Intermediate Accounting Volume 1 (Canadian) 12th edition Kieso Solutions Manual

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CHAPTER 1

THE CANADIAN FINANCIAL REPORTING ENVIRONMENT

Learning Objectives

1. Understand the financial reporting environment.
2. Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.
3. Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.
4. Discuss some of the challenges and opportunities for accounting.

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Summary of Questions by Learning Objectives and Bloom's Taxonomy

Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT	Item	LO	BT
Brief Exercises														
1.	1	C	6.	2	C	11.	2	C	16.	3	C	21.	4	C
2.	1	C	7.	1	C	12.	2	C	17.	3	C	22.	4	C
3.	1	K	8.	2	C	13.	2	C	18.	3	C	23.	4	C
4.	1	C	9.	2	C	14.	3	C	19.	4	C	24.	4	C
5.	1	C	10.	2	C	15.	3	C	20.	4	C	25.	4	C
Cases														
1.	1	C	2.	1	C	3.	1	C	4.	1	C	5.	1	C
Research and Analysis														
1	1	AN	2	2	AN	3	2	C	4	4	AN	5	2	C
6	2	C	7	4	AN	8	1	C	9	1	AN	10	1	C
11	3	AN	12	5	C	13	3	AN	14	5	C	15	1	C
16	2,4	C	17	2	C	18	1	AN	19	3	C			

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Legend**:** The following abbreviations will appear throughout the solutions manual file.

LO	Learning objective	
	Bloom's	
BT	Taxonomy	
	K	Knowledge
	C	Comprehension
	AP	Application
	AN	Analysis
	S	Synthesis
	E	Evaluation
Difficulty:	Level of difficulty	
	S	Simple
	M	Moderate
	C	Complex
Time:	Estimated time to complete in minutes	
AACSB	Association to Advance Collegiate Schools of Business	
	Communication	Communication
	Ethics	Ethics
	Analytic	Analytic
	Tech.	Technology
	Diversity	Diversity
	Reflec. Thinking	Reflective Thinking
CPA CM	CPA Canada Competency Map	
	Ethics	Professional and Ethical Behaviour
	PS and DM	Problem-Solving and Decision-Making
	Comm.	Communication
	Self-Mgt.	Self-Management
	Team & Lead	Teamwork and Leadership
	Reporting	Financial Reporting
	Stat. & Gov.	Strategy and Governance
	Mgt. Accounting	Management Accounting
	Audit	Audit and Assurance
	Finance	Finance
	Tax	Taxation

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ASSIGNMENT CLASSIFICATION TABLE

Topic		Brief Exercises	Cases
1.	Financial statements and financial reporting.	7	
2.	Capital allocation.	1	
3.	Stakeholders.	2	3, 4, 5
4.	Objectives of financial reporting.	3, 15, 23	
5.	Management bias in financial reporting.		1, 2, 4, 5
6.	Importance of user needs in financial reporting.	7, 15	
7.	Need for accounting standards.	6, 7, 8	
8.	Parties involved in standard-setting.	8, 9, 10, 11, 12, 13, 14, 15	
9.	GAAP.	16, 17, 18, 19	
10.	Professional judgement.	20, 21	
11.	Ethical issues.	22, 24	1, 2, 5
12.	Challenges facing financial accounting	21, 25, 26	
13.	Information asymmetry	4, 5	

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SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 1-1

Accounting has the responsibility of measuring company performance accurately and fairly on a timely basis. This enables investors and creditors to assess the relative risks and returns of investment opportunities and channel resources more effectively. If a company's financial performance is measured accurately, fairly, and on a timely basis, the right managers and companies are able to attract investment capital. Unreliable and irrelevant information leads to poor capital allocation, which adversely affects the securities market and ultimately the performance of the economy as a whole.

LO 1 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-2

Some stakeholders using financial accounting information and financial statements include:

Investors – These stakeholders are interested in the performance of their investment in the company. They will use the financial statements to evaluate management stewardship and effectiveness.

Creditors – These stakeholders are interested in evaluating the company to decide whether to lend it money. They use the statements to evaluate the risk that will be taken in making the loan. For example, lenders want to know whether the company will be able to repay its loans when due and service both interest and principal on a timely basis.

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BRIEF EXERCISE 1-2 (CONTINUED)

Canada Revenue Agency (CRA) – This stakeholder establishes the rules for measuring taxable income. It is interested in the fair measurement of the financial position and financial performance of the company so that the appropriate amount of tax will be paid. The financial statement's net income is the starting point in preparing tax returns. Net income for accounting purposes is adjusted to arrive at net income for tax purposes, which is used to calculate the amount of tax payable. The CRA is principally interested in compliance with the Income Tax Act.

Financial Analysts – These stakeholders provide investment advice to their clients. They are interested in evaluating the investment opportunities and potential of various companies.

Note: This is only a suggested list of stakeholders and their possible uses of the financial accounting information. There are many other stakeholders as discussed in the chapter that would be acceptable answers to this question.

Different stakeholders make different decisions that require different information. For example, lenders want to know whether the company will be able to repay its loans but the Canada Revenue Agency (CRA) wants to know the amount of taxes that should be paid for the current year. Much of the information that the lenders would request, such as who are the company's major customers and the amounts they owe the company, would be of no interest to the CRA for income tax purposes yet may be of relevance in a GST/HST review.

LO 1 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-3

The overall objective of financial reporting is to provide financial information that is useful to users (primarily capital providers such as investors and lenders) and that is decision relevant (i.e., will help them make decisions about allocating capital). The statements should communicate information about:

1. **the entity's economic resources and claims to those resources and**
2. **changes in those resources and claims.**

Note the emphasis on resource (or capital) allocation decisions, which requires a focus on the statement of financial position. The assessment of management stewardship is also important since users need to know whether management is doing their job to maximize shareholder value (which is also called fiduciary duty). As a general rule, it is assumed that management stewardship is already taken into account in the resource allocation decision.

LO 1 BT: K Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-4

Information asymmetry exists when one stakeholder in the financial reporting process has more or different information than another. For example, management generally has more information about the company than external investors or creditors. While it is neither practical nor optimal for perfect information symmetry to exist, financial reporting serves the role of ensuring that relevant information is properly communicated to external parties such as investors, and others.

LO 1 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-5

Where information asymmetry exists, there is a risk that the party with the additional information will act in its own self-interest to the detriment of the other party and/or the capital market in general. For instance, management might withhold negative information about the company for fear that it will hurt the manager's bonus. This would not be optimal for external parties such as creditors and investors who may need that information before they invest or lend the company money. The risk that the party with the additional information may act in its own self-interest is known as moral hazard. If people understand that this behaviour is tolerated in the marketplace, the marketplace may attract people and companies that accept and tolerate this behaviour (known as adverse selection). This will degrade the capital marketplace as there will be less transparency and information sharing and thus suboptimal capital allocation.

LO 1 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-6

A common set of standards applied by all businesses and entities provides financial statements which are reasonably comparable. Without a common set of standards, each enterprise could, and would, develop its own theory structure and set of financial reporting practices, resulting in a lack of comparability among enterprises.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-7

General-purpose financial statements are not likely to satisfy the specific needs of all interested parties. Since the needs of interested parties such as creditors, managers, owners, governmental agencies, and financial analysts vary considerably, it is unlikely that one set of financial statements would be equally appropriate for these varied uses. The level of detail in financial statements is based on specific requirements in accounting standards and management's perception of users' needs, balanced against the cost of providing this additional information.

LO 1 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-8

Accounting was affected and changed between 1900 and 1930 by the growth of the corporate form of enterprise, the growing separation of management from ownership, the imposition of tax on business and individual income, and the stock market crash (attributed in part to lax accounting standards and oversight), and the subsequent great depression.

LO 2 BT: C Difficulty: M Time: 5 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-9

The International Accounting Standards Board (IASB) is the dominant standard setting body in the world in 126 jurisdictions, including all of the G20 jurisdictions. Thousands of companies throughout the world will use either the full IFRS or the version for small and medium size enterprises.

