CHAPTER 1

THE CANADIAN FINANCIAL REPORTING ENVIRONMENT

ASSIGNMENT CLASSIFICATION TABLE

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

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.

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 money to it. They will 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 interest and principal on a timely basis.

BRIEF EXERCISE 1-2 (CONTINUED)

Canada Revenue Agency (CRA) – These stakeholders establish the rules for how taxable income will be measured. They are 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. Note that in preparing the tax return, the financial statements net income is the starting point and is then adjusted to arrive at taxable income, which is used to calculate the amount of taxes 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.

BRIEF EXERCISE 1-3

The overall objective is to provide financial information that is useful to users (primarily capital providers such as investors and lenders) 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. (IASB/FASB jointly published Exposure Draft).**

Note the emphasis on resource (or capital) allocation decisions, which is a balance sheet focus. 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.

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 not 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.

BRIEF EXERCISE 1-5

There is a risk where information asymmetry exists, that the party with the additional information will act in their own self-interest to the detriment of the other party and/or the capital maket 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

BRIEF EXERCISE 1-5 (Continued)

need that information before they invest or lend the company money. The risk that the party with the additional information may act in their 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.

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 practices, resulting in a lack of comparability among enterprises.

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.

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.

BRIEF EXERCISE 1-9

The International Accounting Standards Board (IASB) has in recent years become the dominant standard setting body in the world. By 2005, over 7,000 companies had adopted IFRS, with more than 100 countries now requiring or permitting the use of IFRSs, or in the process of converging with the International Accounting Standards Board's (IASB) standards, at present and in the near future this means that hundreds of thousands of companies throughout the world will use either the full IFRS or the version for small and medium size enterprises.

The goal of the IASB is to develop, in the public interest, a single set of high quality global accounting standards. See www.iasb.org for further details.

BRIEF EXERCISE 1-10

The Accounting Standards Board (AcSB) of the CICA 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)

BRIEF EXERCISE 1-10 (Continued)

oversees AcSB activities: its activities include setting the agenda and reporting to the public, among other things.

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. It is important to note that non-publicly accountable entities will also have the option to use IFRS.

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 (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.

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. The CICA has since the early 1970s 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 has is

BRIEF EXERCISE 1-12 (Continued)

responsible for IFRS. This ensures that accounting standards have a high degree of acceptance from its broad community of constituents.

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.

BRIEF EXERCISE 1-14

"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.

BRIEF EXERCISE 1-15

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 number of financial statement users who do not expect as extensive measurement and disclosure requirements as those required under IFRS.

BRIEF EXERCISE 1-16

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.

BRIEF EXERCISE 1-17

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.

BRIEF EXERCISE 1-18

For public companies, GAAP incorporates IFRS, IAS, and Interpretations. For private companies, pension plans, and not-for-profit entities primary sources of GAAP include (in descending order of authority) the Accounting Handbook sections 1400 to 3870, Accounting Guidelines, background information and illustrative material related to the previous items and implementation guides.

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 then adopt accounting policies that are consistent with the primary sources as well as the Conceptual Framework.

BRIEF EXERCISE 1-19

The chairman 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 judgment. 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 are almost limitless.

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.

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, management may seek to optimize their own bonus or the value of their stock options.

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.**

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.

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 report on 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.

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.**

BRIEF EXERCISE 1-25 (Continued)

- **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 now been put in place, or are soon to be put in place, in part by pronouncements by Canadian securities administrators such as the OSC

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 POPOVICH

Overview:

- Reported net income 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 CICA Handbook (publicly accountable entities follow IFRS which is included as Part I to the CICA Handbook and private entities follow ASPE which is Part II to the CICA Handbook). 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.
- Thus – they are not required to change to a new standard until GAAP requires it (the date is written into each standard).
- 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.

CA 1-1 POPOVICH (CONTINUED)

- 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.

CA 1-2 BOSTON CLOTHING 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.
- 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, 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.

CA 1-3 GRAND LIMITED

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 on such funds if obtained. 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.

