CHAPTER 1

**THE CANADIAN FINANCIAL REPORTING ENVIRONMENT**

**CHAPTER STUDY OBJECTIVES**

1***. Understand the financial reporting environment.*** Accounting provides reliable, relevant, and timely information to managers, investors, and creditors so that resources are allocated to the most efficient enterprises. Accounting also provides measurements of efficiency (profitability) and financial soundness. Investors, creditors, management, securities commissions, stock exchanges, analysts, credit rating agencies, auditors, and standard setters are some of the major stakeholders. Illustration 1-4 explains what is at stake for each one. The objective of financial reporting is to communicate information that is useful to key decision makers such as investors and creditors in making resource allocation decisions (including assessing management stewardship) about the resources and claims to resources of an entity and how these are changing. Ideally, all stakeholders should have access to the same information in order to ensure that good decisions are made in the capital marketplace. (This is known as information symmetry.) However, this is not the case—there is often information asymmetry. Of necessity, management has access to more information so that it can run the company. It must also make sure that it does not give away information that might harm the company, such as in a lawsuit where disclosure might cause the company to lose. Aside from this, information asymmetry exists because of management bias whereby management acts in its own self-interest, such as wanting to maximize management bonuses. This is known as moral hazard in accounting theory. Information asymmetry causes markets to be less efficient. It may cause stock prices to be discounted or costs of capital to increase. In addition, it might detract good companies from raising capital in the particular market where relevant information is not available (referred to as adverse selection in accounting theory). The efficient markets hypothesis is felt to exist only in a semi-strong form, meaning that only publicly available information is assimilated into stock prices.

2. ***Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.*** The accounting profession has tried to develop a set of standards that is generally accepted and universally practised. This is known as GAAP (generally accepted accounting principles). Without this set of standards, each enterprise would have to develop its own standards, and readers of financial statements would have to become familiar with every company’s particular accounting and reporting practices. As a result, it would be almost impossible to prepare statements that could be compared. In addition, accounting standards help deal with the information asymmetry problem.

The Canadian Accounting Standards Board (AcSB) is the main standard-setting body in Canada for private companies, pension plans, and not-for-profit entities. Its mandate comes from the Canada Business Corporations Act and Regulations as well as provincial acts of incorporation. For public companies, GAAP is International Financial Reporting Standards (IFRS) as established by the International Accounting Standards Board (IASB). Public companies are required to follow GAAP in order to access capital markets, which are monitored by provincial securities commissions. The Financial Accounting Standards Board (FASB) is also important as it influences IFRS standard setting. Private companies may choose to follow IFRS. Public companies that list on U.S. stock exchanges may choose to follow U.S. GAAP.

3. ***Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.*** Generally accepted accounting principles are either principles that have substantial authoritative support, such as the *CPA Canada Handbook*, or those arrived at through the use of professional judgement and the conceptual framework.

Professional judgement plays an important role in Accounting Standards for Private Enterprises (ASPE) and IFRS since much of GAAP is based on general principles, which need to be interpreted.

4. ***Discuss some of the challenges and opportunities for accounting.*** Some of the challenges facing accounting are the impact of technology, sustainability reporting, oversight in the capital markets, centrality of ethics, standard setting in a political environment, and principles- versus rules-based standard setting. All of these require the accounting profession to continue to strive for excellence and to understand how accounting adds value in the capital marketplace.

**Multiple Choice QUESTIONS**

**Answer No. Description**

d 1. Accounting characteristics

a 2. Nature of financial accounting

c 3. Definition of financial accounting

b 4. Definition of management accounting

d 5. Efficient use of resources

c 6. Capital allocation process

d 7. Importance of accounting information

b 8. Primary exchange mechanism(s) for allocating resources

b 9. Stakeholders in the financial reporting environment

d 10. Preparation of audited financial statements

a 11. Auditor’s responsibility

c 12. Causes of subprime lending crisis

a 13. Management’s *primary* responsibility with respect to financial statements

c 14. Primary responsibility of security and exchange commissions

b 15. Objectives of financial reporting

b 16. Appropriate objectives of general-purpose financial reporting

b 17. Accrual-basis accounting

c 18. Preparation of biased information

c 19. Existence of information asymmetry

b 20. Efficient markets hypothesis

d 21. Management bias

a 22. Moral hazard

d 23. Conservative accounting

d 24. Resource Allocation

c 25. Changing financial reporting environment

b 26. Reduction of information asymmetry

b 27. Development of GAAP

c 28. Financial reporting before 1900

c 29. Responsibility of the AcSB

a 30. Oversight of AcSB

c 31. Authority over accounting standards in the U.S

b 32. Adoption of IFRS

d 33. Activities and authority of the Ontario Securities Commission (OSC)

