

The Canadian Financial Reporting Environment

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Capitalizing on Financial Reporting

SUSTAINABILITY If you have a financial interest in Maple Leaf Foods, you can consult its annual reports to learn facts about its financial picture, such as the following:

- Sales for 2020 were \$4.3 billion, an increase of 9.2% over 2019, thanks to strong growth in the company's two segments (meat and plant protein).
- In 2018, the company acquired 100% of the outstanding shares of privately held Italian meats company VIAU Food Products at a price of \$215 million.
- Basic earnings per share was \$0.81 in 2018, \$0.60 in 2019, and \$0.92 in 2020.

If, however, you turn to the company's sustainability reports, you will learn a wide range of information that an increasing number of stakeholders find just as important, such as the following:

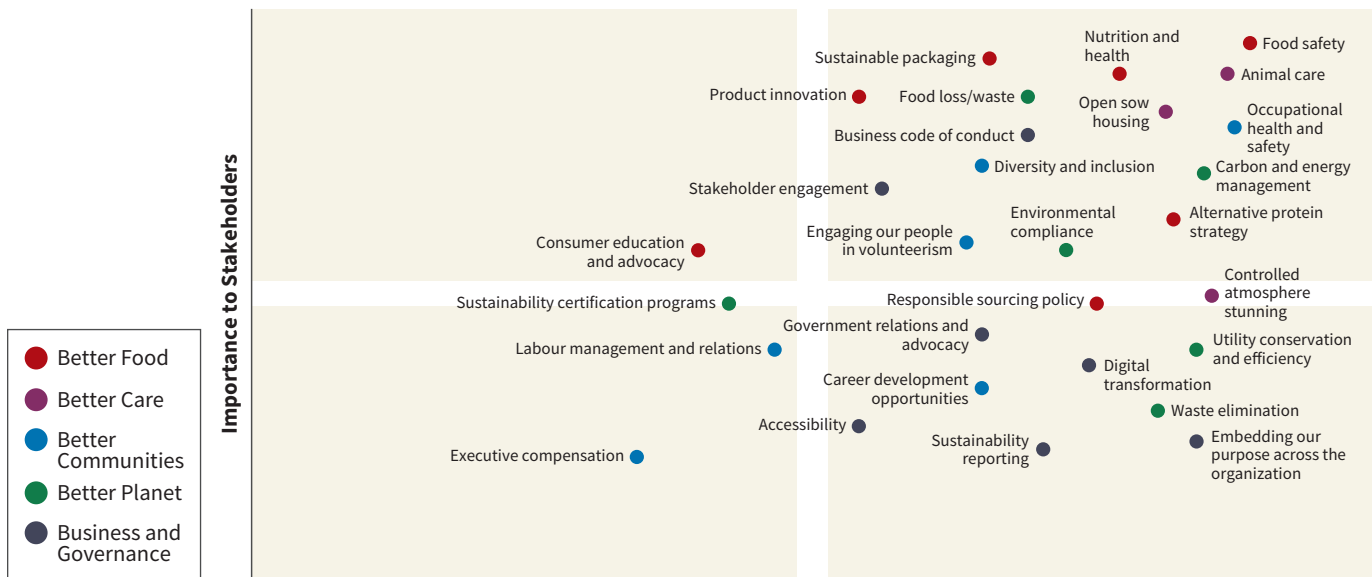
- Maple Leaf Foods became the world's first carbon-neutral food company in 2019. It accomplished this through a combination of reducing its own greenhouse-gas emissions and offsetting the amount that remained through investments in environmental programs.
- The company has hosted an annual food safety symposium every year since 2009.

- Maple Leaf Foods introduced ready-to-eat chicken tikka bites and falafel in 2018 as part of its Halal-certified Mina product line.
- Beginning in 2019, all employees who handle live animals complete an animal care certification training program.
- Maple Leaf Foods contributed more than \$2.3 million to initiatives working to advance food security in 2019.

Since 2012, Maple Leaf Foods has issued an annual sustainability report in addition to its financial report—one of a growing number of companies in Canada and around the world choosing to report on their performance and impact in areas such as the environment, sustainability, and governance, although there is no legal requirement to do so in Canada.

With a stated intent “to be the most sustainable protein company on earth,” Maple Leaf Foods organizes its sustainability reporting into the “four pillars” of “better food, better care, better company, and better planet.” The report is presented as a section of the company's website, easily accessible to all stakeholders.

The range of stakeholders for sustainability reporting is wide—Maple Leaf Foods lists customers, employees, consumers, investors, suppliers, government, and non-profit organizations among them. Following best practice, the company compiles a list of topics based on findings from various stakeholder engagement efforts. This list helps guide its annual sustainability reporting. A materiality matrix, as shown below, illustrates the importance of various topics through two different lenses: that of Maple Leaf Foods and that of its stakeholders.



Importance to Maple Leaf Foods and Our Purpose
Source: Maple Leaf Foods, “2018 Sustainability Report,” p. 10.

Sources: “Sustainability at Maple Leaf Foods,” Maple Leaf Foods website, 2019; Maple Leaf Foods, “2018 Sustainability Report,” 2018; Maple Leaf Foods, “Annual Report to Shareholders for the Year Ended December 31, 2020,” February 5, 2021.

Chapter Roadmap

LEARNING OBJECTIVES

TOPICS

<p>1. Understand the financial reporting environment.</p>	<p>Financial Statements and Financial Reporting</p> <ul style="list-style-type: none"> Accounting and capital allocation Stakeholders Objective of financial reporting Information asymmetry
<p>2. Explain the need for accounting standards and identify the major entities that influence standard setting and financial reporting.</p>	<p>Standard Setting</p> <ul style="list-style-type: none"> Need for standards Parties involved in standard setting
<p>3. Explain the meaning of generally accepted accounting principles (GAAP) and the significance of professional judgement in applying GAAP.</p>	<p>Generally Accepted Accounting Principles</p> <ul style="list-style-type: none"> GAAP hierarchy Professional judgement
<p>4. Discuss some of the challenges and opportunities for accounting.</p>	<p>Challenges and Opportunities for the Accounting Profession</p> <ul style="list-style-type: none"> Impact of technology Sustainability reporting Oversight in the capital marketplace Centrality of ethics Standard setting in a political environment Principles versus rules Conclusion

Preview of Chapter 1

North American financial reporting systems are among the best in the world. Our commitment to keeping our financial reporting systems strong is as intense as ever, because in this changing business world, information must be relevant and reliable for our capital markets to work efficiently. This chapter explains the environment of financial reporting and the many factors that affect it. It provides the theory and concepts underpinning the topics covered in the rest of the chapters, giving you the foundation to exercise professional judgement in the many issues that require it. Big data, data analytics, and expanded views regarding sustainability reporting continue to shape the profession.

1.1 Financial Statements and Financial Reporting

LEARNING OBJECTIVE 1

Understand the financial reporting environment.

Like other human activities and disciplines, accounting is largely a product of its environment. This environment includes conditions, constraints, and influences that are social, economic, political, and legal—all of which change over time. As a result, accounting theory and practices have always evolved and need to continue to evolve in order to remain relevant.

Accounting is defined best by describing its three essential characteristics. Accounting is (1) the identification, measurement, and communication of financial information (2) about economic entities (3) to interested persons.

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. This textbook focuses on financial accounting, while managerial accounting is covered in other courses.

Financial statements are the principal way of communicating financial information to those who are outside an enterprise. These statements give the firm's history, quantified in terms of money. The following are the most frequently provided financial statements:

1. **statement of financial position**
2. **statement of income/comprehensive income**
3. **statement of cash flows**
4. **statement of changes in equity**

See **Alternative Terminology 1.1**.

In addition, **note disclosures** are an important part of each financial statement. Some financial information cannot be expressed in the financial statements or is better expressed through other means. Examples include the president's letter and supplementary schedules in the corporate annual report, prospectuses, reports filed with government agencies, news releases, management forecasts, and descriptions of an enterprise's social or environmental impact. Such information may be required by a pronouncement by an authority or a regulatory rule or custom, or because management wants to disclose it voluntarily.¹ The main focus of this textbook is the basic financial statements (including notes).

Alternative Terminology 1.1

These financial statements are also sometimes called:

1. balance sheet
2. income statement or statement of profit or loss*
3. cash flow statement

Under Accounting Standards for Private Enterprises, a statement of retained earnings is generally prepared instead of a statement of changes in equity.

*The IASB Exposure Draft *General Presentation and Disclosures (Primary Financial Statements)* proposes the label "statement of financial performance" but notes that alternative titles may be used.

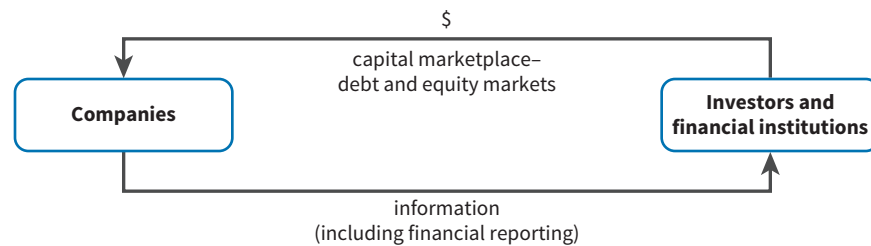
¹All public companies must disclose certain information under provincial securities law. This information is collected by the provincial securities commissions under the Canadian umbrella organization, the Canadian Securities Administrators (CSA), and is available electronically at www.sedar.com.

Accounting and Capital Allocation

Because **resources** are limited, people try to conserve them, use them effectively, and identify and encourage those who can make efficient use of them. Through an **efficient use of resources**, our standard of living increases.