According to the IFRS web site: "Our mission is to bring transparency, accountability and efficiency to financial markets around the world by developing IFRS Standards. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy."
See: www.ifrs.org for further details.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-10

The Accounting Standards Board (AcSB) of Canada has primary responsibility for setting GAAP in Canada. This is accomplished through a lengthy and complex process. Two basic premises underlie the process of establishing financial accounting standards: (1) the AcSB should respond to the needs and viewpoints of the entire economic community, not just the public accounting profession, and (2) it should operate in full public view through a "due process" system that gives interested persons enough opportunity to make their views known. The Accounting Standards Oversight Council (AcSOC) oversees AcSB activities: its activities include setting the agenda and reporting to the public, among other things.

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BRIEF EXERCISE 1-10 (CONTINUED)

The AcSB is responsible for setting standards for non-publicly accountable private enterprises (ASPE), not-for-profit entities, and pension plans only. Standards for publicly accountable entities are set by the International Accounting Standards Board (IASB). It is important to note that non-publicly accountable entities also have the option to use IFRS.

LO 2 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-11

The Provincial Securities Commissions (including the Ontario Securities Commission) collectively are one of the stakeholders in standard-setting. Standard-setting is the responsibility of the Accounting Standards Board (AcSB) (for ASPE) and the International Accounting Standards Board (IASB) (for IFRS). The Accounting Standards Oversight Council (AcSOC) sets the strategic direction and priorities of the AcSB. AcSOC membership consists of regulators and representatives of the financial analyst communities, amongst others.

The OSC issues its own disclosure requirements. These additional requirements are applicable only to companies registered with the OSC.

LO 2 BT: C Difficulty: S Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-12

One of the functions of the Ontario Securities Commission (OSC) and the Securities and Exchange Commission (SEC) is to represent and protect the interests of investors. They do not represent the interests of different users of financial information. Since the early 1970s CPA Canada and its predecessor CICA had the sole legislative and regulatory authority to set national private sector accounting standards in Canada. It delegates this to the AcSB. Starting in 2011, the AcSB is responsible for ASPE and the IASB is responsible for IFRS. This ensures that accounting standards have a high degree of acceptance from its broad community of constituents.

LO 2 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-13

The sources of pressure are innumerable, but the most intense and continuous pressure to change or influence accounting principles or standards comes from individual companies, industry associations, governmental agencies, securities commissions, practicing accountants, academicians, professional accounting organizations, and public opinion. As we move towards international harmonization, the U.S. accounting standards will have a continuing influence on IFRS due to the significant capital pool and flows associated with U.S. markets.

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BRIEF EXERCISE 1-14

The users of financial information from public companies have different needs than the users of financial information from private companies. Public corporations need the opportunity to present financial information using consistent accounting rules as those used globally. To accomplish this, public companies need to follow the International Financial Reporting Standards (IFRS). Doing so helps Canadian companies compete in a global market. Following this set of policies and standards is not essential to privately owned businesses who may have less complex business models and/or fewer financial statement users, who do not expect as extensive measurement and disclosure requirements as those required under IFRS.

LO 3 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-15

No one particular proposal is expected in answer to this question. The students' proposals, however, should be defensible relative to the following criteria:

1. **The method must be efficient, responsive, and expeditious.**
2. **The method must be free of bias and be above or insulated from pressure groups.**
3. **The method must have legislative authority or otherwise command widespread support.**
4. **The method must produce sound yet practicable accounting principles or standards.**

The students' proposals might take the form of alterations of the existing methodology, an accounting court, or governmental device.

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BRIEF EXERCISE 1-16

The explanation should note that generally accepted accounting principles have "substantial authoritative support." They consist of accounting practices, procedures, theories, and broad principles and conventions of general application, including underlying concepts and methods, which are recognized by a large majority of practicing accountants as well as other members of the business and financial community. GAAP is divided into primary and other sources. Primary sources must be looked to first for how to treat an issue. Where primary sources do not deal with the issue, the accounting policy selected must be consistent with the primary sources as well as developed through use of professional judgement in accordance with the conceptual framework.

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BRIEF EXERCISE 1-17

Primary sources of GAAP are the core standards. Where these standards do not cover the accounting in question, then other sources are looked to. Judgment must be applied in looking at these other sources to ensure that they are appropriate and relevant.

For public companies or private companies choosing to follow IFRS, GAAP incorporates IFRS, IAS, and Interpretations. Some IFRS and IAS are accompanied by guidance. The guidance will note whether it is an integral part of the IFRS or IAS or not. Other sources include pronouncements of other standard setting bodies, other accounting literature and accepted industry practices. The entity may also look at IFRS for similar or related transactions.

For private companies following ASPE, primary sources of GAAP include (in descending order of authority) the *CPA Canada Handbook* sections 1400 to 3870 including Appendices and Accounting Guidelines including Appendices. Other sources include Background information and Basis for conclusions documents, pronouncements from other standard setting bodies including IFRS and other sources such as accounting text books, journals and articles. ASPE specifically labels the sources as being primary sources or other sources.

An entity should apply every primary source of GAAP that deals with the accounting and reporting of transactions encountered by an entity. This means that primary sources must be looked to first.

Where primary sources do not deal with a specific issue, the entity should use judgment in looking to the other sources and then adopt accounting policies that are consistent with the primary sources as well as the Conceptual Framework.

LO 3 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-18

The chair of the FASB was indicating that too much attention is put on the bottom line and not enough on the development of quality products. Managers should be less concerned with short-term results and be more concerned with the long-term results. In addition, short-term tax benefits often lead to long-term problems.

The second part of his comment relates to accountants being overly concerned with following a set of rules, so that if litigation ensues, they will be able to argue that they followed the rules exactly. The problem with this approach is that accountants often seem to want more and more rules with less reliance on professional judgement. Less professional judgement leads to inappropriate use of accounting procedures in difficult situations.

In the accountants' defense, recent legal decisions have imposed vast new liability on accountants. The concept of accountant's liability that has emerged in these cases is broad and expansive; the number of classes of people to whom the accountant is held responsible is almost limitless.

LO 3 BT: C Difficulty: M Time: 15 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-19

”Economic consequences” means the impact of accounting reports on the wealth positions of issuers and users of financial information and the decision-making behaviour resulting from that impact. In other words, accounting information impacts various users in many different ways, which leads to wealth transfers among these various groups.

If politics plays too much of a role in the development of accounting standards, standards could become subject to manipulation for the purpose of furthering whatever policy prevails at the moment. No matter how well intentioned the standard setters may be, if information is designed to indicate that investing in a particular enterprise or industry involves less risk than it actually does, or is designed to encourage investment in a particular segment of the economy, financial reporting will suffer an irreplaceable loss of credibility.

LO 4 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-20

Principles-based standards are considered to be based on a conceptual framework and the accounting principles that result may require significant professional judgement in interpreting and applying the standards to ensure compliance. Rules-based standards are generally quite detailed, and in many instances follow a "check-box" mentality that some contend may shield accountants, auditors and companies from legal liability. IFRS and ASPE tend to follow the principles-based standard-setting system, while U.S. GAAP is generally considered more rules-based (even though it is based on principles). This is because it is more prescriptive and detail-oriented.

LO 4 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-21

Concern exists about fraudulent financial reporting because it can undermine the entire financial reporting process. Failure to provide information to users that is accurate can lead to inappropriate allocations of resources in our economy. In addition, failure to detect massive fraud can lead to additional governmental oversight of the accounting profession and financial reporting more generally.

Even though GAAP (including IFRS and ASPE) provides structured information that is relevant and represents underlying business transactions and events, it may be manipulated. This is because the various stakeholders in the process often act in their own self-interest. For instance, members of management may seek to optimize their own bonus or the value of their stock options.

LO 4 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-22

Some of the reasons for difference include:

1. **The objectives of financial reporting often differ among countries.**
2. **The institutional structures are often not comparable.**
3. **Strong nationalist tendencies may be pervasive and therefore there is reluctance to adopt any one country's approach.**

LO 4 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

BRIEF EXERCISE 1-23

Accountants must perceive the moral dimensions of some situations because GAAP does not define or cover all specific features that are to be reported in financial statements. In these instances accountants must choose among alternatives. These accounting choices influence whether particular stakeholders may be harmed or benefited. Ethical decision-making involves awareness of potential harm or benefit and taking responsibility for the choices, which should always consider the public interest.