b 34. Use of ASPE

a 35. IASB’s standard-setting process

d 36. IASB’s funding principles

b 37. IASB oversight

a 38. Role of provincial securities commission

c 39. Primary sources of GAAP under ASPE

c 40. Sources of GAAP

d 41. Exercise of professional judgement

c 42. Rules-based vs. principles-based approach

c 43. Comparison of Canadian GAAP and U.S. GAAP

d 44. Primary sources of GAAP

d 45. Use of professional judgement

b 46. SOX

**Answer No. Description**

a 47. Advancement of technology on financial reporting

a 48. IASB principles regarding funding

c 49. Rules-based GAAP body of knowledge

b 50. Data governance

a 51. Sustainability reporting

**Exercises**

**Item Description**

E1-52 Effective capital allocation

E1-53 Financial statements in practice and theory

E1-54 Stakeholders in the financial reporting environment

E1-55 Sources of capital and stages of company growth

E1-56 Objective of financial reporting

E1-57 Traditional users vs. others

E1-58 Imperfection of the stakeholder financial reporting environment

E1-59 User needs

E1-60 Merits of accrual vs. cash-basis accounting

E1-61 Information asymmetry

E1-62 Maintaining competitive advantage

E1-63 Management bias in financial statement presentation

E1-64 Financial versus managerial accounting

E1-65 Role of securities commissions and stock exchanges

E1-66 Purpose of accounting standards and standard setting

E1-67 ASPE vs. IFRS

E1-68 IFRS Discussion Group

E1-69 Sources of GAAP

E1-70 Professional judgement

E1-71 SOX and standard setting

E1-72 Role of executives and management in a post-SOX world

E1-73 Technology and financial information

E1-74 Principles- versus rules-based approaches

E1-75 Value creation

E1-76 Standard setting in a political environment

**PROBLEMS**

**Item** **Description**

P1-77 Information Asymmetry

P1-78 U.S. GAAP impact on Canadian GAAP

P1-79 Challenges facing financial reporting

P1-80 Shortcomings of rules-based approach

P1-81 Sustainability reporting

**MULTIPLE CHOICE**

1. The essential characteristic(s) of accounting is (are)

a) communication of financial information to interested internal parties only.

b) communication of economic information to external parties.

c) identification and measurement of financial information only.

d) identification, measurement, and communication of financial information.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

2. Financial accounting is concerned with the process that culminates in

a) the preparation of financial reports.

b) specialized reports for inventory management and control.

c) specialized reports for income tax calculation and recognition.

d) reports on changes in stock prices and future estimates of market position.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

3. Financial accounting can be broadly defined as the area of accounting that prepares financial statements to be used

a) by parties internal to the business enterprise only.

b) by investors only.

c) by parties both internal and external to the business enterprise.

d) primarily by external users and Canada Revenue Agency.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

4. Management accounting can be broadly defined as the area of accounting that communicates financial information

a) to investors only.

b) to parties internal to the business enterprise only.

c) to parties both internal and external to the business enterprise.

d) primarily to external users and Canada Revenue Agency.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Analytic

5. Whether a business is successful and thrives is determined by

a) free enterprise or competition.

b) competition and markets only.

c) markets and free enterprise only.

d) markets, competition, and free enterprise.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

6. Which of the following is correct?

a) Reported accounting numbers do not affect the transfer of resources.

b) Credit rating agencies use accounting information to assess only assets.

c) Efficient capital markets promote productivity and encourage innovation.

d) Efficient capital markets promote productivity but do not encourage innovation.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

7. Which of the following statements regarding the importance of information provided by accounting to investors and creditors is NOT correct?

a) It allows investors and creditors to compare income and assets of companies.

b) It helps investors and creditors assesses the relative risks and returns of investment opportunities.

c) It helps investors and creditors channel their resources more effectively.

d) It determines the share prices and lending portfolios for investors and creditors.

Answer: d

Difficulty: Medium

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Analysis

AACSB: Analytic

8. In Canada, which of the following is part of the primary exchange mechanism for allocating resources.

a) shareholders

b) financial Institutions such as banks

c) government authorities such as the Canada Revenue Agency (CRA)

d)management

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

9. Stakeholders who help in the efficient allocation of resources include

a) investors and creditors.

b) financial analysts and regulators.

c) creditors and auditors.

d) management and auditors.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

10. Audited financial statements are prepared by

a) auditors.

b) financial analysts.

c) Canada Revenue Agency.

d) management.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

11. The auditor’s primary responsibility is to

a) review financial statements and discuss them with management.

b) prepare financial statements.

c) report to Canada Revenue Agency.

d) report to standard setters.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

12. The widely publicized subprime lending crisis was NOT caused by

a) capital market participants who acted in their own self-interest.

b) a lack of transparency.

c) the practice of securitizing assets.

d) a lack of investor understanding of the investment's true risk.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Finance

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

13. Management’s primary responsibility with respect to financial statements is to

a) prepare them, as they have the best insight and know what should be included.

b) audit them, as they are distant enough from daily operations.

c) rely on them to make decisions.

d) None of the above are true.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

14. The primary responsibility of security and exchange commissions with respect to financial statements is to

a) set generally accepted accounting principles (GAAP), which must be followed in preparing statements.

b) review accounting choices made by companies in the financial statements to ensure decision-making logic is sound.

c) monitor financial statements to ensure full and plain disclosure of material information, thus maintaining compliance with listing requirements.

d) monitor and analyze the information looking for signs of an improved or weakened financial condition.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

15. Objectives of financial reporting does NOT include

a) providing information that is useful to users in making resource allocation decisions.

b) providing information about the liquidation value of an enterprise.

c) providing information about an entity’s economic resources, obligations, and equity/net assets.

d) providing information about changes in an entity’s economic resources, obligations, and equity/net assets.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

16. As part of the objective of general-purpose financial reporting, which of the following perspectives is considered appropriate?

a) proprietary perspective

b) entity perspective

c) stakeholder perspective

d) None of the above perspectives are considered appropriate.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

17. Which of the following is NOT true regarding accrual-basis accounting?

a) A company records events that change its financial statements in the periods in which the events occur.

b) Revenues and expenses are recognized in the periods in which the company receives or pays cash.

c) It has greater potential to depict meaningful trends in revenues and expenses.

d) Revenues and expenses can be more easily related to the economic environment of the period in which they occurred.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

18. The preparation by some companies of biased information is sometimes referred to as

a) conservative financial reporting.

b) full disclosure of all material facts.

c) aggressive financial reporting.

d) stewardship.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

19. Where information asymmetry exists, the capital market may attract the wrong kind of market participants. This is known as

a) moral hazard.

b) conservative accounting.

c) adverse selection.

d) an inefficient marketplace.