Finance Markets, free enterprise, and competition determine whether a business will succeed and thrive. The accounting profession has the important responsibility of **measuring company performance** accurately and fairly on a timely basis. The information provided by accounting enables investors and creditors to **compare** the income and assets of companies and thus **assess the relative risks and returns** of different investment opportunities. Based on their assessments, investors and creditors can then channel their resources (that is, invest in these companies or lend them money) more effectively. **Illustration 1.1** shows the process of **capital allocation**.

ILLUSTRATION 1.1
Capital Allocation Process

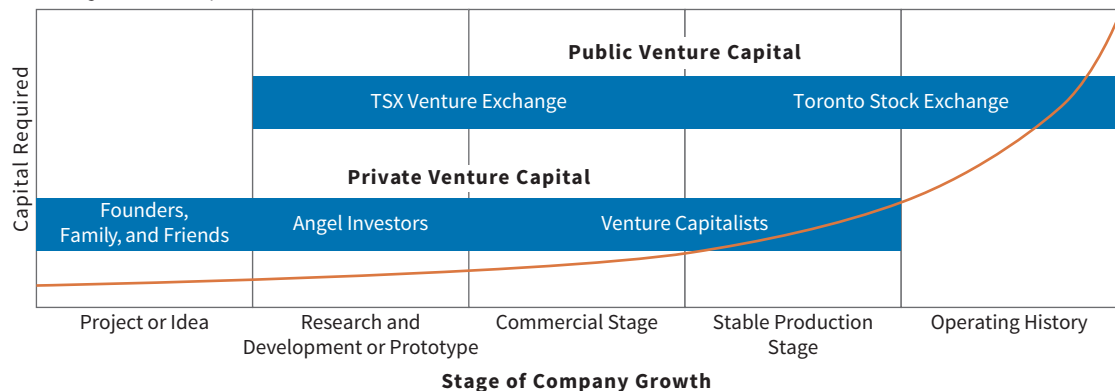


In Canada, the primary exchange mechanisms for allocating resources are **debt and equity markets**, as well as **financial institutions** such as banks.^{2,3} The debt and equity marketplace includes both public stock markets/exchanges and private sources.

Illustration 1.2 shows the sources of capital in Canada for various stages of company growth.

ILLUSTRATION 1.2
Sources of Capital

Financing Growth Companies



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Providing an effective system to facilitate capital allocation is critical to a healthy economy. Efficient capital markets promote productivity, encourage innovation, and provide a platform for buying and selling securities and obtaining and granting credit.⁴ Unreliable and

²The largest, most senior equity market in Canada is the Toronto Stock Exchange (TSX). The junior market—the TSX Venture Exchange (TSXV, formerly called the CDNX Stock Market)—was created in 2001 to handle start-up companies, and the Canadian Securities Exchange (CSE), another junior market, was launched in 2004. The Montreal Exchange (MX), known also as the Canadian Derivatives Exchange, is the main market for derivatives and futures trading. In 2014, the TMX Group, which operates the TSX, launched a new market to help private companies raise capital. It is called TSX Private Markets and is operated through Shorcan, a subsidiary of the TMX Group.

³The largest banks in Canada by market capitalization are Royal Bank of Canada, Toronto Dominion Bank, Bank of Nova Scotia, Bank of Montreal, and Canadian Imperial Bank of Commerce.

⁴AICPA Special Committee on Financial Reporting, “Improving Business Reporting: A Customer Focus,” supplement in *Journal of Accountancy*, October 1994.

irrelevant information leads to **poor capital allocation**, which hurts the securities markets and economic growth. The accounting numbers that companies report affect the **transfer of resources** among companies and individuals. Consider the fact that stock prices generally rise when positive news (including financial information) is unexpectedly released. In addition, **credit rating agencies** use accounting and other information to rate companies' financial stability.⁵ This gives investors and creditors **additional independent information** to use when making decisions. For companies, a better rating can mean greater access to capital and at lower costs.

Stakeholders

Stakeholders are parties who have something at risk in the financial reporting environment, such as their salary, job, investment, or reputation. Key stakeholders in the financial reporting environment include **traditional users** of financial information as well as others. In the stakeholder context, **users** may be more broadly defined to include not only parties who are relying directly on the financial information for resource allocation (such as investors and creditors) but also others who help in the efficient allocation of resources (such as financial analysts and regulators).

The broader definition of users includes anyone who **prepares, relies on, reviews, audits, or monitors financial information**. It includes investors, creditors, analysts, managers, employees, customers, suppliers, industry groups, unions, government departments and ministers, the public in general (such as consumer groups), regulatory agencies, other companies, and standard setters, as well as auditors, lawyers, and others. **Illustration 1.3** shows the relationships among these stakeholders.

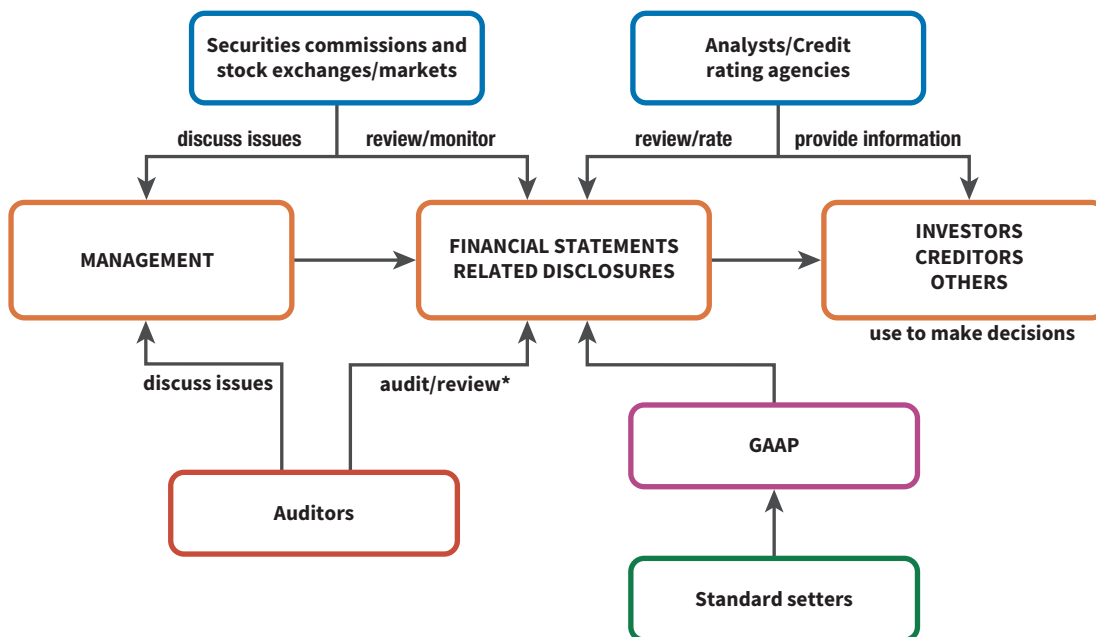


ILLUSTRATION 1.3
Selected Key Stakeholders in the Financial Reporting Environment

*Not all financial statements are required to be audited. In general, all companies whose shares or debt is **publicly traded** must have an audit and therefore comply with generally accepted accounting principles (GAAP). Private companies may decide not to have an audit but must have unanimous shareholder consent according to the Canada Business Corporations Act. For private companies, the decision to have an audit or not may depend on whether the statements' users would find audited GAAP statements more useful.

Various stakeholders have specific functions in the financial reporting environment. Company management **prepares** the financial statements. It has the best insight into the business and therefore knows what should be included in the financial statements. The statements are then **audited** by auditors, who may discuss with management how economic events and

⁵For example, institutions such as DBRS, Moody's Investor Services (Moody's), and Standard & Poor's (S&P) rate issuers of bonds and preferred shares in the Canadian and global marketplaces.

transactions have been communicated in the financial statements. The value that auditors add to the statements lies in the auditors' independence. They act on behalf of the shareholders to ensure that management is accounting properly for the economic transactions. The auditors also **review** the information to ensure that it reflects sound accounting practices.

Law Investors and creditors **rely on** the financial statements to make decisions. It is up to these parties to carefully examine the information given. Standard setters set **generally accepted accounting principles (GAAP)**. Securities commissions and stock exchanges **monitor** the financial statements to ensure full and plain disclosure of material information and to determine whether the companies may continue to list their shares on stock exchanges. Finally, the credit rating agencies and analysts **monitor and analyze** the information produced by many companies, looking for signs of change; that is, an improved or weakened financial condition.

Illustration 1.4 identifies what is at stake for each stakeholder. This is not meant to be a complete list. Rather, it identifies the major stakeholder groups.

ILLUSTRATION 1.4

What Is at Stake for Each Stakeholder

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
Others	Various

As noted in Illustration 1.3, the system provides **checks and balances** to ensure that the people with capital—the investors and creditors—have good information to use when deciding where best to invest or allocate their capital. The system does not always work, however. Because the system involves people, human behaviour is often a key unpredictable variable. People often act in their own **self-interest** rather than in the **best interest of the capital marketplace, the economy and society more broadly**.

Objective of Financial Reporting

What is the **objective of financial reporting**? The objective of **general-purpose financial statements** 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 capital providers**.⁶ (This is referred to as the **decision-usefulness approach** to financial reporting.) Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not investors and creditors. Let's examine each of the elements of this objective.