LO 4 BT: C Difficulty: M Time: 10 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-24

Some major challenges facing the accounting profession relate to the following items:

Credibility – how to regain public confidence in the aftermath of corporate fraud and poor reporting practices.

Globalization of companies and capital markets – Canadian companies are operating and trading securities in global markets and are subject to accounting regulations in other jurisdictions. Canadian investors are investing in the global marketplace.

Non-financial measurement – how to report significant key performance indicators such as customer satisfaction indexes, backlog information and reject rates on goods purchased.

Soft assets – how to measure and report intangible assets, such as market know-how, intellectual capital, market dominance, and well-trained employees.

Timeliness – how to report more reliable real-time information in the Internet age.

LO 4 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001 CM: Reporting

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BRIEF EXERCISE 1-25

The following are some of the key provisions of the Sarbanes-Oxley Act (SOX), enacted in 2002:

- **Establishes an oversight board for accounting practices. The Public Company Accounting Oversight Board (PCAOB) has oversight and enforcement authority and establishes auditing, quality control, and independence standards and rules for Auditors.**
- **Implements stronger independence rules for auditors. Audit partners, for example, are required to rotate every five years and auditors are prohibited from offering certain types of consulting services to corporate clients.**
- **Requires CEOs and CFOs to personally certify that financial statements and disclosures are accurate and complete and requires CEOs and CFOs to forfeit bonuses and profit sharing when there is an accounting restatement.**
- **Company management must report on the effectiveness of the financial reporting internal control system and the auditors must assess and report on these internal controls.**
- **Requires audit committees of Boards of Directors to be comprised of independent members and members with financial expertise.**
- **Companies must disclose whether they have a code of ethics for their senior financial officers.**

In Canada, many of the SOX requirements have been put in place, in part by pronouncements by Canadian securities administrators such as the OSC.

LO 4 BT: C Difficulty: M Time: 20 min. AACSB: None CPA: cpa-t001, cpa-t004 CM: Reporting and Audit

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CASES

See the Case Primer on the Student Website as well as the summary case primer in the front of the text. Note that the first few chapters of the text lay the foundation for financial reporting decision-making. Therefore the cases in the first few chapters (1–5) are shorter with less depth. As such, they may not cover all aspects of a full-blown case analysis.

CA 1-1 ETHICS

a.
Sherry Tsang is faced with an ethical dilemma. On a personal level, she wishes her business to become and/or remain successful thereby retaining its ability to continue operations to provide her with an increase in wealth as a shareholder. By reporting profit from operations, two of the means to this objective can be met. They include the retention of a government grant and the renewal of a bank loan to finance her operations.

If the business is very profitable, the choices Sherry will need to make in accounting for estimates or choosing accounting policies will likely not be influenced by her concern to achieve profitability. On the other hand, if the results are poor and show that the government grant and bank loan could be in jeopardy, Sherry will be tempted to exercise control over the outcome as the preparer of the financial statements. She can apply a biased approach concerning the measurement and recording of transactions as well as the presentation and disclosure contained in the financial statements of her business.

Sherry is not independent to the business. The financial statements are not being reviewed or audited by an independent accountant. Sherry's motivation to exclude the involvement of an independent accountant is to achieve cost reduction. She has placed herself in a precarious position and this demonstrates poor judgement on her part. If she involved an independent accountant when applying for the government grant and/or the bank loan, failing to use that expertise for the preparation of year-end financial statements will attract signification attention by the financial statement users. Upon query by the users concerning the results, if false or biased approaches were taken by Sherry in the preparation of the information, it will not matter if profitability could have been achieved in spite of her biased approach. The bank will not renew the loan and the government will not renew the grant because of the lack of confidence in Sherry. Her reputation will consequently be severely hurt and may cause her not to be able to secure necessary financing for future operations.

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CA 1-1 ETHICS (CONTINUED)

b.
The business is small and is not a public company. Consequently, Sherry is not required to follow IFRS and can follow ASPE. As a small company, ASPE would result in more cost effective financial statement preparation as the standards generally require less detailed presentation. However, if Sherry has plans to expand and take the corporation public in the future, she would be well advised to follow IFRS.

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CA 1-2 PRENTICE

Overview:

- Reported net income is a key focus for management – represents a reporting bias.
- Controller (Paula) is concerned about doing the right thing – not just doing what is required under GAAP.

Analysis and Recommendation:

- GAAP constrained companies must adopt new standards as prescribed in the *CPA Canada Handbook* (publicly accountable entities follow IFRS which is included as Part I to the *CPA Canada Handbook* and private entities follow ASPE which is Part II to the *CPA Canada Handbook or IFRS*). Normally the standard setters give companies some lead time so that they may ensure that they have all the appropriate information needed to present the information.
- They are not required to change to a new standard until GAAP requires it (the date is written into each standard), although early adoption is usually encouraged as part of the standard's implementation guidelines.
- The issue is whether to adopt a change earlier even though not required or later when required.

	Adopt new standard as required	Adopt new standard earlier than required
	- GAAP requirements are met. - Need additional time to ensure that the company has all the information needed to prepare the financial statements under the new standard i.e. to ensure **reliable.** - Other.	- Provides greater **comparability** between years earlier if adopted earlier. - If this is the **better presentation**, why not share it with users as soon as possible. - Consideration of the impact on net income should not be a motivator for making the financial reporting decision **(unbiased**). - Other.

- In conclusion, earlier adoption of the standard is always encouraged and should be attempted where the costs of doing so do not exceed the benefits.

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CA 1-3 VERITY RETAIL LIMITED

Overview

- When the company went public, IFRS became a legal constraint.
- The company was in the retail sales business and was struggling to maintain financial solvency. It had hired new management to turn the company around – they may have had an interest in showing the company in a better light than in reality. When it went public, the company appeared as though it had turned a corner (presumably thanks to the new management team). Thus the shares sold at $15 per share. Note that the selling price would consider sustainable earnings.
- Subsequently, after going public, the company could not sustain its earnings and the share price dropped. Many shareholders lost their investments.

a. Prior to Verity Retail Limited going public, it would have been required to follow IFRS for several years prior to the initial public offering in order to have comparative financial information prepared on a consistent basis.

b and c.

Stakeholders included:

1. The investors and potential investors who relied on the financial statements in deciding whether to invest or not. They would have been influenced by the net income as well as cash from operations as presented in the notes to the financial statements.
2. The management and prior owners of the company – since the company was private, the prior owners stood to gain because of the higher share price at the time they took the company public. They would not have been affected by subsequent stock price declines once they had sold their share of the business.
3. The auditors – the auditors signed off on the statements that the investors would have relied on in making their decisions. They would have provided assurance that the financial statements presented fairly the results of operations. Subsequently, investors would be able to sue the auditors successfully if they could prove that the information was misleading.
4. Other—creditors, customers, employees, etc.

N.B. Since there are no financial reporting issues (i.e. dealing with recognition, measurement, presentation or disclosure) the analysis and recommendations section of this solution is not presented.

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CA 1-4 GRAND LIMITED

a. Are the credit rating agencies stakeholders from Grand Limited's perspective? Yes – they rate companies in terms of credit risk and therefore their customers rely on them for accurate and well researched credit ratings. They would not necessarily give a credit rating lightly without doing the proper research. If they are wrong, their own business and reputation will suffer.

b. Knowing that a credit rating agency will be rating their debt, Grand would be biased to make sure that they obtain the best rating possible. Since the financial statements will be used by the rating agency to rate the company, there is a risk that the financial statements might paint the company in a more favourable light.

   The impact of a negative rating on Grand is that the company may have a more difficult time borrowing funds and will have to pay a higher rate of interest. The rating reflects the perceived financial strength of the company and the lower rating means that the company's fiscal responsibility may be in question. This may affect the company's long-term outlook and ability to carry out long-term contracts requiring long-term financing.

   The fact that Grand's bonds now have the status of "junk bonds" means that the number of institutional investors interested in Grand will be much lower since their rating has fallen below the level acceptable for many pensions and mutual funds. "Junk" bonds are considered speculative investments and are attractive only to those investors seeking higher returns and who are willing to take on the increased default risk associated with bonds in this category.

