: Katy McDevitt

Senior production editor: Claire Linsdell

Permissions editor: Haidi Bernhardt

Copyeditor: Annabel Adair

Proofreader: Jess Ni Chuinn

Indexer: Mary Coe

Design coordinator: Dominic Giustarini

Cover design: Patricia McCallum

Internal design: Lauren Statham

Typeset by SR Nova Pvt Ltd

Printed in China on 70 gsm matt art by 1010 Printing International



ABOUT THE AUTHOR

CRAIG DEEGAN, BCom (University of NSW), MCom (Hons) (University of NSW), PhD (University of Queensland), FCA, is Professor of Accounting in the School of Accounting at RMIT University in Melbourne. Craig has taught at both undergraduate and postgraduate levels in Australia for many years and his main teaching interests are in the area of financial accounting, financial accounting theory, social and environmental accountability, and research methods. Prior to working in the university sector, he worked as a chartered accountant in Sydney, having formerly completed the professional program of the Institute of Chartered Accountants in Australia.

Craig's research has tended to focus on various social and environmental accountability and financial accounting issues and has been published in a number of leading international accounting journals, such as *Accounting, Organizations and Society*, *Accounting and Business Research*, *Accounting, Auditing and Accountability Journal*, *Journal of Business Ethics*, *Critical Perspectives on Accounting*, *Accounting and Finance*, *British Accounting Review*, *Australian Accounting Review* and the *International Journal of Accounting*. He has successfully supervised more than forty PhD, Masters and Honours students, many of whom have subsequently taken up academic positions in Australia and overseas, and he continues to supervise many research students. He also serves on the editorial boards of several leading international accounting journals.

Craig regularly provides consulting services to corporations, government and industry bodies on issues pertaining to financial accounting and corporate social and environmental accountability. He also works closely with the Australian accounting profession and has authored a number of research papers and monographs issued by the profession, as well as being former chairperson of the Triple Bottom Line Issues Group of the Institute of Chartered Accountants in Australia and a former board member of the Institute of Public Accountants. Craig continues to actively contribute to the education program of CPA Australia, particularly in the area of corporate social responsibility.

He has been the recipient of various teaching and research awards, including teaching prizes sponsored by KPMG and the Institute of Chartered Accountants in Australia. In July 1998 he was the inaugural recipient of the Peter Brownell Manuscript Award, an annual research award presented by the Accounting and Finance Association of Australia and New Zealand. In 1998 he was also awarded the University of Southern Queensland Individual Award for Research Excellence.

Craig is also the author of the leading financial accounting textbook *Australian Financial Accounting*, now in its seventh edition, and (with Grant Samkin) its adaptation *New Zealand Financial Accounting* (now in its sixth edition). *Financial Accounting Theory* is widely used throughout Australia as well as extensively throughout Europe.

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PREFACE

This book has been written to provide readers with a balanced discussion of different theories of financial accounting. Various theories for and against the regulation of financial accounting are critically discussed and various theoretical perspectives are introduced to explain different types of voluntary reporting decisions. The book also describes and evaluates the development of various normative theories of accounting, including various approaches developed to account for changing prices, different normative perspectives about the accountability of business entities, as well as various issues associated with the development of conceptual frameworks for financial reporting. The book also emphasises the role of a number of factors in explaining both international differences in accounting and the recent efforts towards, and the obstacles to, the globalisation of international financial reporting standards.

Apart from providing explanations for why or how organisations should disclose particular items of financial information, the book investigates research that explores how or whether people at an aggregate and individual level demand or react to particular disclosures. Reflecting the growing relevance of social and environmental accountability and reporting issues to students, government, industry and the accounting profession, social and environmental accountability and reporting issues are discussed in depth. The book also provides an insight into the role of financial accounting from the perspective of a group of researchers who are often described as working from a 'critical' perspective.

Divided into twelve chapters sequenced in a logical order, this book provides the basis for subjects or units that investigate financial accounting theory. Alternatively, the book can be used as a key text for more general courses that include coverage of aspects of financial accounting theory. The entire book could realistically be used in the average eleven- to thirteen-week university term, with chapters being studied in the sequence in which they are presented. Because it presents a balanced perspective on alternative and sometimes conflicting theories of financial accounting, it also provides a sound basis for readers contemplating further research in different areas of financial accounting.