Theory As part of the objective of general-purpose financial reporting, an **entity perspective** is adopted. Using this perspective, companies are viewed as separate and distinct from their owners (present shareholders). The assets of incorporated entities such as companies listed on stock exchanges are viewed as assets of the company and not of a specific creditor or shareholder. Investors and creditors have claims on a company's assets in the form of equity or liability

⁶IASB Conceptual Framework, Chapter 1. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission. Reprinted/adapted with permission from the *CPA Canada Handbook—Accounting* © 2020, Part II, Section 1000.12, by Chartered Professional Accountants of Canada. All rights reserved by the copyright owner.

claims. The entity perspective is common today, because most companies that report their financial information have substance distinct from their investors (both shareholders and creditors). Thus, the perspective that financial reporting should be focused only on the needs of shareholders—often referred to as the **proprietary perspective**—is not considered appropriate.

As mentioned earlier, investors are interested in assessing (1) the company’s ability to generate net cash inflows and (2) management’s ability to protect and enhance the capital providers’ investments. Financial reporting should therefore help investors assess the amounts, timing, and uncertainty of prospective cash inflows from dividends or interest, and the proceeds from the sale, redemption, or maturity of securities or loans. In order for investors to make these assessments, they must understand an enterprise’s economic resources, the claims to those resources, and the changes in them. Financial statements and related explanations should be a primary source for determining this information.

The emphasis on “assessing cash flow prospects” does not mean that the cash basis is preferred over the accrual basis of accounting. Information based on accrual accounting generally better indicates a company’s present and future ability to generate favourable cash flows than does information limited to the financial effects of cash receipts and payments. Recall from your first accounting course the objective of **accrual-basis accounting**. It ensures that a company records events that change its financial statements in the periods in which the events occur, rather than only in the periods in which it receives or pays cash. Using the accrual basis to determine net income means that a company recognizes revenues when it provides the goods or services rather than when it receives cash. Similarly, it recognizes expenses when it incurs them rather than when it pays them. Under accrual accounting, a company generally recognizes revenues when it makes sales. The company can then relate the revenues to the economic environment of the period in which they occurred. Over the long run, trends in revenues and expenses are generally more meaningful than trends in cash receipts and disbursements.

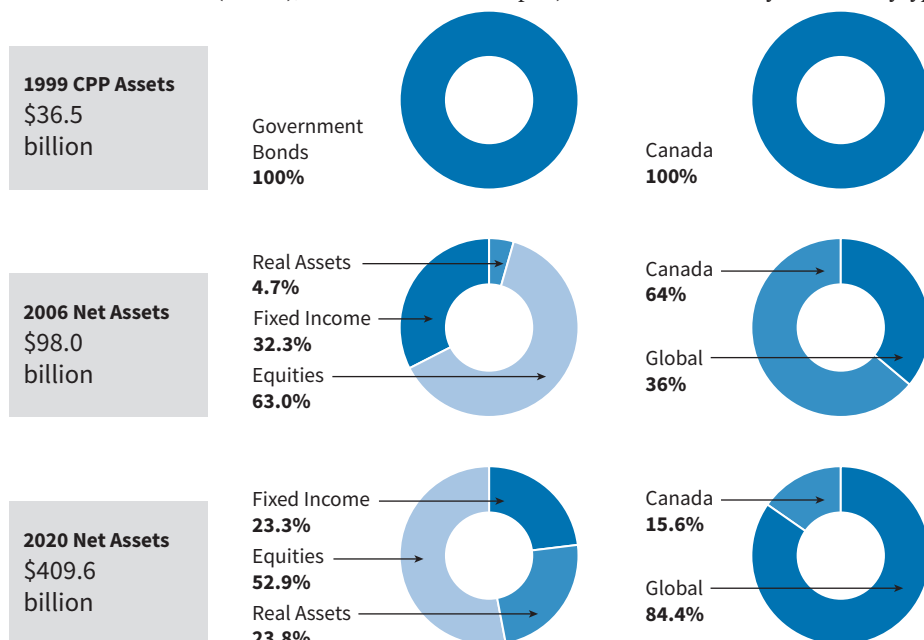
Providing information that is useful to users is a challenging task because they have **different needs and levels of knowledge**. **Institutional investors**, such as the Canada Pension Plan (see **What Do the Numbers Mean? 1.1**), hold an increasing percentage of

What Do the Numbers Mean? 1.1

The Canada Pension Plan (CPP) is one of the 10 largest retirement funds in the world according to its website. Over 20 million Canadians participate in the plan. The plan is managed by the Canada Pension Plan Investment Board (CPPIB), which decides

how to invest the CPP funds. Its mandate is to “maximize returns without undue risk of loss.”

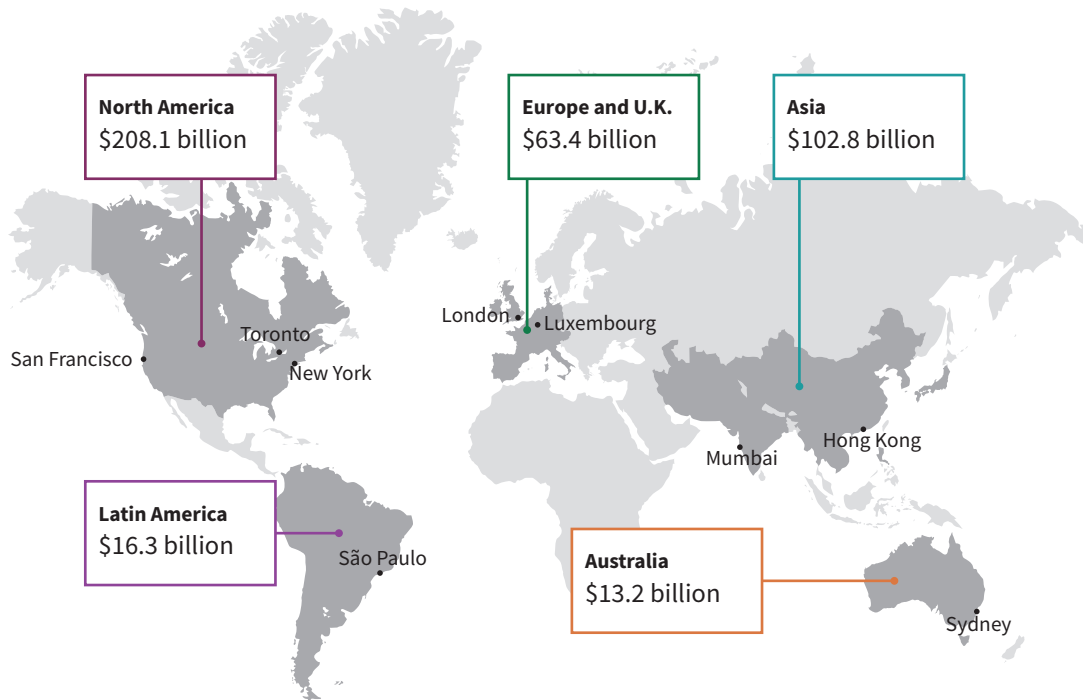
The visualizations below (based on the CPPIB 2020 Annual Report) show where the money is invested by type of asset and region.



The fund stood at \$409.6 billion as at March 31, 2020, and experienced a 3.1% rate of return for 2020. The lower return on investment is partially attributed to the COVID-19 pandemic, which surfaced in late 2019 and had far-reaching global economic effects. As you can see in the above diagram, the composition of types of assets has shifted over the past two decades from primarily fixed income to primarily equities—including shares in publicly traded corporations as well as private companies. CPPIB

has increasingly expanded its investment in real assets, including real estate, infrastructure, agricultural land, energy, and natural resources. As a large institutional investor with substantial equity holdings, the CPP is a significant stakeholder in terms of how publicly traded companies report their financial information. CPPIB also migrated the investment portfolio geographically from Canadian investments to primarily global investments, as noted in both diagrams.

Regional Investment Highlights



equity shareholdings and generally put a lot of their resources into managing their investment portfolios.⁷ Can those who prepare financial information therefore assume that the average individual investor has the same needs and knowledge level as an institutional investor when it comes to business and financial reporting? Likely not.⁸ We will discuss this issue further in Chapter 2.

⁷Institutional investors are corporate investors such as insurance companies, pension plans, mutual funds, and others. They are considered a separate class of investors because of their size and financial expertise, and the large size of the investments that they hold in other companies. In general, for these reasons, institutional investors have greater power than the average investor.

⁸The Canadian Coalition for Good Governance (CCGG) is a group of institutional investors that manages over \$4.5 trillion in investments (including investments in private and public equities and bonds). Its members include many significant pension funds in Canada, such as the Alberta Teachers' Retirement Fund, Ontario Teachers' Pension Plan, OPSEU Pension Trust, and Ontario Municipal Employees Retirement System, as well as many significant mutual funds and financial institutions, such as Manulife Investment Management, RBC Global Asset Management Inc., and TD Asset Management Inc. According to its website (www.ccg.ca), CCGG was started in 2002 "to represent Canadian institutional shareholders in the promotion of corporate governance practices that best align the interests of boards and management with those of the shareholder." As a comparison point, the total market capitalization of the TSX is estimated at \$2.1 trillion (as at September 2020).

Information Asymmetry

Ideally, to facilitate the flow of capital in the most efficient and effective manner, all stakeholders should have equal access to all relevant information. In other words, there should be symmetry of access to information (**information symmetry**). This is nice in theory, but it does not always work in practice. Management may feel that disclosure of too much information may hurt the company's competitive advantage or position. For instance, if the company were in the middle of a lawsuit, management would want to be careful about how much information was disclosed because it might affect the outcome of the lawsuit. In such cases, the company must weigh the costs and benefits of sharing information. On the one hand, if the company is known to be open and forthright, revealing information may facilitate the flow of capital to the company and perhaps lower the cost of capital. On the other hand, if the company is too open, it might give away proprietary information that could cause profits to fall. For this reason, perfect information symmetry does not exist and, as a general rule, management rightly has access to more or better information than others because they run the company. In other words, there is **information asymmetry**. (See **What Do the Numbers Mean? 1.2** for a discussion on how the internet is changing information asymmetry.)