Are the credit rating agencies stakeholders? 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. 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.

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TIME AND PURPOSE OF WRITING ASSIGNMENTS

WA 1-1 (Time 15-20 minutes)

Purpose—to provide the student with an opportunity to evaluate the viewpoint of removing mandatory accounting standards and allowing each company to voluntarily disclose the information it desired.

WA 1-2 (Time 30-40 minutes)

Purpose—to provide the student with an opportunity to discuss the pros and cons of the politicization of standard-setting, the impact accounting has on the environment, and the environment's influence on accounting.

WA 1-3 (Time 15-20 minutes)

Purpose—to provide the student with an opportunity to focus on the type of standard-setting environment exists in Canada. In addition, this case explores why user groups are interested in the nature of financial reporting standards and why some groups wish to issue their own standards.

WA 1-4 (Time 15-25 minutes)

Purpose—to provide the student with an opportunity to discuss the pros and cons of a continuous reporting model.

WA 1-5 (Time 15-20 minutes)

Purpose–to provide the student with an opportunity to discuss the Nortel company failures and the role of their auditors in issuing clean audit opinions.

WA 1-6 (Time 20-30 minutes)

Purpose—to provide the student with an opportunity to discuss the steps taken to increase government regulation in the capital marketplace as a result of the recent corporate failures. The student must also discuss the strengths and weaknesses of government regulation.

TIME AND PURPOSE OF WRITING ASSIGNMENTS (CONTINUED)

WA 1-8 (Time 30-35 minutes)

Purpose – to provide the student with an opportunity to discuss the reasons why Canada decided to adopt a two-tiered system – one for private companies and one for public companies. The student must also discuss the pros and cons of this type of system.

WA 1-9 (Time 15-20 minutes)

Purpose – to provide the student with an opportunity to consider how management may be bias in terms of the information they share with the public, and how the asymmetry of information may impact users decisions.

WA 1-10 (Time 15-20 minutes)

Purpose – to provide the student with an opportunity to consider the ethical dilemma of judgemental decisions with financial reporting and evaluate the potential consequences of those decisions.

WA 1-11 (Time 5-10 minutes)

Purpose – to provide the student with an opportunity to consider the integrated reporting initiative and the impact it would have on various users of financial statements.

WA 1-12 (Time 15-20 minutes)

Purpose – to provide the student with an opportunity to investigate and compare the funding for AcSB/FASB and comment on the funding principals of each. Students are asked to comment on what impact the principals have and the potential issues if they did not exist.

SOLUTIONS TO WRITING ASSIGNMENTS

WA 1-1

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.

WA 1-2

(a) Arguments for politicization of the accounting rule-making 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 rule-making 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.

WA 1-3

(a) Model 2 is used in Canada—the private, professional approach. The *CICA 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 has conferred legal authority on the provisions of the *CICA Handbook*. (Note to Instructor: the public/private model applies in the United States.)

(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 resources are transferred among entities and individuals as a consequence of these numbers. 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 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.

WA 1-4

The advantages of a continuous reporting model are that users have access to information on a more timely 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 does not necessarily imply more 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.

The recent corporate failures, recent downturn in the technology-based industry and issues such as 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.

WA 1-5

Auditors are responsible to provide 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 however on the negative side, financial statement preparers may act in their own self-interest and provide biased information. Where incentive systems such as bonuses and stock option plans exist, this may be a big problem.

A second factor may be the relationship between the company and the auditors. The company may hide information or mislead the auditors. This is a big audit risk and although auditors design the audit to ensure that the statement are not materially misstated, it is not possible for the auditors to audit every single document and transaction.

WA 1-6

(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 include new rules for auditors, conflicts 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 auditing, 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, CEO's and CFO's must forfeit bonuses and profit sharing. The effectiveness of the financial reporting internal control systems must be reported 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 nonassurance services for audit clients and what services may be provided. This is echoed by the profession's standard for auditor independence. Those 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.