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment. .

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Professional & Ethical Behaviour

Bloomcode: Knowledge

AACSB: Analytic

20. The “efficient markets hypothesis” proposes that

a) market prices reflect information known only to internal stakeholders.

b) market prices reflect all information about a company.

c) market prices reflect information known only to external stakeholders.

d) information asymmetry is required.

Answer: b

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Finance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

21. Which of the following does NOT describe a cause of management bias?

a) the company’s need to comply with contracts, such as debt covenants

b) management’s desire to meet financial analysts’ expectations

c) the tendency of management to downplay negative events

d) the desire for all stakeholders to have access to all information

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

22. When people think that no one is watching, they will often shirk their responsibilities. This is known as

a) moral hazard.

b) conservative accounting.

c) adverse selection.

d) an inefficient marketplace.

Answer: a

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

23. Conservative accounting refers to

a) a manager’s tendency to shirk his stewardship responsibilities.

b) a manager’s engagement in greater risk taking.

c) a decision to downplay the negative and focus on the positive.

d) a decision to downplay the positive and focus on the negative.

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

Feedback: a), b), and c) describe aggressive accounting.

AACSB: Analytic

24. Which of the following stakeholders do NOT typically rely on the financial statements to make resource allocation decisions?

a) investors

B) creditors

C) analysts

D) standard setters

Answer: d

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

25. Which of the following is/are major factors in the rapidly changing financial reporting environment in Canada?

a) increased demand for accountants and the impact of technology

b) globalization and the unethical actions of accountants

c) the growing number of institutional investors who want more information regarding environmental and social issues

d) increased use of the Internet

Answer: c

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

26. The problem of information asymmetry can be reduced by

a) aggressive accounting.

b) accounting standards.

c) adverse selection.

d) only focusing on positive events.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Analytic

27. Which of the following sources of generally accepted accounting principles (GAAP) are NOT developed by the Canadian Accounting Standards Board (AcSB)?

a) Accounting Standards for Private Enterprises (ASPE)

b) International Financial Reporting Standards (IFRS)

c) GAAP for pension plans

d) GAAP for not-for-profit entities

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

28. Before 1900, which of the following accurately describes financial reports?

a) They emphasized the need for standardized and increased corporate disclosures.

b) They were for widespread use and distribution.

c) They emphasized solvency and liquidity.

d) None of the above accurately describe financial reports pre-1900.

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

29. As of 2011, the responsibilities of the Accounting Standards Board (AcSB) in Canada relate to setting standards for

a) publicly accountable entities only.

b) both publicly accountable entities and private enterprises.

c) private enterprises, not-for-profit entities, and pension plans.

d) not-for-profit entities and pension plans only.

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Audit & Assurance

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

30. In Canada, the body that has the responsibility of overseeing the Accounting Standards Board (AcSB) is the

a) Accounting Standards Oversight Council (AcSOC).

b) International Accounting Standards Board (IASB).

c) Canadian Institute of Chartered Accountants (CICA).

d) Financial Accounting Standards Board (FASB).

Answer: a

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

31. In the United States, the body that has the final authority over accounting standards is the

a) Financial Accounting Standards Board (FASB).

b) International Accounting Standards Board (IASB).

c) Securities Exchange Commission (SEC).

d) Accounting Standards Oversight Council (AcSOC).

Answer: c

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

32. The adoption of International Financial Reporting Standards in Canada is an example of

a) the impact of technology on user's needs.

b) the impact of globalization on capital markets.

c) ethical behaviour.

d) the desire of most private companies to expand internationally.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

33. Which of the following statements does NOT describe the activities and authority of the Ontario Securities Commission (OSC)?

a) The OSC reviews and monitors the financial statements of companies whose shares are listed on the Toronto Stock Exchange.

b) The OSC issues its own disclosure requirements for listed companies.

c) The OSC has the ability to fine or delist companies.

d) The OSC issues financial accounting standards for Canadian companies.

Answer: d

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

34. Which of the following does NOT support the use of Accounting Standards for Private Enterprises (ASPE)?

a) Private enterprises usually have less complex business models.

b) Private enterprises that are “going public.”

c) Private enterprises usually have fewer users.

d) Private enterprises’ financial statement users tend to have first-hand information.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

35. Which of the following does NOT describe a step in the IASB’s standard-setting process?

a) appointing trustees to the IFRS Foundation

b) development of an exposure draft

c) provision of strategic advice by the IFRS Advisory Council

d) public consultation

Answer: a

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

36. In order to ensure that funding does not result in politicization of standard setting, the IASB has committed to four principles. Which of the following is not one of these principles?

a) Funding should be broad-based.

b) Funding should be compelling.

c) Funding should be open-ended.

d) Funding should not be country specific.

Answer: d

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

37. International Financial Reporting Standards (IFRS) are issued by the

a) FASB.

b) IASB.

c) SEC.

d) EU.

Answer: b

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

38. The role of the provincial securities commissions in Canada in relation to financial reporting is to

a) ensure that investors have access to the information they need to make informed decisions.

b) make recommendations for financial accounting standards.

c) form professional judgements regarding overall adherence to GAAP.

d) develop standards for financial reporting by publicly traded companies.

Answer: a

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

39. Under ASPE, the primary sources of GAAP include

a) accounting textbooks and journals.

b) International Financial Reporting Standards.

c) the CICA Handbook and appendices.

d) research studies.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

40. Under ASPE, the other (as opposed to primary) sources of GAAP include

a) the CICA Handbook and appendices.

b) Accounting Guidelines, including appendices.

c) pronouncements by accounting standard-setting bodes in other jurisdictions.

d) All of these are primary sources of GAAP.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

41. The exercise of professional judgement does NOT involve

a) the use of knowledge gained through education.

b) the application of knowledge gained through experience.

c) the use of ethical decision making.

d) aggressive accounting.