What Do the Numbers Mean? 1.2

In their book *Freakonomics*, Levitt and Dubner acknowledge that it is very common in transactions for one party to have more or better information than the other. Often, in a transaction, one party is an expert and the other not. In the capital marketplace, experts, including accountants, bankers, institutional investors, and company managers, all have more and better information than the average consumer or investor. Levitt and Dubner go on to argue, however, that the internet allows information to pass freely from experts to non-experts. They argue that the internet has “vastly shrunk the gap between experts and the public.”

Shifting to another discipline, consider, for example, your own relationship with your family doctor. Several decades ago, if something was wrong with you, you would have made an appointment and sat passively in the examining room while the doctor analyzed your symptoms and made a diagnosis. At that time, the doctor might have shared the analysis and diagnosis with you and then handed you an illegible prescription

to fill. The internet has changed this. Now, most people do a bit of research before they go to the doctor. By doing a quick search on the internet, patients are able to get information so they know what questions to ask and what options might be available for treatment. Patients can now freely access information about side effects and new drugs. Many people keep their own medical histories. Doctors understand that their role is to help their patients navigate the significant amount of information that is available, not necessarily (only) to dictate a diagnosis and treatment.

Returning to the business world, the real question is this: As people turn more and more to the internet and the information there becomes more and more robust, what is the role of experts in the capital marketplace, and how will the issue of information asymmetry evolve?

Source: Steven Levitt and Stephen Dubner, *Freakonomics* (New York: HarperCollins, 2005).

As well as the above, there are other reasons why information asymmetry exists in the marketplace. These reasons have to do both with the way the markets operate and with human nature:

1. Capital markets such as stock exchanges are not necessarily fully efficient; that is, not all information is incorporated into the stock prices of companies. The problem, of course, is that the prices may not reflect hidden or insider information. This discrepancy may be due to the reasons noted above, or other reasons in point 2 below.
2. Human behaviour sometimes results in individuals and companies acting in ways that will maximize their own well-being at the cost of other capital market participants. For instance, management may wish to show only positive information about a company in order to ensure access to capital markets or maximize their own personal bonuses.

Accounting and economic theory tries to help us understand these issues. The **efficient markets hypothesis** proposes that market prices reflect all publicly available information about a company.⁹

Theory In addition to researching whether market mechanisms are efficient or not, accounting theorists look at the issue of information asymmetry from other perspectives. There are two common types of information asymmetry problems that are studied by academics: adverse selection and moral hazard. These are briefly explained below. Accounting theory argues that information asymmetry results in a suboptimal or inefficient capital marketplace. In markets where this phenomenon is observed, investors may discount share prices, require higher returns on investment (as a penalty for having to deal with the lack of information), or choose not to invest in the market. In the extreme case, information asymmetry may interfere with a company's ability to access capital or minimize the cost of capital.

We will refer back to these concepts throughout the text. Because these concepts are also studied in other disciplines, the examples below look at them from a financial reporting and capital marketplace perspective.

The first type of information asymmetry is **adverse selection**. Basically, this means that, where information asymmetry exists, the marketplace may attract the wrong types of market participants (including buyers and sellers as well as investors). If buyers cannot assess the quality of the product they are buying, they may decide not to buy anything, or to buy only at a discount. Sellers, knowing this, will therefore put only inferior products up for sale; thus, the market could contain only companies with poor products, or it could fail. In addition, companies with higher-quality products may choose not to enter the capital marketplace, knowing that share prices may be discounted due to information asymmetry that does not allow investors to separate high-quality firms from "lemons" that produce low-quality products.

The second type of information asymmetry is **moral hazard**. This is the concept that people will often shirk their responsibilities if they think that no one is watching. For instance, a manager of a pharmaceutical company may choose not to work as hard if, as a result of information asymmetry, investors cannot tell the level of effort being made. Similarly, the manager may choose not to disclose negative information about ongoing drug trials, knowing that it will result in a decline in share prices and perhaps the manager's bonus. The manager may also engage in greater risk-taking. Accountants sometimes refer to this as **management bias**. Managers may decide to downplay the negative and focus on the positive (referred to as **aggressive accounting**). This bias might take the form of overstated assets and/or net income, understated liabilities and/or expenses, or carefully selected note disclosures that emphasize only positive events.¹⁰ **Conservative accounting** would be the opposite.¹¹ Any bias in financial reporting results in less useful information.

There are many reasons why management may present biased information in the financial statements. **Illustration 1.5** examines these possible motivations. We will revisit the issue of bias in Chapter 2 and throughout the text.

⁹There are three forms of the efficient markets hypothesis: (1) the weak form (market prices incorporate all historical publicly available information), (2) the semi-strong form (market prices incorporate all public information), and (3) the strong form (market prices incorporate all information, whether public or not). Historically, economists have argued that North American markets are less than perfectly efficient and that they are efficient in the semi-strong form only. This hypothesis has come under attack in recent years. Many feel that we have put too much faith in the belief that markets are efficient, and may need other mechanisms to deal with information asymmetry.

¹⁰This is not a new problem. David Brown, then-chairman of the Ontario Securities Commission (OSC), spoke at length on this topic in a speech in 1999 titled "Public Accounting at a Crossroads." Arthur Levitt, then-chair of the U.S. Securities and Exchange Commission (SEC), discussed his concerns over this issue in "Numbers Game," a major address to New York University in 1998. Both the OSC and the SEC review financial statements and financial reporting practices to ensure that investors have "full and plain disclosure" of all material facts that are needed to make investment decisions. In their speeches, Brown and Levitt both cited specific cases where they felt that financial reporting practices were problematic.

¹¹As noted earlier, conservative accounting would generally result in ensuring that assets and income are not overstated and that all relevant information is disclosed.

ILLUSTRATION 1.5 Possible Motivations for Management Bias

Motivation to Bias Information	Explanation
Evaluation of management performance	Financial statements provide evidence to investors about how management has discharged its stewardship function. Stewardship is how well management has looked after the money invested in the company. Ideally, they have at least maintained the capital and have hopefully increased it. If they did not, there may be incentive to introduce bias to make it look like they did.
Compensation structures	Management remuneration may be based on financial statements directly (for example, bonus based on net income) or indirectly (stock options based on the value of the shares that may be affected by reported net income).
Access to capital markets and meeting financial analysts' expectations	There is a strong desire to meet financial analysts' expectations because this may affect a company's cost of capital or access to capital markets. ¹² In addition, there may be a concern that share prices—and therefore management compensation—may drop.
Contractual obligations	Many lending agreements and contracts require that certain financial benchmarks be met, and these often relate to financial stability or liquidity. For instance, a debt covenant (a term in a loan agreement) may state that the company must maintain certain minimum financial ratios or the loan may be called (demanded to be repaid).

1.2 Standard Setting**LEARNING OBJECTIVE 2**

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

Need for Standards

Accounting standards help reduce the information asymmetry problem in financial reporting. They do this by requiring that transactions and events be recognized, measured, presented, and disclosed in a specific way. But the main controversy in financial reporting is this: Whose rules should we play by, and what should they be? The answer is not immediately clear. This is because the users of financial statements have both similar and conflicting needs for information of various types.

Accounting professions in various countries have tried to develop a set of standards that are generally accepted and universally practised. Without these standards, each enterprise would have to develop its own standards, and readers of financial statements would have to

¹²Financial analysts monitor earnings announcements carefully and compare them with their earlier expectations. They and others (including certain stock markets) post what they refer to as “earnings surprises” each day on their websites. Earnings surprises occur when a company reports net income figures that are different from what the market expected. The focus is on net income or earnings. If net income is higher than expected, this is a positive earnings surprise. If net income is lower than expected, this is a negative earnings surprise, and the market will generally react unfavourably, resulting in declining share prices. For instance, for quarterly earnings numbers released on August 13, 2020, the NASDAQ website noted that there were 20 positive earnings surprises and 16 negative earnings surprises. Positive earnings surprises included Brookfield Asset Management Inc. and WESCO International Inc. Selected negative earnings surprises noted for the same day included Precision Biosciences, Inc. and Teekay Tankers Ltd.

become familiar with every company's particular accounting and reporting practices. It would be almost impossible to prepare statements that could be compared.

This common set of standards and procedures is called generally accepted accounting principles (GAAP). The term “generally accepted” means either that an authoritative rule-making body in accounting has created a reporting principle in a particular area or that, over time, a specific practice has been accepted as appropriate because it is used universally.¹³ Although principles and practices have resulted in both debate and criticism, most members of the financial community recognize GAAP as the standards that over time have proven to be most useful. A more detailed discussion of GAAP is presented later in this chapter.

Parties Involved in Standard Setting

Before 1900, single ownership was the most common form of business organization in our economy. Financial reports emphasized **solvency and liquidity** and were only for **internal use** or for banks and other lending institutions to examine. From 1900 to 1929, the growth of large corporations and their absentee ownership led to **increasing investment and speculation** in corporate stock. When the stock market crashed in 1929, this contributed to the Great Depression. These events emphasized the need for **standardized and increased corporate disclosures** that would allow shareholders to make informed decisions.