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In writing this book, a style has been adopted that enables students at both the undergraduate and the postgraduate level to gain a sound understanding of financial accounting theory. As each chapter incorporates research from around the world, the book is of relevance to financial accounting theory students internationally.

To assist in the learning process, each chapter provides learning objectives, chapter summaries and end-of-chapter discussion questions. Throughout the book readers are encouraged to critically evaluate and challenge the various views presented. To give the different perspectives a 'real world' feel, many chapters use recent articles from newspapers, directly related to the issues under consideration.

In the fifteen years since the first edition of this book was published, it has proved very popular with students and lecturers in Australia and internationally. This new edition retains and builds on the features of the first three editions that students and lecturers found so appealing and distinctive, such as the use of straightforward explanations, the assessable nature of the language, frequent practical examples, and illustrations using newspaper articles. I have taken the opportunity of updating the text to reflect significant developments in accounting theory over the past fifteen years.

I hope readers continue to find this book interesting, informative and enjoyable to read and I welcome constructive feedback.



Craig Deegan
RMIT University

ACKNOWLEDGMENTS

Many people helped me write this book. I would like to thank all those who generously provided some very useful ideas in the early stages of developing the first edition of this book back in 1999, including Professor Rob Gray from the University of St Andrews in Scotland, Professor David Owen from the University of Nottingham in England, Professor Julie Cotter and Mark Vallely from the University of Southern Queensland, and Michaela Rankin from Monash University. Appreciation is also extended to the staff at McGraw-Hill Education Australia for providing support throughout the various writing and publication phases of this and previous editions.

I would also like to acknowledge Professor Reg Mathews, who also gave great help to me when I wrote the initial edition of this book. Sadly, Reg passed away in 2012. He was a great friend to many of us, an influential and early pioneer in the area of social accounting, and a patient and generous mentor for many up-and-coming academics. He is greatly missed by his many friends.

I would like to join McGraw-Hill Education in thanking the many people who have provided feedback on the various chapters of this book since it was first published in 1999. This input is much appreciated and valuable.

My thanks also go to a number of colleagues at RMIT for providing great friendship and encouragement for my various projects with particular thanks going to Rob Inglis and Sophia Ji—my regular ‘lunchtime buddies’ for over a decade. I would also like to sincerely thank the many PhD, Masters and Honours students that I have supervised across time and who have provided a variety of valuable and interesting insights that have invariably found their way into this book, and who exposed me to various literatures that I might not have otherwise been aware of. Thanks must also go to Mary Exton for her great support, and last but certainly not least, appreciation goes to my dear daughter, Cassie, for all her love.

OUR SUPPLEMENT AUTHORS

DIGITAL RESOURCES

Craig Deegan BCom, MCom, PhD, FCA

The solutions manual and PowerPoints accompanying this edition have been prepared by the author, Craig Deegan.

Parmod Chand BA, MA, PhD

A new testbank has been prepared by Parmod Chand of Macquarie University. Dr Chand has substantial experience in teaching financial accounting courses, at both undergraduate and postgraduate levels, and his research on accounting convergence is prominent, both nationally and internationally. His most significant contribution to the field of international accounting research has been his work published in leading international accounting journals on issues relating to convergence of accounting standards. In addition, he has contributed to a number of publications on the issues confronting accountants.

Dr Chand also has substantial experience in serving professional accounting institutes. He is currently serving as Senior Lecturer in the Department of Accounting and Finance at Macquarie University.

Robyn Parry BBus (Acc), MEd, MComm, CPA, AFAANZ

The self-study quizzes have been prepared by Robyn Parry. Robyn represents the Russo Higher Education group, lecturing in accounting at James Cook University (Brisbane) to both undergraduate and postgraduate students. Robyn began her career in public practice then worked in the mining, construction and government sectors before moving into accounting education. She has lectured in both financial and management accounting, including accounting theory, and has a keen interest in the development of accounting education and the promotion of the professional accounting bodies.

HIGHLIGHTS IN THIS EDITION

OVERALL

Various theories for and against the regulation of financial accounting are critically discussed, including different types of voluntary reporting decisions. The development of various normative theories of accounting is evaluated. The role of a number of factors in explaining the differences in international accounting and recent efforts towards the globalisation of international financial reporting standards are discussed. The growing relevance of social and environmental reporting issues is discussed in depth in various chapters. The end-of-chapter questions have been significantly increased and strengthened.