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CA 1-5 SAVE THE TREES (STT)

a. The stakeholders in this case include:
   i. The citizens of the city
   ii. The staff, management and Board of the not-for-profit organization
   iii. The (municipal, provincial or federal) government that is providing grants for funding the not-for-profit organization

   All stakeholders have a vested interest in ensuring that Save the Trees (STT) succeeds in keeping cities green by planting and looking after trees. The citizens who pay taxes enjoy the benefits of the activities of STT. The organization itself is invested in its activities to reach their mandate, and the government is responsible to spend money wisely in providing its citizens with green spaces that have trees.

b. Save the Trees (STT) should follow GAAP for not-for-profit organizations as provided in Part III – Accounting Standards for Not-for-Profit Organizations of the *CPA Canada Handbook.* Because not-for-profit organizations do not have shareholders and are not involved in typical business ventures to create profits, no goal exists to amass wealth for owners.

   The spending mandate of these organizations is imposed by its members and contributors. Contributors include individuals, corporations, organizations and other donors such as governments and other public sector bodies that grant funds for specified and non-specified purposes.

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RESEARCH AND ANALYSIS

RA 1-1 STANDARDIZED VERSUS VOLUNTARY DISCLOSURE

It is not appropriate to abandon mandatory accounting standards and allow each company to voluntarily disclose the type of information it considers important. Without a coherent body of accounting theory and standards, each accountant or enterprise would have to develop its own theory structure and set of practices, and readers of financial statements would have to familiarize themselves with every company's own accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared and there would be a tremendous waste of resources in both preparation and in analysis.

Further, GAAP has been set by standard setters to help with the preparation of financial statements and to help reduce management bias. A single set of general-purpose financial statements is prepared to meet the majority of users' needs.

In addition, voluntary disclosure may not be an efficient way of disseminating information. Some companies will be likely to disclose less information if given the discretion. Thus, companies can reduce the cost of assembling and disseminating information. However, an investor wishing additional information has to pay to receive the desired additional information. Different investors may be interested in different types of information. Since the company may not be equipped to provide the requested information, it would have to spend additional resources to fulfill such needs; or the company may refuse to supply such information if it is too costly to do so. As a result, investors may not get the desired information or they may have to pay a significant amount of money for it. Furthermore, redundancy in gathering and distributing information occurs when different investors ask for the same information at different points of time. To the society as a whole, this would not be an efficient way of utilizing resources.

Note that a contrary argument to companies providing less disclosure is set out in the "competitive disclosure hypothesis" which suggests that companies in competition for scarce capital resources will actively increase their disclosure to reduce their perceived risk and therefore reduce their cost of capital and increase their access to investors.

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RA 1-2 POLITICIZATION OF STANDARD SETTING

a. Arguments for politicization of the accounting standard-setting process:
   1. Accounting standards and financial reporting depend in large part on public confidence for its success. Consequently, the critical issues are not solely technical, so all those having a bona fide interest in the output of accounting should have some influence on that output. In fact, all stakeholders can comment on proposed changes and new standards through the "due process" that standard setting entails.
   2. There are numerous conflicts between various interest groups. In the face of this, compromise is necessary, particularly since many of the critical issues in accounting are value judgements, not the type that can be solved, as we have traditionally assumed, using deterministic models. Only in this way (reasonable compromise) will the financial community have confidence in the fairness and objectivity of the accounting standard setting process.
   3. Over the years, accountants have been unable to establish, on the basis of technical accounting elements, rules which would bring about the desired uniformity and acceptability. This inability itself indicates that standard-setting is primarily consensual in nature.
   4. Since the economic well-being of businesses and individuals is influenced to a substantial degree by accounting standards, it is only natural that they should try to influence or control the factors that determine this. Businesses and individuals would also want to ensure that accounting standards reflect the realities of financial activity in their particular industry.

b. Arguments against the politicization of the accounting standard-setting process:
   1. Many accountants feel that accounting is primarily technical in nature. Consequently, they feel that substantive, basic research by objective, independent, and fair-minded researchers ultimately will result in the best solutions to critical issues, such as the concepts of income and capital, even if it is accepted that there isn't necessarily a single "right" solution for most accounting issues.
   2. Even if it is accepted that there are no "absolute truths" as far as critical issues are concerned, many feel that professional accountants—because of their independence, education, training, and objectivity—are in the best position to decide what generally accepted accounting principles should be, especially if one takes into account the diverse interests of the various groups using accounting information.
   3. The complex situations that arise in the business world require that trained accountants develop the appropriate accounting principles.
   4. The use of consensus to develop accounting principles would decrease the professional status of the accountant.
   5. This approach would lead to "lobbying" by various parties to influence the establishment of accounting principles.

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RA 1-3 ACCOUNTING STANDARD-SETTING MODELS

a. Model 2 is used in Canada—the private, professional approach. The *CPA Canada Handbook* is the sole responsibility of the AcSB. The membership of the AcSB is primarily made up of professional accountants. The self-regulating nature of the profession stems from tradition in general, and from the fact that the Canada Business Corporations Act and securities legislation have conferred legal authority on the provisions of the *CPA Canada Handbook*.

b. Publicly reported accounting numbers influence the distribution of scarce resources. Resources are channelled where needed at returns commensurate with perceived risk. Thus, reported accounting numbers have economic effects in that investment resources are transferred among entities and individuals as a consequence of these numbers. Labour unions have very significant assets and liabilities and operating results that need to be reported to their members to whom they are accountable. Trade associations want to act in the best interests of the companies in their industry, and may present a unified and collective voice on selected accounting issues that may affect the industry. It is not surprising then that individuals affected by these numbers will be extremely interested in any proposed changes in the financial reporting environment.

c. Some possible reasons why other groups might wish to establish standards are:
   1. As indicated in the previous answer, standards have economic effects and therefore certain groups would prefer to make their own standards to ensure that they receive just treatment.
   2. Some believe the AcSB does not act quickly to resolve accounting matters, either because it is not that interested in the subject area or because it lacks the resources to do so.
   3. Some argue that the AcSB should not set standards in certain areas, for example, provincial, federal and municipal governments, because the problems are unique and not well-known by the AcSB. The CPA Canada's Public Sector Accounting Board is charged with responsibility for accounting standards for public sector entities.

   The Ontario Securities Commission issues its own disclosure requirements in addition to those required by IFRS for publicly traded companies. The OSC reviews and monitors financial statements of publicly traded companies to determine whether the statements present fairly the financial position and results of operations of the companies.

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RA 1-4 CONTINUOUS REPORTING MODEL

The advantages of a continuous reporting model are that users would have access to information on a timelier basis. This in turn makes the information more relevant to their needs. The use of the internet to disseminate the information also allows the company to provide this information at a lower cost and to access a larger group of users. The use of technology also means that the companies can provide additional disclosure of information that traditionally was not available to small investors (for example, interviews with senior management, briefings with analysts, etc.).

The disadvantages of a continuous reporting model reflect the issue of the quality of the information. More timely information usually comes at the cost of less accurate information. As has been demonstrated with interim reporting, when the time frame of the information is shortened, additional estimates have to be made. This can lead to additional confusion for users if information has to be subsequently modified or reclassified. An additional issue for the quality of the information is oversight of the information provided. Current annual financial reports are audited and annual and interim reports are reviewed by securities commissions. The same review standards do not exist for continuous reporting. If these standards were required, this would significantly increase the cost of providing the information as well as the time lag.

The availability of information on company websites also means that companies are increasingly using non-GAAP financial measures and metrics, in addition to traditional financial reporting. Users now have access to high-quality, verified information through financial statements, as well as management's interpretation and analysis.

Corporate failures and issues related to corporate stock option plans have illustrated that investor confidence is key to the capital marketplace. The importance of audited, reliable information to users is critical to investor confidence and reiterates the need for periodic, audited information.

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RA1-5 FAIR PRESENTATION

Auditors are responsible for providing their opinion as to the fairness of the financial information presented in the companies' financial statements. This opinion is based to a large extent on whether the companies have followed GAAP. One of the main issues raised with respect to the Nortel misstatements is over accounting standards.