Several organizations play a role in developing financial reporting standards in Canada. The major standard-setting organizations are the following:

1. the Canadian **Accounting Standards Board (AcSB)** (www.frascanada.ca)
2. the **International Accounting Standards Board (IASB)** (www.ifrs.org)
3. the **Financial Accounting Standards Board (FASB)** (www.fasb.org) and the U.S. **Securities and Exchange Commission (SEC)** (www.sec.gov)
4. **provincial securities commissions** such as the **Ontario Securities Commission (OSC)** (www.osc.gov.on.ca)

Illustration 1.6 shows how these organizations influence GAAP for Canadian entities. We will discuss each in greater detail in the pages that follow.

ILLUSTRATION 1.6 Entities Responsible for GAAP

Standard-Setting Body	GAAP Development	How GAAP Applies to Canadian Entities
AcSB	GAAP for Canadian private companies (referred to as Accounting Standards for Private Enterprises, or ASPE), pension plans, and not-for-profit entities	ASPE became effective for periods beginning on or after January 1, 2011. Not-for-profit entities in the public sector may have to follow public sector GAAP, which is the responsibility of the Public Sector Accounting Board (PSAB).
IASB	GAAP for public companies, referred to as International Financial Reporting Standards (IFRS)	IFRS became effective for periods beginning on or after January 1, 2011. Private companies and not-for-profit entities may choose to use IFRS.
FASB	GAAP for U.S. entities (referred to as U.S. GAAP)	Canadian public companies may choose to follow U.S. GAAP.
Securities commissions	Not responsible for GAAP but often require additional disclosures for public companies	The Ontario Securities Commission requires that public companies follow IFRS (or U.S. GAAP where public companies list on U.S. stock exchanges or markets and choose to follow U.S. GAAP instead of IFRS) for periods beginning on or after January 1, 2011.

¹³The terms “principle” and “standard” are used interchangeably in practice and throughout this textbook.

Canadian Accounting Standards Board (AcSB)

The first official recommendations on standards of financial statement disclosure were published in 1946 by the **Canadian Institute of Chartered Accountants (CICA)**. The CICA was one of the predecessor organizations of **Chartered Professional Accountants of Canada (CPA Canada)**. Today, the Accounting Standards Board (AcSB) has primary responsibility for setting GAAP in Canada. The AcSB produces a variety of authoritative material, including the most important source of GAAP, the *CPA Canada Handbook*.¹⁴ The *CPA Canada Handbook* was originally published in 1968 and now consists of several volumes of accounting and assurance guidance.^{15,16}

The objectives of the AcSB are as follows:

- a. to establish financial reporting standards that improve the quality of information reported by Canadian entities with due consideration for the costs and the benefits to the preparers and users of financial statements, and changes in the economic environment
- b. to facilitate the capital allocation process in both the business and not-for-profit sectors through improved information
- c. to participate with other standard setters in the development of a single set of high-quality internationally accepted financial reporting standards
- d. to support the implementation of financial reporting standards and the resolution of emerging application issues¹⁷

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.
2. The AcSB should **operate in full public view** through a **due process** system that gives interested persons enough opportunity to make their views known.

The **Accounting Standards Oversight Council (AcSOC)** oversees AcSB activities. Its duties include providing input to AcSB activities and reporting to the public, among other things. Members of the AcSB and the AcSOC come from a wide range of groups that are interested or involved in the financial reporting process.¹⁸

The AcSB is responsible for setting standards for public and private entities as well as not-for-profit entities (including some profit-oriented government entities). As noted in Illustration 1.6, from 2011 onward, the AcSB has been responsible for developing standards for private enterprises, not-for-profit entities, and pension plans only. Standards for publicly accountable entities (public companies) are developed by the International Accounting Standards Board even though they are still adopted into Canadian GAAP by the AcSB. This approach makes sense for a number of reasons, including the following:

1. Public companies often operate globally and may raise funds in global capital markets; therefore, it makes sense to have a common language for reporting financial position and performance so that users can compare companies internationally.

¹⁴The Canada Business Corporations Act and Regulations (CBCA), Part XIV Financial Disclosure and Part 8 (paras. 70 and 71), as well as provincial corporations' acts, require that most companies incorporated under these acts prepare financial statements in accordance with Canadian GAAP. This textbook usually refers to this document as the *CPA Canada Handbook* or just the *Handbook*.

¹⁵The *Handbook* is available to students and members online. Most members use the online version as their main source of GAAP.

¹⁶Technically, IFRS is considered to be part of the Canadian *CPA Canada Handbook—Accounting* for legal reasons. However, the *CPA Canada Handbook* as it relates to IFRS will exactly mirror the IASB standards as long as the AcSB continues to officially accept any updates or changes into Canadian GAAP. This was done because many Canadian laws refer to Canadian GAAP.

¹⁷AcSB Terms of Reference (www.frascanada.ca).

¹⁸AcSOC membership consists of senior members from business, finance, government, academe, the accounting and legal professions, regulators, and the financial analyst community. The members have a broad perspective on the complex issues facing standard setters. The goal is to achieve full representation across the spectrum of stakeholders (www.frascanada.ca).

- Private companies often operate locally and have less complex business models and fewer users, who are often close to the company and can gain other information about the business first-hand. Therefore, it makes sense to have a separate GAAP that is less complicated, has fewer disclosures, and is geared toward fewer users who have access to additional information about the company.

Note that there are some private companies that are global and complex. These entities have the option to use IFRS. Private entities that are planning to go public may find it easier to follow IFRS right from the beginning.¹⁹

The AcSB has created a subcommittee called the **IFRS Discussion Group (IFRS DG)**. The IFRS DG meetings create a public forum, allowing for discussion of issues arising in Canada as a result of implementing IFRS. The group's mandate is to raise awareness of these issues and to make recommendations to the AcSB for referral to the International Accounting Standards Board and its subcommittees.

International Accounting Standards Board (IASB)

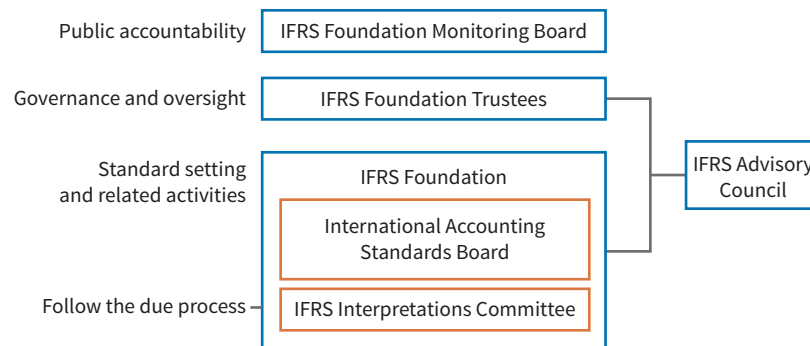
Most countries agree that more uniform standards are needed. As a result, the International Accounting Standards Committee (IASC) was formed in 1973 to try to lessen the areas of difference among countries' own standards. The IASC's objective in standard setting was to work generally to improve and harmonize regulations, accounting standards, and procedures relating to the presentation of financial statements. Eliminating differences is not easy: the financial reporting objectives in each country are different, the institutional structures are often not comparable, and there are strong national tendencies in most countries. Nevertheless, much progress has been made since the IASC's early days. In 2001, a new International Accounting Standards Board (IASB) was created, replacing the IASC.

According to the IASB website: "Our mission is to develop IFRS standards that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy."²⁰

Illustration 1.7 shows the IASB's governing structure. The **IFRS Foundation** monitors, reviews the effectiveness of, appoints members to, and funds the IASB. The IASB is

ILLUSTRATION 1.7

How the IASB Is Set Up²¹



¹⁹Actually, there are at least six sets of GAAP in Canada. The *CPA Canada Handbook—Accounting* is divided into four parts: Part I—IFRS (for publicly accountable enterprises), Part II—Accounting Standards for Private Enterprises, Part III—Accounting Standards for Not-for-profit Organizations, and Part IV—Accounting Standards for Pension Plans. In addition, the *Public Sector Accounting Standards Handbook* contains GAAP for governments. Finally, as mentioned earlier, the Ontario Securities Commission allows Canadian public companies that are U.S. reporting issuers to use U.S. GAAP.

²⁰According to the IFRS Foundation website, www.ifrs.org, note that the IASB also establishes standards for small and medium-sized private entities (referred to as IFRS for SMEs). Since the AcSB produces separate standards for Canadian private entities, Canadian companies do not follow IFRS for SMEs.

²¹IFRS Foundation Annual Report 2019, p. 17. Copyright © International Financial Reporting Standards Foundation. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

supported by the **IFRS Advisory Council** (which is composed of representatives from various user groups) and the **Accounting Standards Advisory Forum** (which is composed of national standard setters). Both groups provide guidance and advice to the Board. The **IFRS Interpretations Committee (IFRIC)** studies issues where guidance in IASB is insufficient or non-existent. If necessary, it produces additional guidance in the form of IFRIC interpretations, which are part of IFRS.

Illustration 1.8 shows the various stages in producing an international standard.