Answer: d

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

42. In a rules-based approach (such as U.S. GAAP), compared to a principles-based approach (such as Canadian GAAP),

a) the body of knowledge is smaller.

b) the importance of communicating the best information to users is emphasized.

c) since it is more prescriptive, it may be easier to defend how to account for a particular item.

d) companies frequently do not interpret the rules literally.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

43. In a principles-based standard-setting system (such as Canadian GAAP), compared to a rules-based approach (such as U.S. GAAP),

a) which is more prescriptive, it may be easier to defend how to account for a particular item.

b) there is a rule for every situation.

c) accountants either apply specific standards based on the conceptual framework, or, professional judgement consistent with the framework.

d) it is expected that professional accountants might encounter situations where they are unable to apply the principles appropriately.

Answer: c

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

44. Which of the following is NOT a primary source of GAAP for Canadian private companies?

a) HandbookSections 1400 to 3870

b) Accounting guidelines

c) Appendices to Handbook Sections 1400 to 3870 and Accounting guidelines

d) Pronouncements by accounting standard-setting bodies in other jurisdictions

Answer: d

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

45. Which of the following is NOT true of “professional judgement”?

a) It plays an especially important role in ASPE and IFRS.

b) It is important where standards are based primarily on general principles.

c) It is used in conjunction with the conceptual framework in the absence of specific standards.

d) It requires a rules-based system to be fully utilized.

Answer: d

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

46. The Sarbanes-Oxley Act (SOX) was NOT enacted to

a) help prevent fraud and poor financial reporting practices.

b) ensure the act was applied internationally.

c) enable the SEC to increase its policing efforts.

d) introduce new independence rules for auditors.

Answer: b

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

47. Which of the following is likely to be an advantage of the advancement of technology on financial reporting?

a) Users of financial information will have access to more information.

b) The quality and reliability of the information may be compromised.

c) Equal and fair access may be at issue.

d) Internet reporting will increase costs.

Answer: a

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Technology

48. One political factor influencing the standard-setting process is how the standard-setting bodies are financed. Which of the following is NOT an IASB principle regarding the nature and amount of funding?

a) Closed-loop: Financial commitments for funding should be contingent upon particular outcomes.

b) Broad-based: It should not rely on one or a few sources.

c) Compelling: Constituents should not be allowed to benefit from the standards without contributing to the process of standard setting.

d) Country-specific: Funding should be shared by the major economies on a proportionate basis.

Answer: a

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

Feedback: Funding must be open-ended.

AACSB: Analytic

49. Which of the following is an argument in favour of a GAAP body of knowledge that is more prescriptive, or rules-based?

a) It always emphasizes communicating the best information for users.

b) The body of knowledge becomes significantly smaller and therefore easier to manage.

c) It may be easier to defend how to account for a particular item.

d) There is a tendency for companies to interpret guidelines loosely, and thus account for items inconsistently.

Answer: c

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

50. The collection of processes, roles, policies, standards and metrics that ensure effective and efficient use of information in enabling an organization to achieve its goals is referred to as

a) digitization.

b) data governance.

c) artificial intelligence.

d) machine learning.

Answer: b

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

51. Sustainability reporting requires or encompasses a broader stakeholder perspective. Examples of societal issues, as outlined within the text, that are closely related to a company’s ability to create value, include all of the following EXCEPT for:

a) land use and ecosystems.

b) indigenous rights.

c) health and safety.

d) bribery and corruption.

Answer: a

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**EXERCISES**

**Ex. 1-52**

Explain why an efficient use of resources is important. What role does accounting have in efficient resource allocation? Describe how this is also facilitated through an effective capital allocation process.

##### Solution 1-52

Resources are limited. As a result of this, individuals try to use these resources efficiently and in doing so the overall standard of living is increased. Increased standards of living require businesses to be successful. Therefore, accounting plays a role in ensuring that company performance is measured fairly, accurately and on a timely basis. The information must also enable investors and credits to compare company performance in order to assess the relative risks and returns of different investment opportunities. An effective capital resource allocation process encourages innovation, promotes productivity, and provides a platform for buying and selling securities and obtaining and granting credit.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Management Accounting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-53** Financial statements in practice and theory

What is the purpose of financial statements? What are the four most frequently provided financial statements? Beside the statements themselves, what other information is required to make the statements meaningful?

**Solution 1-53**

The financial statements are the principal way for communicating financial information to external stakeholders. The statements provide the company’s history. The most frequently used statements include:

1. Statement of financial position/Balance sheet

2. Statement of income/comprehensive income/Income statement/ Profit and loss statement

3. Statement of cash flows/ Cash flow statement

4. Statement of changes in equity/ Statement of retained earnings

Note disclosures are also an important part of each set of statements. Some financial information cannot be expressed in the statements and is best expressed through other means such as corporate annual reports, prospectuses, news releases, management forecasts, sustainability reports and so forth.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-54** Stakeholders in the financial reporting environment

Briefly describe the much-publicized subprime lending crisis in the United States, and identify the stakeholders and how they were affected.