GAAP (IFRS and ASPE) is principles-based and requires significant judgement. On the positive side, this allows GAAP to be flexible in order to present information in the most representative way. However on the negative side, financial statement preparers may act in their own self-interest and provide biased information, especially where incentive systems such as bonuses and stock option plans exist.

An additional factor may be the relationship between the company and the auditors. The company may hide information or mislead the auditors. This is a significant audit risk. Although auditors design the audit to ensure that the financial statements are not materially misstated, it is not possible for the auditors to audit every document and transaction, nor to uncover situations where there has been intentional misrepresentation. In addition, estimates often have to be made at the reporting date which may have a wide range of error under certain conditions.

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RA 1-6 GOVERNMENT REGULATION

a. In the U.S., the Sarbanes-Oxley Act enacted by Congress aims at improving the accuracy and reliability of corporate disclosures by requiring chief executive and financial officers to certify quarterly and annual reports. Its provisions included new rules for auditors, conflict of interest guidelines and review of the efficacy of the rules-based system of public accounting in the US.

   In Canada, the Canadian Public Accountability Board (CPAB) was established to develop, codify and implement auditor quality control, and independence standards and rules. Stronger independence rules now exist for auditors; for example there must be a rotation of auditors every 5 years. If there is an accounting restatement, CEOs and CFOs must forfeit bonuses and profit sharing. The effectiveness of the financial reporting internal control systems must be reported on by management and auditors must assess and report on these internal controls. Audit committees must be made up of independent members and members with financial expertise. Companies must disclose whether there are codes of ethics with respect to their senior financial officers.

b Other options include tighter accounting standards and new regulatory measures intended to strengthen the independence and improve the accountability of external auditors.

   The profession is also pushing regulators to promulgate tougher disclosure standards for management discussion and analysis reports.

   The Ontario Securities Commission has developed new securities regulations in response to tougher US auditor rules. Echoing some of the key provisions in Sarbanes-Oxley, the new rules call for five-year engagement partner rotations, a prohibition on financial ties between audit team members and client firms, as well as strict limits on how firms perform non-assurance services for audit clients and what services may be provided. This is echoed by the profession's standard for auditor independence. These rules speak directly to the sorts of non-arm's length relationships that dramatically undermined Arthur Andersen's ability to provide investors with an objective analysis of Enron's murky financial condition.

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RA 1-6 GOVERNMENT REGULATION (CONTINUED)

c. The strengths of government regulation include an independent verification of the financial reporting process, the provision of assurance and increased investor confidence that financial reporting is monitored. Government regulation however, interferes with the free market economy and the self-regulating nature of financial reporting. It will also lead to higher costs and does not necessarily imply fully independent verification since government objectives do not always mesh with those of the economy. This could in turn lead to more politicization of the standard-setting process. Geographically-bound governments also may not address the issues of huge multi-national companies. Additional government regulation does not guarantee that another Enron-type situation will not reoccur. If corporate managers are determined to misrepresent results and commit fraud, additional government regulations will likely not prevent this from happening.

Developed in part from the article “After Enron”, by John Lorinc, CA Magazine, December 2002.

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RA 1-7 DISCLOSURES

a. Non-GAAP measures refer to measures or indicators of an entity's performance other than GAAP-reported net income (profit or loss) and/or comprehensive income. Companies often highlight a performance measure such as income before a number of specific expenses, such as EBIT (earnings before interest and taxes) or EBITDA (earnings before interest, taxes, depreciation and amortization) for example.

   Mr. Hoogervorst's concern relates to situations where companies exclude certain expenses in the period, contending that they should not be taken into account in assessing the current period's results or for predicting the results of operations going forward. Often this is a biased view of current results and the potential for future results. Many of such excluded costs are found on a fairly regular basis on the same company's financial statements going forward. One example of such an expense that is often backed out of net income in calculating the non-GAAP performance measure is restructuring costs. In addition, the adjusted non-GAAP measures tend to report a higher-than-GAAP performance result.

   Mr. Hoogervorst is very open-minded about non-GAAP measures, however. To the extent that there is widespread use of similar measures, he suggests that IFRS should consider whether there is something missing in what the IFRS requires and reports. For example, perhaps the term "operating income" should be defined in the standards.

b. While the extent of note disclosures in financial statements has been growing for many years, there are increased complaints from preparers that much of it is immaterial in nature. Therefore, much of it does not provide useful information. Mr. Hoogervorst contends that boilerplate disclosures contribute to this situation. "Boilerplate" refers to the type of disclosure that can be found in almost every company's notes – information that is so generic that it provides no additional information about the specific companies reporting. An example might be "These financial statements have been prepared using estimates and actual results may differ from the estimates used." The Chair of the IASB contends that these deficiencies can be overcome by the increased use of professional judgement by preparers in determining what information is material and how information could be better presented.

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RA 1-7 DISCLOSURES (CONTINUED)

b. (continued)
Professional judgement is not defined in the IFRS. However, it implies that experienced accountants should be able to make informed decisions, based on the objectives of the financial reports they are preparing, that are consistent with specific IFRS requirements for similar situations, and that are grounded in the agreed conceptual underpinnings of the discipline as set out in the Conceptual Framework for Financial Reporting (the qualitative characteristics, element definitions, and recognition, measurement and presentation and disclosure concepts).

c. Some examples of IAS 1 situations where management/preparers must exercise professional judgement in the preparation of financial statements follow:

Within the limits of IAS 1, required disclosures on the statement of financial position and the statement of comprehensive income, management can exercise professional judgement in how other information is best displayed and reported so as to be most useful to users. This also includes using different names for the financial statements themselves.

IAS1.15 requires financial statements to present fairly the financial position, financial performance and cash flows of the entity. Where there isn't a specific standard covering a given situation, preparers must apply professional judgement to determine the best way to faithfully present that situation's effects on the financial statements.

IAS 1.25 requires management to assess whether the entity is likely to continue as a going concern.

IAS 1.29 leaves it to the preparers of financial statements to determine how to aggregate material classes of similar items.

IAS 1.117b requires disclosure of "other accounting policies used that are relevant to an understanding of the financial statements." This requires professional judgement.

Where estimation uncertainty results in a significant risk of measuring a financial statement element at an amount that could reasonably be a materially different amount and it may change within 12 months from the reporting date, additional disclosures are required. (IAS 1. 125) Professional judgement is required in determining what situations require disclosure under this section, and, of course, in the measurement of the financial statement amounts in the first place.

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RA 1-8 STAKEHOLDER INFORMATION NEEDS

The following groups would be stakeholders in the performance of the public company:

1) Investors. Since the company is public and issues shares, the current and potential future investors would have significant interest in the reported financial information. Current investors would be interested in the profitability and any losses incurred by the company to determine whether their investment is secure and if they are receiving a reasonable return. Potential future investors would look to the financial stability of the company as well as future plans and prospects that might indicate a good investment for their capital.
2) Creditors. Often a public company will have debt financing. The creditors may be banks or individuals, and their interest in the financial statements will be the performance of the company and its ability to repay any loans that have been issued. Creditors may look to the liquidity of the balance sheet or the adherence to covenants to gauge the status of their funds.
3) Management and employees. The management and employees of the company will be interested in the financial results as this may impact their job stability or compensation in the following year.
4) Auditors. The auditors of the company are interested in the financial statements as the fair and accurate presentation of financial information is reflective of their work as auditors. Any errors or omissions in the financial statements would reflect poorly on the auditors and have a major impact on their reputation.
5) Customers. The buyers of oil in the United States would be interested in the financial statements as this information may indicate any changes in the company's ability to drill and supply oil.
6) Public. As the environmental impact of the oil industry has become a mainstream topic of debate in recent years, there are likely other groups concerned with the financial reporting of the oil company as these reports might indicate initiatives that have been taken by the company to reduce their impact on the environment, or any potential liabilities that have resulted from environmental damage including lawsuits or clean-up costs.

What is at stake for the stakeholders in the financial reporting process can be very different and the ability of financial statements to give these users the information they need is a prime concern of standard setting.

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RA 1-9 LIMITS ON DISCLOSURE

A new product may lead to higher sales and better performance for the company. Management may want to provide this information to the public to encourage investors to invest with their company. They may also want consumers to be aware of the new product so that they may create publicity and excitement for the release.