WA 1-6 (CONTINUED)

(c) The strengths of government regulation include an independent verification on the financial reporting process and provide 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 a 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 do not address the issue 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 from the article “After Enron”, by John Lorinc, CA Magazine, December 2002.

WA 1-7

For many years there has been a discussion of whether or not one single set of standards could really meet all the needs of businesses and users. Finally, after years of debate, the AcSB has decided that it is best to have two sets of standards – one for publicly accountable enterprises (PAE's) and one for non-publicly accountable enterprise (non-PAE'S).

The arguments for having a two-tiered system are as follows: (adapted from: "Private Matters", by Jeff Buckstein, CA Magazine, May 2009)

1. The users of non-PAE's financial statements are primarily the owner/managers, the bank and the tax authorities. A large set of users for PAE's financial statements are external users – potential investors. The needs of these users are very different. A two-tiered system allows the standards to be developed with specific user groups in mind.
2. PAEs that are usually involved in global businesses and will be following global accounting standards. Since most private companies do not do business globally, there is no need for global standards to be used. A made-in Canada solution is better.
3. Historically, GAAP has allowed differential reporting which allowed private companies to follow more simplified standards if the shareholders unanimously agreed. These options have now been incorporated into theASPE.
4. Some of the standards are not relevant for private companies and these can be eliminated. Sections pertaining to earnings per share and interim reporting, for example are often not relevant for private companies where the company's shares are closely held.
5. Private companies are usually not involved in complex transactions that require complex accounting standards. In these cases, sections can be simplified to meet the needs specifically for private companies(or example, financial instruments and income taxes). The complexity and disclosure requirements of these sections that is required for PAE's are not relevant for private companies.
6. Disclosure requirements are significant for PAE's given that market analysts want a lot of information. But for private companies, the main users are the bank and leasing companies who do not need a lot of this information. Disclosure is costly to prepare. Therefore, with ASPE, the amount of disclosure can be greatly reduced reducing the cost of preparing financial statements.
7. The corporate structure of non-PAE's is also more simple, usually only consisting of one company, or maybe a few. So the complexities of standards related to consolidations are not really required. More simple accounting treatments can be adopted for private companies.

WA 1-7 (Continued)

8. In many areas of the standards, there will be few changes, so IFRS and ASPE will have many similarities.

Arguments against a two –tiered system:

1. Over time, there is a risk that the two systems will really diverge and become very different. This will make it difficult for professionals to learn and know two sets of accounting standards.
2. It is costly to have two sets of GAAP that must be maintained and updated regularly by the standard setting boards.
3. CFOs working in private companies may not be able to move easily to public companies, since they will not be familiar with the reporting and disclosure requirements.
4. For professionals preparing financial statements – it may also be difficult to move from private companies to public companies.
5. What about large private companies that operate similarly to a PAE? Are their needs really different? Many would argue that the needs and reporting requirements are the same. So at what point does a non-PAE move from ASPE to IFRS?
6. It might be difficult for a private company to go public or raise capital from other sources given that their historical financial statements will be prepared on a more simplified basis.

WA 1-8

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.

WA 1-8 (Continued)

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.

WA 1-9

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 capital 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.

WA 1-10

a) Management may want to wait for confirmation that the product is the cause of the injuries for several reasons. Firstly, 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. Another reason for waiting would be that management may not want to damage their personal reputation or risk losing out on a bonus or promotion by admitting to the failed product.

WA 1-10 (Continued)

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.

WA 1-11

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.