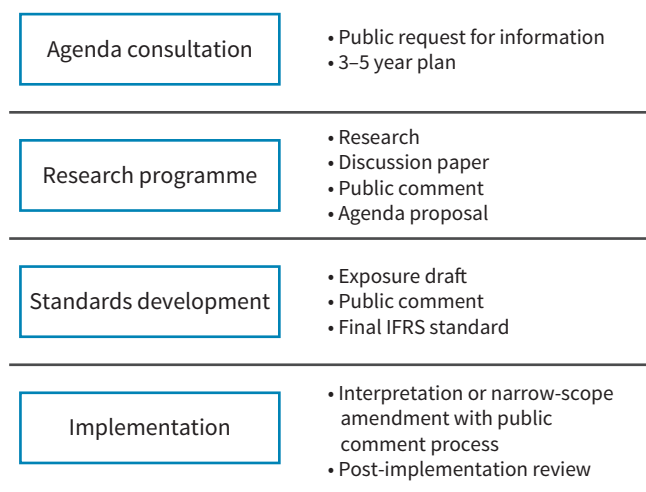


ILLUSTRATION 1.8

Evolution of a New or Revised IFRS²²

The process is very similar to the Canadian and U.S. processes. One difference is the increased and more common use of discussion papers (DPs). DPs are often the predecessors of exposure drafts (EDs). When IFRS are being formulated, the IASB may issue a DP and ask for comment letters just as it does for EDs. Therefore, by the time the proposed standard gets to the ED stage, many key decisions have already been made.²³

The IASB is a dominant global standard-setting body. As of September 2020, 156 countries required or allowed the use of IFRS (with 144 of these countries requiring IFRS for all or most domestic-listed companies).²⁴

Financial Accounting Standards Board and the Securities and Exchange Commission

In the United States, the Financial Accounting Standards Board (FASB) is the major standard-setting body, although it does not have final authority over standards—instead, the Securities and Exchange Commission (SEC) does. (Note that the SEC is a national body, whereas in Canada, the securities commissions are provincial.) The SEC has confirmed its support for the FASB by stating that financial statements that conform to FASB standards will be presumed to have substantial authoritative support. The SEC has also indicated in its reports to the U.S. government that it continues to believe that the private sector (for example, the FASB) should stay responsible for establishing and improving accounting standards, although the commission must oversee any changes. Like the Canadian securities commissions, the SEC also indicates its position on various financial reporting issues through what it calls financial reporting releases.

²²*Pocket Guide to IFRS Standards: The Global Financial Reporting Language*, 2017, p. 21. Copyright © International Financial Reporting Standards Foundation. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

²³For instance, the IASB issued a DP for revenue recognition, financial statement presentation, and fair value measurement and received 221, 227, and 136 comment letters, respectively. These comment letters were used to draft the subsequent ED and the final standard.

²⁴www.ifrs.org, “Analysis of use of IFRS Standards Around the World.” A complete up-to-date list is on the website. Some of these countries allow companies to alter IFRS (that is, not follow certain standards or follow alternative standards).

U.S. GAAP has and will continue to have a significant impact on GAAP in Canada for several reasons. First, because ASPE is based on principles and is fairly open to interpretation, **accounting professionals have often (in the past) relied on the more prescriptive, specific guidance** provided in U.S. GAAP.

Second, many Canadian companies are also listed on U.S. stock markets and exchanges, such as NASDAQ (National Association of Securities Dealers Automated Quotation) and the NYSE (New York Stock Exchange). To be listed on a U.S. exchange, these companies must follow U.S. GAAP or IFRS.^{25,26} 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.

This brings us to the third point, which concerns the fact that the United States has not adopted IFRS and may never do so. Nonetheless, it has representation on the IASB, and thus, influence.

Provincial Securities Commissions

Law Provincial securities commissions oversee and monitor the capital marketplace in their jurisdiction.²⁷ They ensure that participants in the capital markets (including companies, auditors, brokers and dealers, and investors) respect securities law and legislation so that, ultimately, the marketplace is fair. For instance, the British Columbia Securities Commission (www.bsc.bc.ca) states that its mission is to protect and promote the public interest by fostering the following objectives:

- a securities market that is fair and warrants public confidence
- a dynamic and competitive securities industry that provides investment opportunities and access to capital

As part of ensuring that investors have access to the information that they need in order to make informed decisions, securities law and legislation require that companies that issue shares to the public and whose shares trade on a Canadian stock exchange or stock market produce GAAP financial statements.

Ontario is home to the largest stock exchange in Canada, the **Toronto Stock Exchange (TSX)**, and most large Canadian public companies are therefore registered with the Ontario Securities Commission (OSC). The OSC reviews and monitors the financial statements of companies whose shares are publicly traded on the TSX so that it can judge whether the statements present the financial position and results of operations of these companies fairly.²⁸ It also issues its own Management Discussion and Analysis disclosure requirements.²⁹ Stock exchanges, as well as securities commissions, can fine a company and/or delist the company's shares from the stock exchange, which would remove a company's access to capital markets.

²⁵Domestic companies must follow U.S. GAAP. Foreign (non-U.S.) companies may follow IFRS. According to the IASB website (www.ifrs.org), there are more than 500 such companies registered with the SEC.

²⁶Before 2007, Canadian companies that were listed on U.S. exchanges could use IFRS or pre-changeover Canadian GAAP but had to reconcile their reporting to U.S. GAAP. This reconciliation was difficult and cumbersome, and many Canadian entities decided to just use U.S. GAAP for their U.S. filings. The OSC allows Canadian reporting issuers that list on U.S. stock exchanges or markets to use U.S. GAAP or IFRS for their Canadian filings according to Canadian Securities Administrators National Instrument 52-107. As noted earlier, the SEC allows non-U.S. companies that list on U.S. exchanges to use IFRS.

²⁷In Canada, securities regulation is carried out by each province, with each of the ten provinces and three territories being responsible for the companies in its jurisdiction. Many critics feel that this is cumbersome and costly, and they are therefore lobbying for a national securities commission. There has been some movement in this direction. The provincial and territorial regulators have formed the Canadian Securities Administrators (CSA). The CSA is mainly responsible for developing a harmonized approach to securities regulation across the country (www.securities-administrators.ca). For now, the CSA collects and archives all filings that are required under the securities regulations of each province and territory (www.sedar.com).

²⁸The OSC has a Continuous Disclosure Team that regularly reviews public companies' financial statements and other regulatory filings. The team plans to review each company at least every four years. Results of the review are published on the OSC website.

²⁹For instance, in 2016, CSA Staff Notice 52-306 (Revised) on "Non-GAAP Earnings Measures" was issued. In 2018, Staff Notice 52-112 titled "Non-GAAP and Other Financial Measures Disclosures" was issued for comment. This newer document will replace Staff Notice 52-306 and includes mandatory disclosure obligations.

1.3 Generally Accepted Accounting Principles

LEARNING OBJECTIVE 3

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

GAAP includes **not only specific rules, practices, and procedures** for particular circumstances but also **broad principles and conventions that apply generally**, including underlying concepts.

GAAP Hierarchy

The **GAAP hierarchy** identifies the sources of GAAP and lets users know which ones should be consulted first in asking the question: What is GAAP?

ASPE Under ASPE, GAAP is divided into **primary sources** and **other sources**. Based on the *CPA Canada Handbook*, Part II, Section 1100, the **primary** sources of GAAP (in descending order of authority) are as follows:

- **Handbook** Sections 1400 to 3870, including Appendices
- **Accounting Guidelines**, including Appendices

Other sources of GAAP noted in Section 1100 include the following:

- **background information and basis for conclusion documents issued by the AcSB**
- **pronouncements** by accounting standard-setting bodies in other jurisdictions, although it is not necessary to comply with guidance in IFRS or other GAAP in order to comply with Canadian GAAP for private entities³⁰
- **approved drafts of primary sources** of GAAP where no primary sources apply (such as exposure drafts)
- **research studies**
- **accounting textbooks, journals, studies, and articles**
- industry practice (as long as it is consistent with the concepts in Section 1000)

In general, primary sources must be looked at **first** for how to treat an issue. If primary sources do not deal with the specific issue, the entity should use accounting policies that are **consistent with the primary sources**. The policies should also be developed through the use of professional judgement in accordance with the concepts in Section 1000, which is the **conceptual framework**. (The conceptual framework is the foundation of financial reporting and is examined in greater detail in Chapter 2.) As business is constantly changing and new business transactions and contracts are regularly entered into, the other listed sources are also important sources of GAAP.

IFRS Under IFRS, GAAP incorporates the following, which include guidance that is integral to the standard:³¹

- IFRS
- International Accounting Standards (IAS) (standards that were issued by the IASB's predecessor)³²
- Interpretations (IFRIC or the former Standards Interpretation Committee [SIC])

³⁰*CPA Canada Handbook—Accounting*, Part II, Section 1100.20.

³¹IAS 8. Copyright © IFRS Foundation. All rights reserved. Reproduced with permission.

³²The IASB decided to retain the old numbering system for these standards for familiarity and to signal that these standards are older and originated from the IASB's predecessor, the IASC.

What happens when a company has an accounting issue but the above do not specifically apply? In that case, management uses professional judgement, considering the conceptual framework and the applicability of similar IFRS in similar situations, as long as the resulting information is relevant and reliable. The following sources would be considered, in descending order:

- pronouncements of other standard-setting bodies
- other accounting literature
- accepted industry practices

The two hierarchies achieve similar purposes, as follows:

- They provide guidance that helps answer the question “What is GAAP?”
- They rank sources and consider certain sources as more important
- They are grounded in the conceptual framework
- They establish the value of and expect the use of professional judgement.

Professional Judgement

Professional judgement plays an especially important role in ASPE and IFRS.³³ This is due to the basic philosophy of Canadian and international accountants on standard setting: **there cannot be a rule for every situation**. ASPE and IFRS are therefore based primarily on **general principles** rather than **specific rules**. The basic premise is that professional accountants with significant education and experience will be able to apply these principles appropriately to any situation.