Management may want to keep the information confidential to prevent competitors from attempting to copy the product or reach the market first with a new product of their own. There are costs associated with information sharing whether it be purchasing advertising space, paying the salary of public relations professionals or the cost of management time in making decisions about how to share information. In some cases these costs may not be justifiable if the information is not considered important to the organization.

The asymmetry of information in this scenario would impact the actions of competitors and customers. In an efficient market these parties would have access to all of the information and be able to make well-informed decisions.

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RA 1-10 DISCLOSURE DECISION

a. Management may want to wait for confirmation that the product is the cause of the injuries for several reasons. The costs of issuing a recall may be significant and the negative publicity may have an impact on the reputation of the company and reduce future sales. Also, management may not want to damage their personal reputation or risk losing out on a bonus or promotion by admitting to the failed product. The company also does not want to increase its exposure to lawsuits until more information is known.

b. While the expectation is that negative publicity will result from admitting to a faulty product, there is the potential that customers will see the communication as a sign of integrity and it may improve their long-term trust in the brand. As well, recalling the product may help prevent future injuries and potential lawsuits.

c. From an ethical standpoint the best course of action would be to communicate to the public the potential safety hazard related to the product and recall the toy. While the profitability of a company is important, when it comes to potential harm to users, a company should prioritize the safety of their customers. As the advisor to ABC Inc. a recall and further research into the potential malfunction is recommended.

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RA 1-11 USERS OF INTEGRATED REPORTING

Institutional investors are those investors who are willing to devote time and resources to ensuring they make the best investments, and they do this by obtaining a good deal of information about the companies they invest in. A typical institutional investor may be a company similar to a pension or a mutual fund.

Integrated financial reporting takes into consideration non-financial performance measures including environmental and governance indicators. The greater variety of information that would be required with integrated reporting would suit the institutional investor's needs as a user of the statements. The benefit to this type of investor is not only the added variety in information provided, but also enables them to develop a deeper understanding of the business operations in the current period, and where the company is likely headed based on their business model and practices.

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RA 1-12 FUNDING PRINCIPLES

a. The first principle stating that funding should be broad-based indicates that IASB funding should be from many sources so that IASB does not need to rely on one source. The reason for this is if a single group or person provided significant funding to the IASB that group would have undue influence. There is potential for the group to convince standard setters to make changes in their favour in order to maintain the funding the IASB needs to operate.

   The second principle that funding be compelling is to promote funding of some level from all those who will benefit from the centralized standard setting of the IASB. As the IASB has 16 members using its standards, this principle would be that all members should contribute in exchange for the use of the standards. All parties contributing can reduce the risk that one party would have influence in politicizing the standards by being one of few contributors.

   The principle that requires open-ended funding indicates that the funding parties should not be guaranteed any particular results. This reduces the potential politicization of the IASB receiving funding by parties for the sole purpose of fulfilling those parties' goals.

   The fourth principle for the IASB is that funding be country-specific, meaning that participating countries that use the standards set by the IASB should provide funding proportionately. This would encourage funding from all parties and increased funding from all of the larger countries should prevent a single country from having higher influence than any other. This also ensures a sufficient level of funding can exist for the IASB to operate.

b. Without the four principles discussed above there is a high likelihood of standard setting being influenced by individual groups to achieve more favourable standards for their particular type of organization. This would impact the ability of IASB to develop standards that are fair and consistent so that financial information can be presented appropriately.

c. Since the AcSB and FASB are national organizations, the country-specific principles would not apply. Each organization is focused on setting standards for their own country (Canada and the United States). In addition, in Canada up until fairly recently, the AcSB was housed within the CICA and other accounting designations often felt that they did not have appropriate input into the standard setting process. With the unification of the accounting profession in Canada, the principle related to being broad-based is likely to be more fully applied.

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RA 1-13 MATERIALITY

a. As part of the projects connected with its Disclosure Initiative, the IASB was informed that one of the major reasons for the disclosure overload problem was that the concept of materiality was not being applied appropriately in practice, due to lack of guidance on how it should be applied. This has resulted in the reporting of significant amounts of irrelevant information and insufficient relevant information in the notes to the financial statements. To rectify this lack of guidance, the IASB began its materiality project.

b. The intent of the Practice Statement was not to change the definition of the term "material" as already set out in IAS 1 (*Presentation of financial statements*) and IAS 8 (*Accounting policies, changes in accounting estimates and errors*), or of "materiality" as described in the *Conceptual Framework*'s qualitative characteristic QC11:

> "Material
> Information is material if it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report."

c. Practice Statement 2 recommends a systematic process in making materiality judgements, involving a four-step process.

1. Step 1- Identify: Identify information that has the potential to be material.
2. Step 2 – Assess: Assess whether the information identified in Step 1 is, in fact, material.
3. Step 3 – Organise: Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users.
4. Step 4 – Review: Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements.

The Practice Statement also provides guidance on how to make materiality judgements in specific circumstances such as prior-period information, errors and covenants, and in the context of interim reporting.

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RA 1-14 IASB

a. The International Accounting Standards Board (IASB) is the professional standard setting body tasked with establishing a single set of global accounting standards.

It is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in financial statements. In addition, the Board cooperates with national accounting standard setters to achieve convergence in national accounting standards and International Financial Reporting Standards.

The board is responsible for the technical agenda and the development and approval of International Financial Reporting Standards (IFRS). It began full-time operations on April 1, 2001, continuing the work previously carried out by its predecessor, the International Accounting Standards Committee (IASC), established in 1973. Its parent, the IFRS Foundation is governed by trustees who are responsible for raising funds for the IASB, exercising oversight of the IASB and appointing members of the IASB.

b. In summary, the following groups might gain most from harmonization of financial reporting and use of international accounting standards:

- Investors, investment analysts and stockbrokers: to facilitate international comparisons for investment decisions.
- Credit grantors: for similar reasons as for the investment community.
- Multinational companies: as preparers, investors, appraisers of products or staff, and as movers of staff around the globe; also, as raisers of finance on international markets (this also applies to some companies that are not multinationals).
- Governments: as tax collectors and hosts of multinationals; also interested are securities markets regulators and governmental and nongovernmental rule makers.

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RA 1-14 IASB (CONTINUED)

c. The fundamental argument against harmonization is that, to the extent that international differences in accounting practices result from underlying economic, legal, social, and other environmental factors, harmonization may not be justified. Different accounting standards have evolved to serve the different needs of different users. This might suggest that the existing accounting is "correct" for a given nation and should not be changed merely to simplify the work of multinational companies or auditors. There does seem to be strength in this point particularly for smaller companies with no significant multinational activities or connections. To foist upon a small private family company in Luxembourg lavish disclosure requirements and the need to report a "true and fair" view in accordance with IFRS may be an expensive and unnecessary piece of harmonization.

The most obvious obstacles to harmonization are the sheer number and deep-rootedness of the differences in accounting. These differences have evolved over the previous century because of differences in users, legal systems, and so on. Thus, the differences are structural rather than cosmetic, and require revolutionary action to remove them.

Another facet of this is that professional accounting bodies are strong in certain countries such as Canada, the U.S. and the U.K., but weak in other countries such as Italy, Japan, and Switzerland. This means that it is difficult for professional bodies directly to achieve international harmonization throughout the developed western world. Thus, although the professional bodies may be able to make some progress, government intervention would be necessary for a wider harmonization. This brings us to a consideration of the obstacle of nationalism, which may show itself in an unwillingness to accept compromises that involve changing accounting practices towards those of other countries. This unwillingness may be on the part of accountants and companies, or on the part of states, which may not wish to lose their sovereignty. Another manifestation of nationalism may be the lack of knowledge of or interest in accounting elsewhere. A rather more subtle and acceptable variety of this, is the concern that it would be difficult to alter internationally set standards in response to a change of mind or a change of circumstances.