CHAPTER 1: INTRODUCTION TO FINANCIAL ACCOUNTING THEORY

- What do we mean by ‘theory’?
- Why it is important for accounting students to study accounting theory?
- Can we prove a theory?
- A brief overview of theories of accounting
- Evaluating theories—considerations of logic and evidence
- Key factors that influence the ‘research process’

CHAPTER 2: THE FINANCIAL REPORTING ENVIRONMENT

- An overview of the development and regulation of accounting practice
- Rationales for regulating financial accounting practice
- The role and implications of professional judgement in accounting

CHAPTER 3: THE REGULATION OF FINANCIAL ACCOUNTING

- What is regulation?
- An overview of the ‘free-market’ perspective, including discussion about market-related incentives
- Arguments in favour of regulation together with a consideration of the potential effects of excessive regulation
- Theories of regulation, in particular public interest theory, capture theory, and economic interest group theories of regulation
- Pro-regulation perspective
- Economic and social impacts of accounting regulation and insights into the motivations inherent in lobbying activities associated with accounting standards
- Lobbying and the economic interest group theory of regulation
- Accounting regulation as an output of a political process

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CHAPTER 4: INTERNATIONAL ACCOUNTING

- Evidence of international differences in accounting prior to recent standardisation initiatives
- Arguments to suggest why the efforts of the IASB will not ultimately lead to international standardisation in financial accounting practice
- The pros and cons of countries using different accounting methods
- Overview of the IASB and its globalisation activities: new section
- The role of the United States in the international standardisation of financial accounting and discussion of revised views about whether the US will ultimately commit to IFRS
- Reasons to support and oppose the global standardisation of financial accounting standards
- Obstacles to the global standardisation of financial accounting

CHAPTER 5: MEASUREMENT ISSUES: ACCOUNTING FOR THE EFFECTS OF CHANGING PRICES AND MARKET CONDITIONS

- The meaning of ‘measurement’
- Pros and cons of commonly used measurement bases
- Factors to consider when choosing between alternative measurement bases
- Explanation and evaluation of various normative theories for accounting for changing prices
- Fair value accounting—the advantages and disadvantages of this form of measurement together with a consideration of the pro-cyclicality aspects of fair value accounting

CHAPTER 6: NORMATIVE THEORIES OF ACCOUNTING: THE CASE OF CONCEPTUAL FRAMEWORK PROJECTS

- The meaning of, and the benefits and criticisms of, conceptual frameworks of accounting
- Discussion of the pros and cons of the current IASB *Conceptual Framework* versus prior frameworks
- The meaning of ‘accountability’ and its relevance and relationship to conceptual frameworks of accounting
- The ‘decision-usefulness’ and ‘stewardship’ functions of financial reporting and the influences of these functions on current efforts to select among competing measurement approaches

CHAPTER 7: POSITIVE ACCOUNTING THEORY

- Positive Accounting Theory defined: origins and development
- An overview of agency theory and its relevance to Positive Accounting Theory
- Efficiency or opportunistic perspectives relating to accounting method selection
- The use of accounting-based bonus schemes to motivate managers
- The role of accounting-based contracts in controlling conflicts of interest between managers and creditors
- An overview of the meaning of political costs and the implications for accounting choice
- Criticisms of Positive Accounting Theory
- Relevance of Positive Accounting Theory to current efforts of the IASB and FASB to determine 'best' approaches to measurement

CHAPTER 8: UNREGULATED CORPORATE REPORTING DECISIONS: CONSIDERATIONS OF SYSTEMS-ORIENTED THEORIES

- Detailed discussion of Legitimacy Theory, Stakeholder Theory and Institutional Theory
- Substantial research and discussion
- Legitimacy, legitimacy gaps and the legitimating process, with examples from the business world
- Disclosures in company annual reports on social and environmental issues
- Managerial attitudes towards the role of corporate reporting in legitimisation strategies
- Overlapping areas of Stakeholder Theory, Legitimacy Theory and Institutional Theory
- Relationships between media, corporate legitimacy and corporate disclosure policies
- Apparent needs for development in the respective theories

CHAPTER 9: EXTENDING CORPORATE ACCOUNTABILITY: THE INCORPORATION OF SOCIAL AND ENVIRONMENTAL FACTORS WITHIN EXTERNAL REPORTING