WA 1-12

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 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 4 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)

RESEARCH AND FINANCIAL ANALYSIS

RA 1-1 IASB EXPOSURE DRAFT

a) The IASB suggests two general questions for users to provide comments on the exposure draft proposed amendments. The first questions whether the readers agree with the proposal or what alternatives they would recommend, while the second question asks whether the transitional provisions and effective date are considered appropriate. The purpose of the exposure draft is to allow the Board of the IASB to gather user comments on changes to the IFRS standards before the changes are enacted. This allows the users of financial statements in Canada to have input into the standard setting process. This in turn adds value to the IFRS standards as they are more closely meeting users' needs.

b) The first amendment proposed relates to the disclosure of operating segments and would require additional disclosure of the factors an entity uses to identify operating segments. The next amendment would require a reconciliation of total reportable segments' assets to total entity assets if the information is provided regularly to chief decision makers.

c) Both of the proposed amendments clarify the type of information that must be disclosed relating to operating segments. This makes the IFRS standard simpler to apply as the requirements are clearer. Without the changes above it is possible that the same disclosure would be provided if those applying IFRS interpreted the standards to require the same disclosure. The amendments clarify what is provided in the standards and helps improve consistency in the use of IFRS. Without the changes entities using IFRS 8 would likely look to other companies and previous experience to determine the correct disclosure. This is representative of the workings of the GAAP hierarchy. The CICA Handbook standard would first be applied, and afterward users may look to exposure drafts, IASB publications, or the common practice of other companies to determine what is generally accepted.

RA 1-2 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) and began full-time operations on April 1, 2001, further to the work of 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:

- Investors, investment analysts and stockbrokers: to facilitate international comparisons for investment decisions.
- Credit grantors: for similar reasons to bullet point above.
- 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).

RA 1-2 IASB (CONTINUED)

- Governments: as tax collectors and hosts of multinationals; also interested are securities markets regulators and governmental and nongovernmental rule makers.

(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.

RA 1-3 CANADIAN COALITION FOR GOOD GOVERNANCE

(a) An institutional investor refers to a company or organization which is in the business of investing and which holds large investments in other companies. These include insurance companies, pension plans, mutual funds and others. They differ from other investors in that they devote a significant amount of resources into managing their portfolios and thus are much more developed in terms of their knowledge base and level of sophistication than the average investor.

(b) 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.

(c) 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.

(d) Some of the major investments of these companies are as follows:

- CPP:_Barrick Gold, ING Canada, Goldcorp, Agnico Eagle Mines, Encana Corp
- Ontario Teachers' Pension Plan: Hitachi, Ltd., OGX Petróleo e Gás Participações S.A., LLX Logistica S.A.Deutsche Telekom
- Alberta Investment Management Corporation: AIMCo invests in infrastructure for example Compañía Logística de Hidrocarburos, S.A. ("CLH") a refined petroleum product pipeline transportation and logistics company in Spain; and private investments in Centre Rockland for example.

RA 1-4 SOX

(a) The Sarbanes-Oxley Act was enacted in 2002 as a legislative response to the recent corporate bankruptcies and accounting failures (Enron, Worldcom, 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. Board 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. Finally, the only way that SOX can really be effective is to change the culture within

RA 1-4 SOX (Continued)

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 were definitely spillover effects in Canada. 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. They 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. However, similar to the US, the CSA received numerous complaints on the costs required to implement these requirements. In response to these complaints, in 2006 and then again in 2008, the CSA amended these requirements to give companies more freedom in selecting their approach to compliance rules given their own specific circumstances. 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.

Currently, there is some support to move to a more principles-based approach given the fact that you cannot make a rule for everything. In the principles- based approach, the company would have to ensure that it has the controls in place to ensure that financial information is properly disclosed to external investors. The amount and level of these controls will depend on the size and complexity of the company. This concept is similar to accounting standards where professional judgment is required to ensure that the information is faithfully represented for users.

(d) Student responses may differ based on the benefits and weaknesses identified. A sample response is provided:

- The implementation of bill S1933 would have benefits to emerging organizations wishing to go public. There are financial costs related to changing auditors and audit firms as it creates repetition of information sharing. The auditors will need to acquire the same basic knowledge about the organization and efficiencies that could be obtained with repeat auditors would be lost. This is one benefit to the new bill.