##### Solution 1-54

At the centre of this issue were securitized mortgage assets that were sold to investors. These assets were based on mortgages that had been extended to high-risk borrowers who could no longer afford their mortgage payments once interest rates rose. This led to a flooded housing market as borrowers walked away from their houses (and debt). The primary stakeholders were the lenders, borrowers, and investors. Lenders (acting in their own self-interest) sold these investments to investors who may not have fully understood the high-risk nature of their investment. Borrowers lost homes they could no longer afford, and investors suffered large losses due to the defaulted loans.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Finance

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-55** Sources of capital and stages of company growth

Briefly describe how the sources of capital a company relies upon for funding might vary according to their stage of growth.

**Solution 1-55**

As per Illustration 1-2, in the early project/idea stage a company will acquire its initial capital from founders, family, and friends. As they progress to the research and development or prototype stage, private and public venture capital may be introduced, this include capital provided by angel investors, venture capitalists, and public exchanges such as the TSX Venture Exchange or TSX. Venture capitalists and these public exchanges become the dominant source of capital as greater amounts of capital are required and as a company progresses through commercialization and into stable production.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Finance

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-56** Objectives of financial reporting

What is the objective of general-purpose financial statements? How is this objective supported (or not) by the entity perspective and proprietary perspective?

##### Solution 1-56

The objective of financial reporting is to provide financial information about the reporting entity that is useful to current and potential equity investors, lenders and other creditors in making decisions in their capacity as lenders, this is known as the decision usefulness approach.

The entity perspective views companies as separate and distinct from their owners, e.g., corporate assets are viewed as assets of the company and not of a specific creditor or shareholder. Investors and creditors have liability or equity claims. On the other hand, the proprietary perspective holds that financial reporting should focus only on the needs of the shareholders and is not considered appropriate. The entity perspective is adopted as part of the objective of general-purpose financial reporting.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex 1-57** Traditional users vs. others

Identify the six major categories of stakeholders as outlined in the textbook. For each category, indicate what is at stake. Which of these might be considered “traditional” financial statement users?

**Solution 1-57**

Refer to Illustration 1-4.

|  |  |
| --- | --- |
| **Stakeholder** | **What is at Stake** |
| Investors / Creditors | Investment / Loan |
| Management | Job, bonus, reputation, salary increase, access to capital markets by company |
| Securities commissions and stock exchanges | Reputation, effective and efficient capital marketplace |
| Analysts and credit rating agencies | Reputation, profits |
| Auditors | Reputation, profits (companies are their clients) |
| Standard setters | Reputation |

Investors and creditors might be considered “traditional” statement users.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-58** Imperfection of the stakeholder financial reporting environment

The financial reporting environment is a system that provides checks and balances to ensure that the people with capital—investors and creditors—have good information to use when deciding where best to invest and allocate capital. However, the system does not always work. Explain why this is the case.

**Solution 1-58**

The financial reporting environment (Illustration 1-3) does not always provide perfect information for people with capital because it involves people, and human behaviour is an unpredictable variable. People often act in their own self-interest rather than in the best interest of the capital marketplace, and by extension, the economy.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-59** User needs

Explain why providing information to users is a challenging task.

##### Solution 1-59

Firstly, users have very different knowledge levels. Some users have accounting designations or have worked in the finance industry for several years. Others have limited knowledge of how the information is gathered and reported. Secondly, users have very different needs. Some users are institutional investors who hold a large percentage of equity shareholdings and generally devote significant resources to managing their investment portfolios. Others are credit managers at banks or credit unions who deal mainly with small business or personal loans. Still others are labour negotiators whose knowledge of financial reporting is limited to periodic reviews of financial information for the purpose of negotiations.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-60** Merits of accrual vs. cash-basis accounting

Investors are interested in assessing a company’s ability to generate net cash inflows, as well as its ability to protect and enhance capital investments. Briefly explain how each of the accrual and cash-basis methods, respectively, might enhance these objectives.

**Solution 1-60**

Cash-basis accounting provides better information for assessing the timing and amounts of cash flows, which assist with the first objective. The second objective, concerning long-term performance of the company, may be better served by accrual-based accounting, which generally provides better information about future ability to generate favourable cash flows. It also ties operations to events and the surrounding environment, which are better indicators of performance, and the company’s ability to continue operating as a going concern.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Management Accounting

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-61** Information asymmetry

What is information asymmetry and how is it created? In markets where information asymmetry exists, there can be adverse selection and moral hazard. Explain what these terms mean and how this contributes to market asymmetry

##### Solution 1-61

Information asymmetry is the result of management having access to more or better information than others because they run the company. It can also be the result of market functioning. Markets are not fully efficient and human behaviour may result in companies or individuals behaving in a self-interested fashion. Adverse selection refers to *hidden knowledge*, where the capital marketplace may attract the wrong type of company, such as companies who have the most to gain from not disclosing information. Given this situation, companies who do fully disclose all information may choose not to enter the marketplace if they are aware of the presence of adverse selection.

Moral hazardrefers to *hidden actions*, and occurs as a result of human nature. People or companies may shirk their responsibilities if they think they can get away with it, e.g., not disclose negative information since they know it may be detrimental to their share price. This is a form of management bias.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-62** Maintaining competitive advantage

In the most efficient and effective marketplace possible, all stakeholders would have equal access to all relevant information. However, a company may believe that complete disclosure may hurt its competitive advantage or position. Offer an example of a circumstance where this may be the case. What do you think the company should do?

**Solution 1-62**

An example where disclosure may hurt the company’s competitive advantage or position would be a legal battle. If the company were in the middle of a lawsuit, the company would want to be careful about how much information was disclosed because it might affect the outcome of the lawsuit. This is an ethical dilemma. The company must weigh the costs and benefits of sharing information. If the financial impact of the lawsuit is expected to be material, they should, at minimum, disclose its existence in the notes to the financial statements. If the amount and timing of any financial impact are sufficiently known and certain, an accrual of these amounts may be necessary.