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RA 1-15 CANADIAN COALITION FOR GOOD GOVERNANCE (CCGG)

a. According to the mission statement of the Canadian Coalition for Good Governance found on its website, the CCGG represents the interests of institutional investors in promoting:
   - Good governance practices in Canadian public companies
   - Improvements in the regulatory environment so that the interests of boards of directors and management are aligned with those of its shareholders, and
   - Canadian capital market efficiency and effectiveness

b. An institutional investor refers to a company or organization which is in the business of investing and which holds large investments in other companies. They differ from other investors in that they devote a significant amount of resources to managing their portfolios and thus are much more developed in terms of their knowledge base and level of sophistication than the average investor.

c. The presence of a significant number of institutional investors has an impact on the financial reporting decisions made by management in that management is held more accountable for their financial reporting decisions in this type of environment. Institutional investors demand a level of accountability beyond that of an average investor and are powerful enough to get it since they often hold a significant portion of voting shares and often have members sitting on the boards of the companies they invest in.

d. Three of the coalition's largest members were the Canada Pension Plan (CPP) Investment Board, Alberta Investment Management Corporation and the Ontario Teachers' Pension Plan.

   Some of the major investments of these companies are as follows:
   - CPP (with total assets under investment at December 31, 2017 of $337.1 billion): some of its main Canadian public company holdings are Royal Bank of Canada, Canadian National Railway Company, Bank of Nova Scotia, Brookfield Asset Management, Loblaw Cos Ltd.
   - Alberta Investment Management Corporation (with total assets under management of $95.7 billion as of June 30, 2017): AIMCo invests in a mix of money market and fixed income investments, equities, and inflation sensitive assets. Examples include real estate investments such as Toronto's Yorkdale Shopping Mall, Suncor Energy Inc., the UK's consumer discretionary Vue, and London City Airport.

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RA 1- 15 CCGG (CONTINUED)

d. (continued)

- Ontario Teachers' Pension Plan (with total assets under management of $189.5 billion at December 31, 2017): 100% ownership of Bristol (UK) Airport; Facebook Inc.; and Birmingham International Airport.

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RA 1- 16 SOX AND THE CPAB

a. The Sarbanes-Oxley Act was enacted in 2002 as a legislative response to corporate bankruptcies and accounting failures including Enron, Worldcom, and Arthur Andersen. The Act increased government regulation by increasing resources for the SEC to prevent and combat fraud and improve reporting practices. The key components of the Act's provisions include:

- Establishment of the Public Company Accounting Oversight Board (PCAOB) to establish auditing, quality control and independence standards.
- Stronger rules with respect to auditor independence including rotation of audit partner every five years and stricter limits on the types of consulting engagements which can be undertaken by a firm for companies which are also audit clients.
- Accounting restatements will result in the forfeiture of bonuses for CEO's and CFO's.
- Certification that the financial statements, including disclosures, are fairly presented will be required from CEO's and CFO's.
- More stringent requirements for both independence and competence (in terms of financial expertise) for members of audit committees.
- Companies must have a written code of ethics in place for senior financial officers.

b. The act resulted in more accountability at all levels and by all those involved in financial reporting, including senior financial officers, auditors, audit committee members. There was an increase in the quality of collection and presentation of financial information, and more focus on enterprise wide risk management. Governance was also improved with more independent Boards and audit committees. Boards of directors were made more accountable and responsible for their decisions. However, this came at high costs to companies in the form of audit fees and internal staff costs, and many people have since questioned whether or not the benefits of more regulation actually outweighed the costs. In fact, some companies decided not to list their companies on US stock exchanges but went elsewhere (like London, Tokyo and Hong Kong) because the regulatory requirements were less burdensome. In addition, many small publicly traded companies found that the costs of complying with the regulations were prohibitive and not worth the benefits of being a publicly traded company. As a consequence, there have been a large number of companies that went private in the last few years – partially driven also by the private equity funds available to fund these transactions.

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RA 1-16 SOX AND THE CPAB (CONTINUED)

b. (Continued)
Finally, the only way that SOX can really be effective is to change the culture within an organization. SOX is about making internal controls more effective within an organization – it is not about documenting and testing the controls. Just making rules for compliance is not enough – and the amount of resources and time required internally to make these shifts in culture have been much higher than originally expected.

c. There was a major spillover effect on the Canadian regulatory environment. CSA (Canadian Securities Administrators) felt it was necessary to ensure that Canadian standards were as high as the US, and therefore prepared their own set of Canadian made regulations in National Instrument 52 – 108 Auditor Oversight. These were less stringent than required by SOX, since CSA wanted to limit the level of bureaucracy, but did require similar certification by the officers and disclosure in the MD&A and independence of the Board. Similar to the US, the CSA received numerous complaints on the costs required to implement these requirements. In response to these complaints and other issues, the CSA has amended National Instrument 52-108 over time, for example, giving companies more freedom in selecting their approach to compliance rules given their own specific circumstances, and to specify relationship requirements between the auditor, the audit committee and management. Canada also saw a move by small publicly traded companies to become private once again, since the costs of compliance greatly outweighed the benefits of being public.

d. Student responses may differ from the summary below based on the current issues identified on the CPAB website (www.cpab-ccrc.ca).
Improving the auditor's report: There has been a call from those who use the auditor's report for more direct information from the independent auditor about "the potential risks of material misstatements in the company's financial statements and how the auditor addressed those risks during the audit." In particular, the CPAB supports the following initiatives:
- More direct auditor reporting to users about critical audit issues encountered, why each was considered a significant matter, and what audit procedures were undertaken to satisfy the auditor on each issue.
- Requirement for the auditor's report to include specific information about the involvement of other auditors in the audit.
- Working toward a global solution for requirements for the audit report rather than divergent requirements internationally.

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RA 1-16 SOX AND THE CPAB (CONTINUED)

d. (Continued)

The CPAB did not agree with two initiatives raised by other organizations:

- The audit report should not require a specific statement about whether the auditor thought management's use of the going concern assumption was appropriate or inappropriate in the absence of the existence of a material uncertainty.
- It is not necessary to disclose the name of the audit partner who signed off on the audit report, as it places unnecessary emphasis on a single party for work performed by many.

A second current issue discussed and reported on by the CPAB is that relating to the mandatory rotation of audit firms and tendering to improve audit quality by enhancing auditor independence. While many think that requiring these aspects will reduce the familiarity between management and the auditor and auditor-client "self-interest threats" at the institutional level, the CPAB is concerned that increased competition between audit firms will result in unwarranted decreases in audit fees with a subsequent decline in audit quality. Instead, the CPAB prefers an approach of mandatory and comprehensive audit firm review. This approach is far more likely to put the focus directly on audit quality.

A third issue that continues to be addressed by CPAB relates to the quality of the Canadian auditors' work on the foreign operations of Canadian reporting companies. CPAB's concerns relate to the fact that foreign jurisdictions have their own specific regulations, business practices, customs, and laws. These all present unique audit risks including the increased risk of fraud. Such audits also present additional risks associated with often having to rely on the work of auditors located in the foreign jurisdiction. CPAB has often experienced difficulty gaining access to required working papers located in foreign jurisdictions in carrying out their audit firm reviews. The issues related to audits in foreign jurisdictions continue to be on the CPAB's review agenda.

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RA1-17 CONVERGENCE OF IASB AND FASB GAAP

a. The differences between the two approaches is that a rules-based approach attempts to create a specific rule for every situation while a principles-based approach sets more general principles which are to be applied to specific situations on a consistent basis. A rules-based approach results in a much larger volume of detailed standards and new rules must continue to be generated to keep up with new situations as they arise. A principles-based approach requires fewer and more general standards that may be applied to new situations as they arise. This difference in the volume of specific knowledge required means that a rules-based approach is more costly to maintain as new rules are generated by standard-setters and as they are learned, applied and audited. A rules-based approach leaves less room for manipulation but only if a specific situation is covered. It also leaves less room for professional judgement. If a specific situation is not addressed under a rules-based approach, preparers may argue that there is no GAAP for that situation and thus feel free to choose any alternative. Under a principles-based approach, preparers are obligated to apply general principles to all situations, whether specifically covered by a rule or not. This leaves room for exercising professional judgement and results in a more theoretically sound system.

b. The major reason for changes to and convergence of the revenue recognition standards relates to the fact that the standards were different, often resulting in different measures of revenue for similar economic transactions and situations. The FASB standards were detailed and industry-specific, while the IASB standards were principles-based and were intended to apply across industries. These differences affected the comparability of financial information which in turn reduced the value provided to investors. In addition, the principles-based approach used by the IASB often made the application of the standard difficult. The main revisions to the converged standard resulted in more principle-based recognition criteria than the U.S. GAAP standards. This is consistent with the overall convergence goals. As the standards were finalized, the Boards set up a “joint transition resource group (TRG)” to help in the transition to the new standards. This group is finding general agreement at the principles level, but varying views in applying the standards on a consistent basis.

