Preface to Volume I

In 1977, Tom Dyckman, then Director of Research for the American Accounting Association (AAA) encouraged Joel Demski and Jerry Feltham to submit a proposal for a monograph in the AAA Research Monograph series, "on the state of the art in information economics as it impacts on accounting." Joel and Jerry prepared a proposal entitled:

"Economic Returns to Accounting Information in a Multiperson Setting"

The proposal was accepted by the AAA in 1978, and Joel and Jerry worked on the monograph for the next few years, producing several of the proposed chapters. However, the task went more slowly and proved more daunting than expected. They were at separate universities and both found that, as they wrote and taught, they kept finding "holes" in the literature that they felt "needed to be filled" before completing the monograph. This, plus the rapid expansion of the field, meant they were continually chasing an elusive goal.

In the early nineties, Joel and Jerry faced up to the fact that they would never complete the monograph. However, rather than agree to total abandonment, Jerry "reserved the right" to return to the project. While, at that time, he did not expect to do so, he did have 500 pages of lecture notes that had been developed in teaching two analytical Ph.D. seminars in accounting: "Economic Analysis of Accounting Information in Markets," and "Economic Analysis of Accounting Information in Organizations."

Over the years, Jerry had received several requests for his teaching notes. These notes had the advantage of pulling together the major work in the field and of being done in one notation. However, they were very terse and mathematical, having been designed for use in class where Jerry could personally present the intuition behind the various models and their results. To produce a book based on the notes would require integration of the "words" and "graphs" used in the lectures into the notes (and there were still holes to fill).

Peter Christensen had been a student in one of Jerry's classes in 1986. In 1997, Peter asked Jerry if he was going to write a book based on his lecture notes. When Jerry stated it was too big a task to tackle alone, Peter indicated his willingness to become a coauthor. This was an important factor in Jerry's decision to return to the book, since he had worked effectively with Peter in publishing several papers over the preceding 10 years. Also of significance was our assessment that young researchers and Ph.D. students would benefit from a book that provides efficient access to the basic work in the field. The book need not try to provide all the latest results and it need not "fill the holes". The objective is to lay an integrated foundation that provides young researchers with the tools necessary to insightfully read the latest work in the field, and to develop their own theoretical analyses.

Parallel to Jerry's two Ph.D. courses, the book is divided into two volumes.

Economics of Accounting: Volume I – Information in Markets
Economics of Accounting: Volume II – Performance Evaluation

Chapter 1 gives an overview of the content of Volume I, while Chapter 16 gives an overview of the content of Volume II. Each volume is divided into several parts.

Volume I – Information in Markets
- Part A. Basic Decision-Facilitating Role of Information
- Part B. Public Information in Equity Markets
- Part C. Private Investor Information in Equity Markets
- Part D. Disclosure of Private Owner Information in Equity and Product Markets

Volume II – Performance Evaluation
- Part E. Performance Evaluation in Single-Period/Single-Agent Settings
- Part F. Disclosure of Private Management Information in Single-Period/Single-Agent Settings
- Part G. Contracting in Multi-Period/Single-Agent Settings
- Part H. Contracting with Multiple Agents

The three chapters in Part A are foundational to both volumes. However, with occasional exceptions, one can read the material in Volume II without having read Parts B, C, and D of Volume I. Jerry begins both of his Ph.D. courses by ensuring all students understand the fundamental concepts covered in Part A, since these courses are offered in alternate years and the students differ with respect to which course they take first.

Students often seem to find it easier to grasp the material in Volume II, so there is some advantage to doing it first. However, conceptually, we prefer to cover the information in markets material first, and then consider management incentives. The advantage of this sequence is that management incentive models assume the manager contracts with a principal acting on behalf of the owners. The owners are investors, and Volume I explicitly considers investor preferences with respect to the firm's operations. Furthermore, while most principal-agent models implicitly assume incentive risks are firm-specific, there are models that recognize that incentive risks are influenced by both market-wide and firm-specific factors. To fully understand the impact of the market-wide factors on management incentives, one needs to understand how the manager can personally invest in the market so as to efficiently share market-wide risks with other investors. The first volume provides the necessary background for this type of analysis.

Acknowledgments
Our greatest debt is to Joel Demski. Joel and Jerry were colleagues at Stanford from 1967 to 1971, and collaborated on some of the early information economics research in accounting. Their initial work focused on the role of accounting information in facilitating management decisions, and culminated in the book, *Cost Determination: A Conceptual Approach*. In that book they recognized that accounting had both a decision-facilitating and a decision-influencing role, but the book focused on the former. While completing that book, Joel and Jerry were exposed to work in economics which explicitly considered information asymmetries with respect to management's information and actions. They recognized that this type of economic analysis had much to contribute to our knowledge about the decision-influencing role of accounting. In 1978 they published a paper in *The Accounting Review*, "Economic Incentives in Budgetary Control Systems," which would later receive the AAA 1994 Seminal Contribution to Accounting Literature Award. One of Joel's many Ph.D. students, John Christensen, was instrumental to Peter's interest in accounting research. In recent years, Peter, as with Jerry, has had the opportunity to learn much from working with Joel on joint research.