Difficulty: Hard

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Evaluation

AACSB: Communication

**Ex. 1-63** Management bias in financial statement presentation

There are many reasons why management may present biased information in the financial statements. Identify and explain at least three (3) such motivations.

**Solution 1-63**

Possible motivations for management bias include:

1. Evaluation of management performance – If the company has not performed at the level expected by investors, there may be incentive by management to try and present the financial information in a way that is more favourable than the actual results.

2. Compensation structures – Renumeration either bonuses or stock options that are tied directly to net income.

3. Access to capital markets and meeting financial analyst expectations – Desire to meet the financial analysts’ expectations for performance, since this may directly affect cost of capital or share prices.

4. Contractual obligations – Lending agreement covenants that have specific requirements related to liquidity or solvency.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-64** Financial versus managerial accounting

Distinguish between financial and managerial accounting.

**Solution 1-64**

**Financial accounting (financial reporting)** is the process that culminates in the preparation of financial reports that cover all of the enterprise’s business activities and that are used by both **internal and external** parties. Users of these financial reports include investors, creditors, and others.

In contrast, **managerial accounting** is the process of identifying, measuring, analyzing, and communicating financial information to internal decision-makers. This information may take varied forms, such as cost-benefit analyses and forecasts that management uses to plan, evaluate, and control an organization’s operations.

Difficulty: Easy

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-65** Role of securities commissions and stock exchanges

Explain the role of securities commissions and stock exchanges in financial reporting.

##### Solution 1-65

The securities commissions and stock exchanges monitor the financial statements of companies whose shares are publicly traded to ensure that these companies provide full and plain disclosure of material information, and to ensure that the companies may continue to list shares on the stock exchanges. Securities commissions oversee and monitor the capital marketplace.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Management Accounting

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-66** Purpose of accounting standards

Accounting professions in various countries have tried to develop a set of standards that are generally accepted and universally practised. Explain the motivation for creating such a set of standards. How has this influenced the relationship between Canadian GAAP and International Financial Reporting Standards (IFRS).

**Solution 1-66**

Creating standards facilitates comparability across companies and periods. Without standards, each enterprise would develop its own standards, and readers of financial statement would have to become familiar with every company’s particular accounting and reporting practices. It would be almost impossible to prepare statements that could be compared. Since the decision to adopt IFRS was made, Canadian GAAP has been continuously adjusted (converged) to mirror IFRS. Even prior to that convergence, both standards were principles-based (rather than rules-based).

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-67** ASPE vs. IFRS

Accounting standards for Private Enterprises (ASPE) are geared towards fewer users who have access to additional information about the company. The need for common language and comparability as facilitated by IFRS is less necessary among private enterprises. Given this, explain why a private company might choose to voluntarily adopt IFRS.

**Solution 1-67**

A private company that is looking to go public might find it easier to follow IFRS right from the beginning. Other motivations might include specific requests from users, or ease of adoption if the small enterprise is a subsidiary of a larger company with IFRS reporting already in place.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-68** IFRS Discussion Group

Explain the purpose of the IFRS Discussion Group.

**Solution 1-68**

The IFRS Discussion Group (IFRS DG) is a sub-committee created by the AcSB mandated to raise awareness of issues arising in Canada as a result of implementing IFRS, and to make recommendations to the AcSB for referral to the International Accounting Standards Board and its subcommittees.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**Ex. 1-69** Sources of GAAP

International Financial Reporting Standards (IFRS) are the primary source of GAAP for public enterprises in Canada. They are, however, insufficient to address all of the accounting issues facing accountants. When specific guidance cannot be found in primary sources such as the Handbook and Accounting guidelines, what process should the accountant follow in their consultation of other sources? Explain why this is so and outline some other sources of GAAP that accountants use.

##### Solution 1-69

Although IFRS outlines the specific accounting treatment for a multiple items, in some circumstance the guidelines are very general. Also, the business environment is complex and constantly changing and. Therefore, some items may not be discussed at all. If primary sources do not deal with the specific issue, the entity should use accounting policies that are consistent with primary sources. The policies should be developed through use of professional judgement in accordance with the conceptual framework. The accountant might consider pronouncements of other standard setters, accepted industry practices, and other literature, with the goal of producing information that is as relevant and reliable. Thus, accountants must use IFRS in conjunction with other sources like professional judgement, pronouncements of other standard-setting bodies, accounting literature, and accepted industry practices.

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-70** Professional judgement

Explain the principle of professional judgement. When or why might it be necessary to employ professional judgement, even in a rules-based system?

**Solution 1-70**

Professional judgement is the process by which professional accountants with significant education and experience apply general principles appropriately as they see fit. This is important in Canada because IFRS and ASPE are based primarily on general principles rather than on specific rules. It may also be useful in a rules-based system, as novel circumstances and transactions are bound to arise for which a rule does not yet exist. In these scenarios, an accountant must make use of professional judgement to decide which treatment/record-keeping approach to a transaction will provide the most relevant, reliable, and timely information to financial statement stakeholders.

Difficulty: Easy

Learning Objective: Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.

Section Reference: Generally Accepted Accounting Principles

CPA: Communication

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Communication

**Ex. 1-71** SOX and standard setting

After several highly publicized accounting scandals in the U.S. such as Enron, Sunbeam, and WorldCom, all of whom, coincidentally, were clients of the former public accounting firm of Arthur Andersen, the U.S. regulators enacted the Sarbanes-Oxley Act (SOX). Pressure was put on Canada to follow a similar course. Explain what Canada has done to make public companies more accountable.

##### Solution 1-71

First, the Canadian Public Accountability Board (CPAB) was created to supervise accounting issues similar to those addressed by SOX. 2These included establishing auditing, quality control, and independence standards and rules.