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RA1-17 CONVERGENCE OF IASB AND FASB GAAP (CONTINUED)

c. The issue with the financial instrument impairment standards was the delayed recognition of credit losses on such instruments. This was an aspect where both the IASB and FASB wanted improvements. While there was initial agreement on the principles associated with an "expected loss impairment model," the two Boards could not reach an agreement on its application, and each has proceeded with its own approach. While convergence was not possible in its entirety, the major weakness of delayed recognition of credit losses identified originally has been addressed by both sets of standards.

d. Leases is another project where both the FASB and IASB agreed on the ultimate outcome of requiring most lease arrangements to be reported as assets and liabilities on the statement of financial position instead of being reported "off-balance-sheet" in the notes. The economic reality is that both the leverage to which many companies are exposed and the assets used in operations are significantly understated under existing standards. As well, the existing FASB standard is rules-based in nature while the IASB standard is principles-based. The major work completed on this project is converged in that there is common agreement on the principles-based recognition of most leases as assets and lease obligation liabilities. However, the two standard-setters have reached different conclusions on some of the specifics of implementation.

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RA 1-18 FINANCIAL REPORTING PRESSURES

1. The ethical issues that appear in this case are as follows:

   - Troy Normand proceeded to make an entry he felt did not reflect relevant and reliable financial information
   - He succumbed to management and job pressures although he had a moral obligation to ensure the financial statements reflected fairly the financial position of the company
   - He did not act with the best interest of the stakeholders in mind
   - Troy's manager pressured Troy into ignoring his concerns and therefore ignoring his moral and ethical responsibilities to the shareholders
   - Troy's manager is clearly acting with his own best interests in mind

2. Troy Normand acted unethically as stated above

3. Troy should have implemented a further investigation of his concerns with full documentation of his findings.

   - It is evident that he was concerned about some of the costs on the income statement and he was also questioning the adjusting entry he was being asked to record.
   - As an accountant, he would need to follow codes of ethics where he is required to ensure competency i.e. he should have investigated the situation further to educate himself in all financial matters of the company.
   - If there was doubt in any entries or accounting treatments, he was morally obligated to ensure he was educated by further investigating the situation
   - He should have communicated his concerns to others (e.g. other members of management or outside authorities) rather than overlooking it.

4. The stakeholders in this case are investors, shareholders and employees.

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RA 1-19 PRUDENCE

a. Hoogervorst discusses several IFRS standards that incorporate the idea of prudence, even if not the terminology. Some specific examples include:
   i. There is a requirement for companies to value inventory at the lower of cost and net realizable value. This is a prime example of financial standards requiring companies to exercise caution in order to maintain reliable balance sheets values. Those who prepare financial statements are required to show some level of prudence where the net realizable value of goods falls below their cost, although many of the estimates related to this would be subject to professional judgement.
   ii. Not only does IFRS require impairment testing to be performed in order to ensure that carrying amounts are not higher than recoverable amounts of balance sheet assets, but IFRS allows for reversals of impairment back to original costs if circumstances of the impairment are changed. Again, IFRS demonstrates the desire to ensure that balance sheet items are neither over nor under stated. This shows conservative recording of assets by encouraging any significant changes in their value to be reported.
   iii. Risk adjustments are required for mark-to-model fair value measurements. This helps ensure that an overly optimistic estimate by management is at least partially mitigated. The risk adjustment encourages prudence among preparers of financial statements as it requires them to look critically at their estimates and whether the value they are reporting is transparent.
   iv. Guarantee and warranty liabilities are recorded before they are brought in. This is how IFRS supports the inclusion of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty. Earlier recognition of these liabilities promotes a more prudent approach to financial reporting.

b. The idea of prudence was originally removed from the earlier version as an aspect of faithful representation because it was determined that it was inconsistent with requiring neutral or unbiased measures. Prudence in the past tended to be interpreted in a variety of ways, but often in the same light as conservatism, i.e., always choosing between alternatives on the basis of the policy that results in lower asset values, higher liability values and the least positive effect on income. Because the lack of general understanding of what the term means has led to inconsistent application in the past, and because it has led to increased subjectivity in the preparation of financial statements, it was agreed to remove the reference to prudence as a qualitative characteristic.

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RA 1-19 PRUDENCE (CONTINUED)

b. (continued)

The Basis for Conclusions accompanying the 2015 Exposure Draft Conceptual Framework for Financial Reporting indicates that the concept was reintroduced because of the widespread support for a different view of prudence, supported by academic research and the effects on financial reports resulting from past financial crises. Numerous reasons were offered for why prudence should be retained in the qualitative characteristics.

- Prudence is actually applied in various accounting treatments (see examples provided by Hans Hoogervorst in a. above). Because of this it should be included in the conceptual framework in order to support consistent usage of the term.
- Management has a bias toward optimism which needs to be offset to some extent. The application of prudence would accomplish this.
- Investors tend to be more interested in knowing about downside risk than upside potential.
- Exercising prudence levels the playing field between shareholders and management, and exercising it can reduce moral hazard.

The IASB, therefore, concluded that prudence, when defined as the "exercise of caution when making judgements under conditions of uncertainty" is useful in achieving neutrality in financial statement information. Such "cautious prudence" is therefore a factor in the faithful representation of the elements of financial statements. It should be clearly interpreted to mean that neither overly positive caution nor overly negative caution should be applied so that assets and liabilities (and the resulting revenues and expenses) are neither overstated nor understated.

c. There is the potential for professional judgement to affect accounting wherever there is uncertainty. With a clearer explanation in the Conceptual Framework of how prudence should be interpreted, it is likely there will be far more consistent application of the concept going forward than in the past.

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RA 1-20 BIG DATA, DATA ANALYTICS AND ARTIFICIAL INTELLIGENCE (CONTINUED)

Artificial Intelligence:

From the SAS website at (Artificial Intelligence - What it is and why it matters, n.d.)

> Artificial intelligence (AI) makes it possible for machines to learn from experience, adjust to new inputs and perform human-like tasks. Most AI examples that you hear about today – from chess-playing computers to self-driving cars – rely heavily on deep learning and natural language processing. Using these technologies, computers can be trained to accomplish specific tasks by processing large amounts of data and recognizing patterns in the data.

From Google's online dictionary:

> The theory and development of computer systems able to perform tasks that normally require human intelligence, such as visual perception, speech recognition, decision-making, and translation between languages.

(a) The use of Big Data, Data Analytics and Artificial Intelligence can be used in several areas of accounting. The availability of Big Data means that companies now have access to more information, more detail and faster, as well as information that was not previously available collected from various sources. This data can be used to improve forecasts for budgeting, estimate the timing of future cash needs and devise cost-saving measures and improve targeted sales.

Data analytics can be used in accounting to improve the quality of information reporting in financial statements and improve the quality of management estimates. For example, data analytics are used by automobile manufacturers, using data collected from various devices in the vehicles to estimate warranty costs. The devices in vehicles send back information on driving patterns, the location of vehicles, the pattern of servicing of the vehicle, the condition of automobile parts, etc.

Artificial intelligence involves machines learning from experience, to adjust to new inputs and perform human-line tasks such as image and sound recognition. "Computers can be trained to accomplish specific tasks by processing large amounts of data and recognizing patterns in the data." (Artificial Intelligence - What it is and why it matters, n.d.)

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RA 1-20 BIG DATA, DATA ANALYTICS AND ARTIFICIAL INTELLIGENCE (CONTINUED)

> Repetitive accounting tasks, such as tax, payroll, audits, banking… "will be fully automated using AI-based technologies, which will disrupt the accounting industry in a way it never was for the last 500 years, bringing both huge opportunities and serious challenges."
> (Su, 2018)

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