We also want to acknowledge our debt to other coauthors who have significantly contributed to our knowledge through the joint research process. These include Joy Begley, Hans Frimor, Jack Hughes, Jim Ohlson, Jinhan Pae, Martin Wu, and Jim Xie. Their names are mentioned frequently throughout the two volumes, as we describe some of the models and results from the associated papers.

As noted above, Jerry's Ph.D. lecture notes provide the foundation for much of the material in our two volumes. Jerry acknowledges that he has learned much from preparing the notes for his students and interacting with them as they sought to learn how to apply economic analysis to accounting. The accounting Ph.D. students who have been in Jerry's classes as he developed the notes include Amin Amershi, Derek Chan, Peter Clarkson, Lucie Courteau, Hans Frimor, Pat Hughes, Jennifer Kao, Claude Laurin, Xiaohong Liu, Ella Mae Matsumura, Jinhan Pae, Suil Pae, Florin Sabac, Jane Saly, Mandira Sankar, Mike Stein, Pat Tan, Martin Wu, and Jim Xie. Some have been Jerry's research assistants, some have been his coauthors (see above), and Jerry has supervised the dissertations of many of these students. In addition to the accounting Ph.D. students, Jerry's Ph.D. seminars have been attended by graduate students in economics, finance, and management science, as well as a number of visiting scholars. All have contributed to the development of the material used in this book.

We are particularly appreciative of colleagues who have read some draft chapters and given us feedback that directly helped us to improve the book. These include Hans Frimor, Jim Ohlson, Alex Thevaranjan, and Martin Wu. Recently, Anne Adithipyangkul, Yanmin Gao, and Yinghua Li (three current Ph.D. students) have served as Jerry's research assistants and have carefully read through the recent drafts of all of the chapters. We are thankful for their diligence and enthusiasm. We are grateful to Peter's secretary, Lene Holbæk, for her substantial editorial assistance.

Jerry's research has been supported by funds from the American Accounting Association, his Arthur Andersen Professorship, and the Social Sciences and Humanities Research Council of Canada. Peter's research has been supported by funds from the Danish Association of Certified Public Accountants, and the Social Sciences Research Council of Denmark.

The writing of a book is a time consuming process. Moreover, every stage takes more time than planned. One must be optimistic to take on the challenge, and then one must constantly refocus as various self imposed deadlines are past. We are particularly thankful for the loving patience and good humor of our wives, Else and June, who had to put up with our constant compulsion to work on the book. Also, Peter has three sons at home, Kasper, Esben, and Anders. They had to share Peter's time with the book, but they also enjoyed a sabbatical year in Vancouver.

Peter O. Christensen

Gerald A. Feltham

Preface to Volume II

As we stated in the preceding "Preface to Volume I," Volume II focuses on accounting's decision-influencing role in the form of providing performance measures that are useful for incentive contracting. Part A of Volume I contains three chapters that provide foundational material on the decision-facilitating role of information: single-person decision making under uncertainty, decision-facilitating information, and risk sharing, congruent preferences, and information in partnerships. If the reader is not familiar with the basics, you are encouraged to read those three chapters before reading this second volume.

While it is helpful to have read Parts C, D. and E of Volume I before reading Volume II, it is not necessary for the vast majority of topics. The exceptions are the few sections in Volume II in which we consider either private investor information or the impact of economy-wide versus firm-specific risks, assuming only the latter are diversifiable.

Chapter 16 gives an overview of the content of Volume II, which is now divided into the following four parts.

Part E. Performance Evaluation in Single-period/Single-agent Settings
Part F. Private Agent Information and Renegotiation in Single-period/Single-agent Settings
Part G. Contracting in Multi-period/Single-agent Settings
Part H. Contracting with Multiple Agents in Single-period Settings

Acknowledgments
This second volume is a direct outgrowth of the work Joel Demski and Jerry started in their 1978 *Accounting Review* paper, "Economic Incentives in Budgetary Control Systems." This paper later received the AAA 1994 Seminal Contribution to Accounting Literature Award. Joel is referenced many times throughout this volume because he has produced a number of significant papers dealing with agency theory. Other co-authors of papers referenced in this volume are Hans Frimor, Christian Hofmann, Florin Şabac, Martin Wu, and Jim Xie. We are also very thankful to Hans Frimor, Christian Hofmann, and Florin Şabac for their detailed comments on recent drafts of several chapters. Earlier drafts were read by Alex Thevaranjan, and Martin Wu, as well as by three Ph.D. students who are currently finishing their dissertations: Anne Adithipyangkul, Yanmin Gao, and Yinghua Li. We are thankful to all who have contributed to the two

volumes, and we are grateful to Peter's secretary, Lene Holbæk, for her substantial editorial assistance.

Jerry's research on the second volume has been supported by funds from his Arthur Andersen Professorship, his Deloitte and Touche Professorship, and the Social Sciences and Humanities Research Council of Canada. Peter's research has been supported by funds from the Danish Association of Certified Public Accountants, and the Social Sciences Research Council of Denmark.

Our wives, Else and June, have endured the long, and often consuming, process as we worked to complete a second volume of over 600 pages. We again thank them for their loving care and good humor. Also, Peter has three sons, Kasper, Esben, and Anders, who have had to share Peter's time with the book.

Peter O. Christensen

Gerald A. Feltham