The Canadian Securities Administrators (CSA) has issued guidelines/rules that require (among other things) the following:

1. company management to take responsibility for the appropriateness and fairness of the financial statements

2. public enterprises to have independent audit committees

3. public accounting firms to be subject to CPAB

4. greater disclosures including ratings from rating agencies, legal proceedings, payments to stock promoters, and details about corporate directors.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Communication

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-72** Role of executives and management in a post-SOX world

SOX introduced sweeping changes to the institutional structure of the accounting profession. What key provision was introduced relating to the role of management and executive officers, and their relationship to financial reporting? Why?

**Solution 1-72**

Chief executive officers (CEOs) and chief financial officers (CFOs) are required to certify that the financial statements and company disclosures are appropriate and fairly presented. In many cases, they must forfeit bonuses and profits if there is a restatement of their company’s’ accounting disclosures. Management must report on the effectiveness of financial reporting internal control systems. Requiring management and executives to make these attestations holds them accountable, and creates a greater sense of ownership over the financial statements. When this is done, management and executives are unable to claim ignorance if intentional misrepresentations or frauds present in the financial reports are uncovered, as many were in the pre-SOX era.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

CPA: Professional & Ethical Behaviour

CPA: Strategy & Governance

Bloomcode: Knowledge

AACSB: Communication

**Ex. 1-73** Technology and financial information

Explain how technology impacts the accountants’ role as providers of information.

**Solution 1-73**

Technology impacts the process of identifying, measuring, and communicating useful information to users in profound ways. Information is increasingly abundant and available through technology. Trends including digitization, digitalization and artificial intelligence have been accelerating at an exponential pace. This is also a significant increase in the volume of information available (big data). For accountants this means more information on which to base decisions. However, this also creates some important questions related to the use of this data. How reliable is the information? How much information is needed to make decisions? What types of data is relevant? The sheer volume of information and the speed at which it accumulates also presents challenges. A new area of practice is also emerging – data governance. A major challenge for the role of the accountant is to embrace technological opportunities without losing the quality and content or traditional reporting.

Difficulty: Hard

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Audit & Assurance

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Evaluation

AACSB: Technology

**Ex. 1-74** Principles versus rules-based approaches

Explain the difference between the principles versus rules-based approaches with regard to GAAP.

**Solution 1-74**

In a **rules-based** approach—much like the Canadian tax system—there is a rule for most things (even though the rule may be based on a principle). The result is that the body of knowledge in a rules-based approach is significantly larger than that in a principles-based approach.

IFRS and ASPE are **principles-based**. The body of knowledge is smaller and the idea is that one or more principles form the basis for decision-making in many differing scenarios. In addition, professional judgement is fundamental. There is less emphasis on right and wrong answers. Rather, the financial reporting is a result of carefully reasoned application of the principle to the business facts.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**Ex. 1-75** Value creation

Describe the term “value creation” as defined by CPA Canada. Explain how this supports and expands sustainability reporting. How does this compare to past definitions of value creation?

**Solution 1-75**

CPA Canada defines value creation as the process by which an organization creates the potential for revenue and net income that can be realized in the future and /or future benefits for the organization’s stakeholders. The very definition supports the idea of sustainability of reporting by working towards and embracing positive societal outcomes. In the past, the term value creation was discussed in the context of a shareholder perspective and profitability. This has been expanded to include a much broader definition of a stakeholder, to include all interested parties.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

**Ex. 1-76** Standard setting in a political environment

Analyze the IASB funding structure. How does the IASB use this to mitigate political influence over international standard setting bodies?

**Solution 1-76**

The IASB follows and applies the following principles in order to mitigate politicization of the standard setting process:

1. Broad-based: It should not rely on one or few sources. This mitigates to risk of one country having undue influence over the process.
2. Compelling: Constituents should not be allowed to benefit from the standards without contributing to the process. This ensures that members cannot be unduly influenced to make to decisions in another party’s best interest.
3. Open-ended: Financial commitments for funding should not be contingent upon any particular outcomes that may infringe upon independence in the standard setting process. This ensures that funding is committed to the process not the outcome.
4. Country-specific: Funding should be shared by major economies on a proportionate basis. This ensures that less wealthy countries are still entitled to participate in the process.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**PROBLEMS**

**P1-77** Information Asymmetry

Gable Fire Systems hired an operations manager at the beginning of the current fiscal year. The manager’s compensation package included a 30%-year end bonus on net income before taxes. It is now the year end and the manager has asked the accounts receivable department to recognize revenues for any signed contracts in the current period and in advance of the provision of services. Is this appropriate? Why or why not? What is the operations manager’s motivation to make this request? If the accounts receivable department recognizes the revenue as requested, does this create any type of information asymmetry? If so, what type and why?

**Solution 1-77**

The operations manager is asking the accounts receivable department to recognize revenues that have not yet been earned, since services have not been provided to the customer. This is not appropriate as it will overstate revenues and thus net income. The operations manager’s request is the result of the compensation structure and as a result there is management bias. This results in information asymmetry, more specifically moral hazard. The manager is operating in his own best interest at the expense of other users of the financial statements and the bias is taking the form of an overstatement of net income.

Difficulty: Hard

Learning Objective: Understand the financial reporting environment.

Section Reference: Financial Statements and Financial Reporting

CPA: Communication

CPA: Financial Reporting

CPA: Strategy & Governance

Bloomcode: Synthesis

AACSB: Communication

**P1-78** U,S. GAAP on Canadian GAAP

Explain why U.S. GAAP has and will continue to have a significant impact on GAAP in Canada.