RA 1-4 SOX (Continued)

(d) Continued

- A second benefit is that the time devoted to an IPO and going public is demanding on an organization. Fewer requirements for audit standards and SOX compliance during and after this process will allow management to focus on a smooth transition into operating as a public entity with new accounting and reporting standards. Compliance with the numerous SOX standards could function as a barrier to entry, in which case S1933 would help limit that barrier and simplify the process of going public for smaller firms.
- A risk related to this bill is that repeatedly using the same auditor could lead to potential conflicts of interest. An overly close relationship between management and the auditor may lead to hidden financial information and prevent the auditor from noticing or reporting fraud.
- The S1933 will have fewer internal control requirements, and a longer window to obtain internal controls audits for high-earning start-ups. Public accounting firms will not need to report on internal controls which could potentially lead to ineffective or poorly operating controls. A weak internal control system may go unnoticed for a significant amount of time which would negatively impact the emerging growth company while also adding risk for investors.

RA1-5 IASB and FASB Convergence

a) The Update Report discusses two main reasons for the need for changes to revenue recognition standards. The first reason is that U.S. GAAP includes industry specific guidance that can be inconsistent across industries. This impacts the comparability of financial information since different industries can use different standards which is turn reduces the value provided to investors. A second reason for the convergence talks is that the IFRS standards for revenue recognition do not provide application guidance, meaning that it is difficult for preparers of financial information to use IFRS standards. The main revisions will result in more principle-based recognition criteria than the U.S. GAAP standards. This is consistent with the overall convergence goals to result in a more principles based U.S. standard rather than their current rules-based model.

RA1-5 IASB and FASB Convergence (Continued)

b) The report discusses the need for changes to Impairment standards as the incurred loss model previously used resulted in significant financial issues during the recent financial crisis. The incurred loss model resulted in later recognition of losses which prevented financial statements users from having current information. The proposals of the IASB and FASB are focused to create a standard that has more guidance on the timing of recognizing expected losses. As the Boards recognize that there are different types of investments and expected loss factors, the standard will be principle-based and require greater disclosure so that financial statements have better comparability. As with the revenue recognition changes discussed above, the principles-based IFRS standards help with the comparability of financial statements and U.S. GAAP is moving towards this type of reporting standards.

c) 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.

RA1-5 IASB and FASB Convergence (Continued)

d) A principles-based approach is better for the reasons mentioned above. Historic accounting scandals that used “loopholes” in the accounting rules provide evidence that a rules-based approach is not necessarily better. You cannot create a rule for everything. As business transactions become more complex, it is difficult to anticipate the accounting rule that might be required to properly present the information. Hence, the use of professional judgement to ensure that transactions are faithfully represented will ensure that a “true and fair view” of the activities is presented. This may be an impediment for acceptance in the US for IFRS since practitioners are familiar with a rules-based approach and will likely resist change and argue against change. However, in light of the huge scandals in the US, there may be support that what was used in the past is no longer the right way.

RA 1-6 FINANCIAL REPORTING ISSUES

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 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

RA 1-7 PRUDENCE- IMPACT OF IFRS

a) Hoogervorst discusses several IFRS standards that incorporate the idea of prudence, 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 judgment.

   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 sheets 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.

RA 1-7 PRUDENCE- IMPACT OF IFRS (CONTINUED)

b) There is the potential for professional judgment to impact all of the areas above as each involves some estimation uncertainty. A professional applying the IFRS standards would need to consider whether their estimates are reliable as this will impact the fair value measurement of the asset or liability. There is also the potential for earnings management if the decision-makers make estimates that result in more favourable financial reporting.

c) The reasons stated by Hoogervorst as to where prudence still exists in the standards are true. While prudence in name has been eliminated there are significant disclosure requirements and guidance on estimates of impairment and assets that encourage decision-makers to consider the fair representation of financial information. While the IFRS standards do not require conservatism but instead require neutrality, it is the responsibility of professionals applying the standards to avoid overly optimistic reporting. IFRS is a valuable tool for presenting financial information and the replacement of prudence with neutrality does not impact the value of financial reporting standards as long as decision-makers are following the guidance in the standards to achieve neutrality.

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