- Expanded discussion reflecting the growing acceptance of corporate social responsibility reporting, incorporating new industry examples, media extracts and significant new research
- Developing notions of sustainability
- Objectives of the social and environmental reporting process—the *why* stage
- Identifying stakeholders—the *who* stage
- Identifying stakeholder information needs and expectations—the *what* stage
- Theoretical perspectives on some social and environmental reporting procedures—the *how* stage
- The role of the Global Reporting Initiative (GRI) in reporting procedures for sustainability
- Recent initiatives in relation to Integrated Reporting and why the earlier promise of Integrated Reporting now seems to be eroded
- An overview of climate change and its relevance to accountants (and everybody else on the planet)
- A consideration of various accounting issues associated with cap-and-trade systems used to address carbon emissions
- Accounting for externalities
- Social auditing
- A consideration of various corporate governance mechanisms aimed at improving corporate social and environmental performance
- A consideration of the important, but often neglected, topic of personal social responsibility

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CHAPTER 10: REACTIONS OF CAPITAL MARKETS TO FINANCIAL REPORTING

- Evidence about how, and why, capital markets react to some accounting information, but not other accounting information
- The assumptions inherent in capital markets research
- The implication for capital markets research when we relax key assumptions about market efficiency: discussion of new research

CHAPTER 11: REACTIONS OF INDIVIDUALS TO FINANCIAL REPORTING: AN EXAMINATION OF BEHAVIOURAL RESEARCH IN ACCOUNTING

- Expanded information on the definition of, and schools of, behavioural research as it applies to accounting theory
- Discussion of the Brunswik Lens Model
- The relevance of differences in culture: expanded section
- The role of accounting 'conservatism' and its implication for accounting method selection

CHAPTER 12: CRITICAL PERSPECTIVES OF ACCOUNTING

- The critical perspective defined
- Critical accounting research versus social and environmental accounting research
- The possible impact of critical accounting research on social practice
- Role of the state versus role of accounting in supporting existing social structures
- The subjectivity of accounting reports
- A critical reflection of the role of critical accounting researchers in actually creating changes to those systems that they criticise and oppose

TEXT AT A GLANCE

LEARNING OBJECTIVES

Each chapter starts with a list of learning objectives that flag what you should know when you have worked through the chapter. Checking through them to confirm your knowledge is an excellent way of preparing for exams.

LO **LEARNING OBJECTIVES**

- 5.1 Be aware of some particular limitations of historical cost accounting in terms of its ability to cope with various issues associated with changing prices.
- 5.2 Be aware of a number of alternative methods of accounting for non-current assets that have been developed to address problems associated with changing prices.
- 5.3 Be able to identify some of the strengths and weaknesses of various alternative accounting methods.

OPENING ISSUES

At the beginning of each chapter, a number of issues or questions are raised that relate to the material covered. You should be able to answer these on completing the chapter. You might like to try providing an answer to the opening issues before reading the chapters, and then revisiting the Opening Issue to see whether you might change your opinions as a result of being exposed to particular points of view covered in the chapter.

OPENING ISSUES

Various asset valuation approaches are often adopted in the financial statements of large corporations. Non-current assets acquired for perhaps revalued at fair value will simply be added together to give a total dollar value, even though their historical costs or valuations might provide little reflection of the current value of the assets. For example, pursuant to IAS 16/AASB 116 'Property, Plant and Equipment', it is permissible for some classes of property, plant and equipment to be measured at cost, less a provision for depreciation, whereas another class of property, plant and equipment is allowed to be measured at fair value.¹ The different measurements are then simply added together to give a total value of property, plant and equipment which is with the total representing neither cost nor fair value.

INTRODUCTION

An introduction to each chapter highlights the material to be covered and shows how it builds on topics introduced in previous chapters.

INTRODUCTION

Chapter 3 considered various theoretical explanations for why regulation occurs. Perspectives derived from *public interest theory*, *capture theory* and the *theory of regulation* did not attempt to explain what form of regulation was best. Rather, by adopting certain theoretical assumptions about individual behaviour, the theories attempted to explain which parties were most likely to try to influence the process, and perhaps succeed in doing so.

This chapter considers a number of *normative* theories of accounting. These theories provide judgements about the types of information people *need* (which could be *wanted*), the various normative theories provide prescriptions about how accounting *should* be undertaken.²

ACCOUNTING HEADLINES

Media extracts highlight the relevance of the chapter content to the business world and often present thought-provoking or opposing viewpoints. Most are recent, but some older ones are included to illustrate defining moments.