**Solution 1-78**

U.S. GAAP has and will continue to have a significant impact on GAAP in Canada for three reasons:

1. First, because ASPE is based on principles and is fairly open to interpretation, accounting professionals have often (in past) relied on the more prescriptive, specific guidance provided in U.S. GAAP.
2. Second, many public Canadian companies are also listed on U.S. stock markets, such as NASDAQ and the NYSE. To be listed on a U.S. exchange, these companies must follow U.S. GAAP or IFRS. As we move toward international harmonization in accounting standards, the U.S. standards will continue to influence Canadian and international standards due to the significant capital pool of these markets.
3. Third, the United States has not adopted IFRS and may never do so. Nonetheless it has representation on the IASB, and thus, influence.

Difficulty: Easy

Learning Objective: Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.

Section Reference: Standard Setting

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**P1-79** Challenges facing financial reporting

In North America, the financial reporting environment is changing at a very rapid pace. Briefly describe the challenges related to oversight, ethics, standard setting and a principles-based system. Make sure to illustrate the current impact of these challenges on the accounting profession.

##### Solution 1-79

1. Oversight in the capital marketplace. The Sarbanes-Oxley Act (SOX) instituted the Public Company Accounting Oversight Board (PCAOB) mandating stronger independence rules for auditors, reporting on the effectiveness of the financial reporting internal control system, and disclosure of a code of ethics for senior financial officers.

Canada has followed suit and developed the Canadian Public Accountability Board (CPAB). As well, the Canadian Securities Administrators (CSA) requires company management to take responsibility for the appropriateness and fairness of the financial statements, public companies to have independent audit committees, and public accounting firms to be subject to the CPAB. The CSA also requires much greater disclosures. The overall impact of these financial reforms has been to put more emphasis on government regulation and less on self-regulation.

2. Centrality of ethics. Accountants are central in making the capital marketplace efficient and effective. However, ethical dilemmas are common, often precipitated by management bias. It is not always easy to “do the right thing.” Pressure to “bend the rules,” “play the game,” or “just ignore it” are often present. There is no consensus (yet) among accounting professionals as to what a comprehensive ethical system is, and so it is up to the individual accountant to maintain a high standard of ethics at all times.

3. Standard setting in a political environment. Since standard setting is part of the real world, accounting standards often arise from political action. The stakeholders who lobby the hardest may unduly influence new or revised accounting standards. This is not surprising since many accounting standards have economic consequences. Thus, standard setters such as the IASB must consider the needs of all stakeholders when creating or changing standards. The challenge is to find a balance between letting stakeholders have a say while not bowing to undue political pressure.

4. Principles vs. rules. Rules-based, prescriptive systems (such as U.S. GAAP or the Canadian income tax system) have a significantly larger body of knowledge than a principles-based approach such as IFRS and ASPE. However, there is a tendency to interpret the rules literally with a rules-based approach, possibly because it may be easier to defend the accounting for a particular item. A disadvantage of the rules-based approach is that it may not always communicate the best information to the user. The principles-based approach is based on professional judgement, resulting in a carefully reasoned application of the principle to the business facts. Since the body of knowledge is smaller with a principles-based approach, the standard setters must ensure it rests on a cohesive set of principles and a conceptual framework, which is sufficiently flexible and detailed to provide good guidance.

Additional challenges include the impact of technology and sustainability reporting.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Communication

CPA: Financial Accounting

CPA: Management Accounting

CPA: Professional & Ethical Behaviour

Bloomcode: Comprehension

AACSB: Communication

**P1-80** Shortcomings of rules-based approach

Discuss the shortcomings of the rules-based approach regarding GAAP.

**Solution 1-80**

In a **rules-based** approachthere is a tendency for companies to interpret the rules literally and many companies take the view that, if there is no rule for a particular situation, the company is free to choose whatever treatment it thinks is appropriate (within reason). Similarly, many companies may also believe that as long as the entity complies with a rule, even in a narrow sense, it is in accordance with GAAP. Consequently, the rules-based approach does not always emphasize the importance of communicating the **best** information to the users. Just because a practice is defensible does not mean it provides the best information. This particular issue is a significant one for the United States as it continues to debate whether to adopt IFRS, which is principles-based rather than rules-based.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Knowledge

AACSB: Analytic

**P1-81** Sustainability Reporting

What is the goal of sustainability reporting? How has this changed the disclosure framework over the past several years, specifically related to governance? Provide examples of the types of information that would be included in these disclosures comparing to past practices.

**Solution P1-81**

CPA Canada defines value creation as “the process by which an organization creates the potential for: a) revenue and net income that can be realized in the future, and / or b) future benefits for the organization’s stakeholders.” Sustainability and working towards more positive societal goals are embraced in this definition and form the basis of sustainability reporting.

Institutional investors (and a broader group of stakeholders) are looking for more information on how a company deals with environmental, societal and governance (ESG) issues. These issues are closely related to a company’s ability to create economic value. As a result, disclosure models have evolved to include governance issues such as:

1. Quality of the board of directors (independence and accountability)
2. Oversight of executive performance and compensation
3. Oversight of a company’s strategy, risk management, performance and disclosure.

In the past, the discussion of value creation was limited to the profitability and the shareholder perspective only. It did not take into consideration these ESG factors and the impact these factors might have on either creating or destroying economic value. Even less familiar to many is the impact of environmental and social issues on value creation, specifically things like climate change, energy management, cybersecurity and data privacy, just to name a few.

Difficulty: Easy

Learning Objective: Discuss some of the challenges and opportunities for accounting.

Section Reference: Challenges and Opportunities for the Accounting Profession

CPA: Financial Reporting

Bloomcode: Comprehension

AACSB: Analytic

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