In a principles-based standard-setting system, the conceptual framework underlies the standards. Therefore, accountants either apply specific standards that are based on the conceptual framework, or, if no specific standard exists, they use the conceptual framework and professional judgement to reason through to an answer, as noted previously as part of the GAAP hierarchy.³⁴

1.4 Challenges and Opportunities for the Accounting Profession

LEARNING OBJECTIVE 4

Discuss some of the challenges and opportunities for accounting.

Beginning in December of 2019, COVID-19 began to emerge as a new (novel) coronavirus. At the end of January 2020, approximately 8,000 cases were recorded. By March of 2020, the virus had begun to spread more pervasively on a global scale, resulting in the World Health Organization declaring a pandemic. To stop the spread, many countries mandated strict limits on social interactions, including travel and mobility. This had a significant negative effect on the economy, and as a result, many businesses declared bankruptcy despite significant

³³As mentioned earlier, U.S. GAAP is often said to be more prescriptive, and provides significantly more detailed guidance than IFRS and ASPE.

³⁴Neither ASPE nor IFRS is a perfect principles-based system. The conceptual frameworks for both were written after many of the other standards were written. Therefore, there may be inconsistencies. Standard setters are working to get rid of these inconsistencies in the standards.

government support.³⁵ Many individuals contracted the disease, and globally, there were over 1 million deaths by late 2020.³⁶

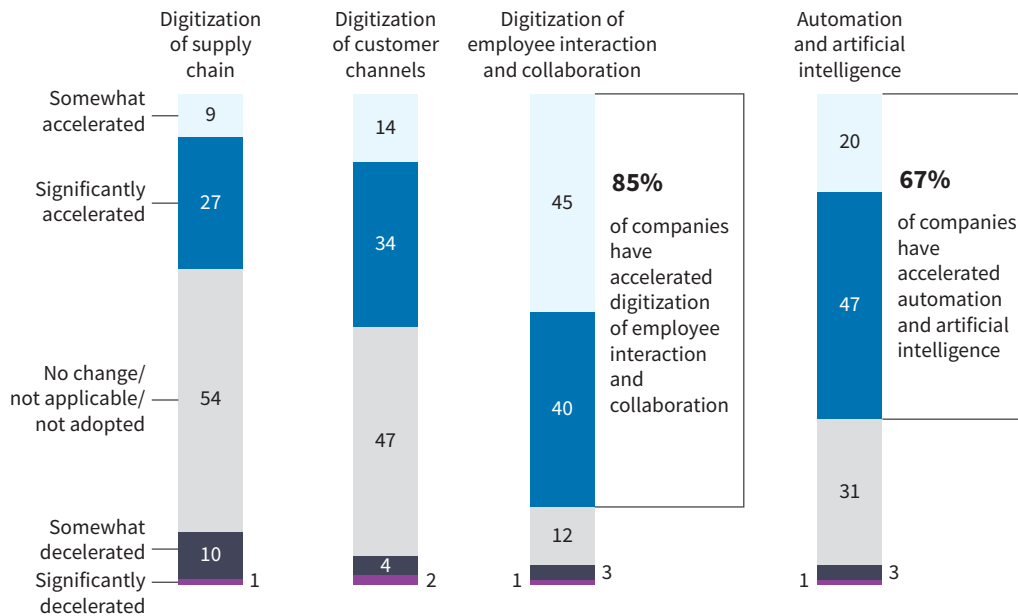
Given the mandated government restrictions regarding social interactions and mobility, businesses were forced to adapt their business models or declare bankruptcy. Many businesses moved online where at all possible. A significant number of employees and business owners therefore migrated to a remote work environment, working from home. **Illustration 1.9** shows the results of a study completed by McKinsey in 2020 during the pandemic. You can see a dramatic increase in automation and the use of certain technologies during this period.³⁷

Executives say they have accelerated the deployment of digitization and automation during the COVID-19 pandemic.

ILLUSTRATION 1.9

Accelerated Use of Technology During COVID-19

Since the start of the COVID-19 outbreak, how has your company’s or business area’s adoption of the following technology trends changed? % of respondents (n = 800)



Note: Figures may not sum to 100%, because of rounding.
 Source: McKinsey Global Business Executives Survey, July 2020

The resulting turmoil has given accountants a chance to re-examine their roles in the capital marketplace—and in society more broadly—in this changed environment. Are we doing what we should? Can we do better? Do others understand what we do in this increasingly automated and altered world? The accounting profession had already started a major initiative in 2018 to look at new and emerging opportunities for accountants. Work on this project is continuing and has been escalated, owing in part to the continuing rate of change and in part to the disruption caused by COVID-19.³⁸ Two emerging areas of practice include data governance and economic value creation. We will discuss issues relating to these two areas below.

³⁵The government of Canada had pledged support of over \$1 trillion (<https://www.canada.ca/en/department-finance/economic-response-plan/fiscal-summary.html>).

³⁶As at October 31, 2020, there were over 45 million cases globally, with over 1.1 million deaths (Johns Hopkins University Coronavirus Resource Centre).

³⁷McKinsey Global Institute, *What 800 Executives Envision for the Postpandemic Workforce*, September 2020.

³⁸CPA Canada, *Foresight: Reimagining the Profession – The Way Forward*, 2018.

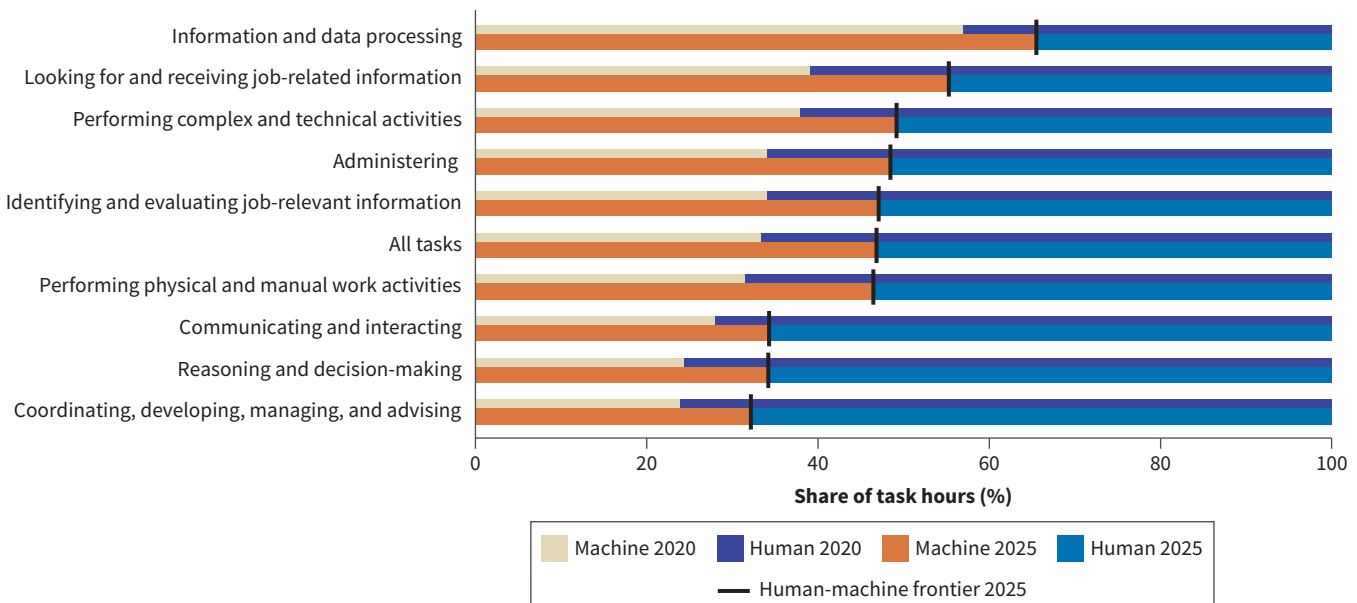
Impact of Technology

Data Analytics As **providers of information**, accountants **identify, measure, and communicate useful information to users**. Information is becoming increasingly abundant and available. Trends, including digitization, digitalization, artificial intelligence (AI), and others, have been accelerating at an exponential pace in the last few years (including dramatically during COVID-19, as noted in Illustration 1.9). These are having a profound impact on accounting. As more things are digitized (turned into machine-readable data), there is a corresponding increase in the amount and variety of data (information). This data is often referred to as “big data” due to its volume, the speed at which it accumulates, and the variety of forms in which it is collected (including, for instance, pictures, video, and sound).³⁹

For accountants, this means more information on which to base decisions. However, some very important questions need to be asked before big data is used in decision-making. Is it reliable? How much data is enough to base a decision on? What types of data are relevant? These are all good questions, and the profession is grappling with how to deal with big data. For instance, in assurance, auditors must gather “sufficient and appropriate evidence” (information or data) so that they may give an opinion on the financial statements of entities (that is, on whether they present fairly the underlying business). What does “sufficient and appropriate” mean in the context of big data? In response to such questions, a whole area of accounting called “data analytics” is emerging.⁴⁰

Another issue relating to big data is the sheer volume and speed at which it accumulates. Human beings do not have the mental capacity to deal with so much information, and we are increasingly turning to newer technological advancements in computing, including AI. Large amounts of data are used to develop the algorithms, which power machine learning and AI more broadly. For that reason, many feel that big data is “the new gold” or “the new oil.”⁴¹ How will AI change the way professional accountants work? More and more work is being done by computers, and this trend will continue, especially since technologies such as AI will allow the analysis of increasing amounts of big data. **Illustration 1.10** looks at the changing ratio of human to machine working hours.

ILLUSTRATION 1.10 Ratio of Human to Machine Working Hours



Source: Based on information from *The Future of Jobs Report 2020*, the World Economic Forum, October 2020.