Call for inflated books

BRIAN MAHONEY

With their capitalist ship slowly sinking from the weight of inflation, company directors and accountants are at last doing something about the problem.

They are not exactly finding a way to overcome it, but they have decided on a way of recording the effects of inflation in company accounts.

Members of the Institute of Chartered Accountants in Australia at the annual Victorian congress last weekend and a panel of directors at the Institute of Directors in Australia in Sydney on Wednesday agreed

Under CPP, figures are adjusted by an index to a constant purchasing power.

Another such draft of another form of inflation accounting—Replacement Cost—is expected within a few months and hopefully some decision will be made after that as to what form of accounting will be encouraged.

RC accounting aims at showing the replacement value of non-monetary assets expected to be replaced, with consequential adjustments to profits.

As the ICAA pointed out at its

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EXHIBITS

Exhibits generally contain extracts from company documents, annual reports or websites to help show the relevance of the theory to business life.

CPP Limited Statement of Financial Position as at 31 December 2010

Current Assets	
Cash	100 000
Trade debtors	20 000
Inventory	35 000
Non-current Assets	
Plant and equipment	90 000
Accumulated depreciation	(9 000)
Land	75 000
Total Assets	

SUMMARY

Each chapter concludes with a summary of the key topics and viewpoints that have been covered.

CHAPTER SUMMARY

This chapter has explored different models of accounting that have been used to provide financial information in periods of rising prices. These models have been developed in response to the perceived limitations of historical cost accounting, particularly in times of rising prices. Historical cost accounting suggests that, because historical cost accounting is tied to maintaining financial capital intact, it tends to be conservative in periods of rising prices. Historical cost accounting adopts an assumption that the purchasing power of currency remains constant over time. Debate about the best model to use in periods of rising prices was vigorous in the 1960s through to the 1980s. In this time, inflation levels tended to be relatively high. Since then, inflation levels have tended to be low and the debate about which model to adopt to address rising prices has waned. Nevertheless, there has been a general movement by regulators to

REFERENCES

Each chapter is extensively referenced, allowing students wishing to undertake further studies to explore topics in greater depth.

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QUESTIONS

A variety of thought-provoking questions are provided at the conclusion of each chapter.

QUESTIONS

- 5.1 What assumptions, if any, does historical cost accounting make of the currency? (LO5.XX)
- 5.2 List some of the criticisms that can be made of historical cost accounting in times of rising prices. (LO5.XX)
- 5.3 Why do you think that corporate management might prefer to be valued on the basis of current market prices rather than being required to value assets on the basis of historical costs? (LO5.XX)
- 5.4 As shown in this chapter, Mautz (1973) made the following statement: 'Accounting is what it is today not so much because of the demands of businessmen, but because of the influence of businessmen. If those who make investment decisions had not found financial reports based on historical costs, changes in accounting would long since have been made.' Evaluate the statement. (LO5.XX)

FOOTNOTES

Extensive footnotes add insights and information, as well as linking to additional coverage of topics elsewhere in the text.

³⁶ Broadbent and Laughlin (2005) argue that the conception of 'public interest' will vary from person to person (and will also change over time).

DIGITAL RESOURCES



The Online Learning Centre (OLC) that accompanies this text helps you get the most from your course. It provides an enhanced learning experience beyond the printed page.

The OLC contains premium online resources. Students can access it by registering the code located at the front of this text. Instructors have access to an additional instructor-specific resource area.

www.mhhe.com/au/deegantheory4e

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E-STUDENT

Self-study quizzes

Students can test their knowledge of key concepts using our online quizzes. Each chapter has a set of multiple choice questions designed for self-paced revision. Answers to the questions are supplied along with references to the relevant sections in the book.

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PowerPoint® presentations

Prepared by Craig Deegan, these summarise the key points of each chapter. They may be downloaded and adapted to suit individual instructor requirements or distributed to students as lecture notes.

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Prepared by Craig Deegan, the solutions manual contains comprehensive rationales and solutions to end-of-chapter questions and problems.

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Testbank

A bank of test questions written specifically for this text allows instructors to build examinations and assessments quickly and easily. The testbank is available in a range of flexible formats: in Microsoft Word®, in EZ Test Online or formatted for delivery via Blackboard or other learning management systems.

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