³⁹Francis Diebold, “On the Origin(s) and Development of the Term ‘Big Data,’” *SSRN Electronic Journal*, 2012, 10.2139/ssrn.2152421.

⁴⁰See the *Data Analytics and Accounting* module in the online course. Chapter 3 also discusses these concepts.

⁴¹Robert Toews, “Questioning the Long-term Importance of Big Data in AI,” *Forbes*, November 4, 2019.

What new jobs are emerging as a result of all this? **Illustration 1.11** shows that data and AI rank in the top 10 skills and emerging jobs. Accountants have a role in many of these emerging jobs. It is an exciting time to be entering the profession, as many opportunities are opening up.

Emerging Jobs

- 1 Artificial Intelligence Specialist
- 2 Data Scientist
- 3 Data Engineer
- 4 Big Data Developer
- 5 Data Analyst
- 6 Analytics Specialist
- 7 Data Consultant
- 8 Insights Analyst
- 9 Business Intelligence Developer
- 10 Analytics Consultant

Top 10 Skills

- 1 Data Science
- 2 Data Storage Technologies
- 3 Development Tools
- 4 Artificial Intelligence
- 5 Software Development Life Cycle (SDLC)
- 6 Management Consulting
- 7 Web Development
- 8 Digital Literacy
- 9 Scientific Computing
- 10 Computer Networking

ILLUSTRATION 1.11

Data and AI⁴²

Scale of Opportunity: ● Small-scale ● Large-scale
Skill Type: ● Tech Disruptive ● Tech Baseline ● Business

Finally, we need systems to capture, store, and access all this data. We also need to ensure that privacy is maintained. Broadly, this new area of practice is known as **data governance**. According to CPA Canada, “data governance is often defined as a collection of processes, roles, policies, standards and metrics that ensure the effective and efficient use of information in enabling an organization to achieve its goals.”⁴³ The challenge for accountants is to embrace technological opportunities without losing the quality and content of traditional financial reporting. It is a significant challenge.

Sustainability Reporting

SUSTAINABILITY **Financial performance is rooted in a company’s business model** (that is, the earnings process, how companies finance the process, and what resources companies invest in). A company’s ability to articulate its strategic vision and carry out that vision affects financial performance. According to a current explanation from CPA Canada, “**Value creation** can be defined 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.”⁴⁴ Sustainability and working toward a more positive societal value are embraced in this definition. In the past, the term “value creation” was usually discussed in the context of a shareholder perspective and profitability. The updated definition of value creation presented here encompasses a broader stakeholder perspective, beyond shareholders and beyond profits. There is a growing body of research to support this broader view of value creation.

Institutional investors (and indeed, a broader group of stakeholders) are increasingly looking for more information about how businesses deal with environmental, social, and

⁴²World Economic Forum, *Jobs of Tomorrow 2020*, January 2020.

⁴³CPA Canada, *Data Governance Primer: Mastering and Shaping a Data-Driven Economy*, February 2020.

⁴⁴CPA Canada, *Value Creation Decision and Measurement Primer*, February 2020.

governance (ESG) issues.⁴⁵ ESG issues are closely related to a company's ability to create (or, conversely, destroy) economic value. Many companies have been disclosing this type of information, so various frameworks for disclosure have evolved over the years. Of the three types of issues, governance concerns tend to be the most familiar to investors. These include the following:

1. quality of the board of directors (including independence and accountability)
2. oversight of executive performance/compensation
3. oversight of the company's strategy, risk management, performance, and disclosure⁴⁶

Less familiar to many are the related environmental and social issues and their impact on value creation (or destruction). **Illustration 1.12** provides examples of factors relating to environmental and social issues.

ILLUSTRATION 1.12
Factors Relating to Environmental and Social Issues⁴⁷

Environmental Issues	Social Issues
Greenhouse gas emissions	Human capital management
Climate change impacts	Employee engagement, diversity, and inclusion
Air quality	Health and safety
Energy management	Labour practices
Waste and wastewater management	Indigenous rights
Land use and ecosystems impacts	Product quality and safety
Biodiversity (including deforestation)	Cybersecurity and data privacy
Product design and life cycle management	Bribery and corruption
Supply chain environmental issues	Supply chain social issues

A company must assess its ESG factors in the context of identifying risks and opportunities. In Canada, under securities regulations, public companies must disclose all material information relating to their business. IFRS also requires this disclosure.^{48,49} These are basic principles, which presumably apply to ESG. In addition, many issuing bodies have contributed to more structured sustainability guidelines and frameworks. **Illustration 1.13** gives a high-level overview of some of these.

⁴⁵In March 2014, CPA Canada and the TMX Group (which operates the Toronto Stock Exchange) issued a publication titled *A Primer for Environmental & Social Disclosure*. It is available online (www.tsx.com). The primer was updated in August 2020.

⁴⁶TMX and CPA Canada, *A Primer for Environmental & Social Disclosure*, August 2020, p. 4.

⁴⁷TMX and CPA Canada, *A Primer for Environmental & Social Disclosure*, August 2020, p. 5.

⁴⁸CSA Staff Notices 51-333, 51-358 and 58-311. Note that major stock exchanges such as the TSX similarly require these disclosures (see *Policy Statement on Timely Disclosure*).

⁴⁹See IAS 1.112, which requires disclosure of any information that is relevant to understanding the financial statements.

ILLUSTRATION 1.13 Overview of Various Disclosure Guidelines and Frameworks That Consider Sustainability

Issuing body	Disclosure guidelines and frameworks	Emphasis	Reference
Global Sustainability Standards Board (GSSB)	Sustainability Reporting Guidelines (GRI Guidelines)	Sustainability reporting (including ESG)	www.globalreporting.org/standards
International Integrated Reporting Council (IIRC)	Integrated Reporting Framework (IR Framework)	Integrated reporting	integratedreporting.org
Sustainability Accounting Standards Board (SASB)	SASB Disclosure Standards for U.S. registrants	Environmental, social, and governance disclosures	www.sasb.org
Financial Stability Board (FSB)	Task Force on Climate-related Financial Disclosures (TCFD)	Climate-related disclosures	www.fsb.org
Climate Disclosure Standards Board (CDSB)		Climate-related disclosures	www.cdsb.net
World Economic Forum (WEF)	Corporate Reporting Dialogue	Core metrics and disclosures for non-financial metrics	www.weforum.org

Sustainability reporting offers the opportunity to view financial reporting as part of a larger integrated “ecosystem” and not in isolation. The IFRS Foundation is proposing to create a new International Sustainability Standards Board which would harmonize sustainability reporting.

Oversight in the Capital Marketplace

Ethics **Law** While most stakeholders fulfill their roles in the capital marketplace in a positive and productive manner, some do not. Should the markets be self-regulating? Accounting scandals at companies such as **Enron**, **Cendant**, **Sunbeam**, **Rite-Aid**, and **Livent** have prompted governments to increase regulation in the capital marketplace. In the United States, the Sarbanes-Oxley Act (**SOX**), enacted in 2002, gave more resources to the SEC to fight fraud and poor business practices.⁵⁰ The SEC was able to increase its policing efforts and approve new auditor independence rules and materiality guidelines for financial reporting. In addition, SOX introduced sweeping changes to the institutional structure of the accounting profession. The following are some of the legislation’s key provisions:

- An **accounting oversight board** was established and given oversight and enforcement authority. It was mandated to establish auditing, quality control, and independence standards and rules, and is known as the **Public Company Accounting Oversight Board (PCAOB)**.
- Stronger **independence rules** were made for auditors. Audit partners, for example, are required to rotate every five years.
- 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. They must **forfeit bonuses and profits** if there is a restatement of their companies’ accounting disclosures.
- Company management must **report on the effectiveness of the financial reporting internal control systems**, and the auditors must assess and report on these internal controls.
- Audit committees must consist solely of **independent members**, and companies must disclose whether at least one member is a “financial expert” and if not, why not.
- Companies must disclose whether they have a **code of ethics** for their senior financial officers.

⁵⁰Sarbanes-Oxley Act of 2002, H. R. Rep. No. 107-610 (2002).

Stakeholders in Canada were faced with the question of whether similar reforms should be put in place in our capital markets. Companies that issue shares in the United States are bound by SOX, and these companies therefore have no choice.⁵¹ Many stakeholders felt that unless Canada matched the standard set by SOX, Canadian capital markets would be seen as inferior. As a result, many of the SOX requirements have now been put in place in Canada, as follows:

- The **Canadian Public Accountability Board (CPAB)** was formed to look after similar issues to the PCAOB.⁵²
- The **Canadian Securities Administrators (CSA)** issued rules that, among other things, require 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.⁵³
- The **CSA** issued a harmonized statement that requires much **greater disclosures**, including ratings from rating agencies, payments by companies to stock promoters, legal proceedings, and details about directors, including their previous involvement with bankrupt companies.⁵⁴

The impact of these reforms on North American capital markets has been to put more emphasis on government regulation and less on self-regulation. Do we have the balance right? At a minimum, there is greater understanding of the roles that the various stakeholders play. However, stakeholders should be doing things because they are the right things to do, not just because they must do so by law.

Centrality of Ethics

Ethics Accountants play significant roles in the capital marketplace. Illustration 1.3 shows that they are part of every stakeholder group, including preparers, auditors, regulators, investors, and others. They are therefore central in making the capital marketplace efficient and effective. However, decision-making is a complicated and human process. In accounting, as in other areas of business, **ethical dilemmas** are common. Some of these dilemmas are simple and easy to resolve. Many, however, are complex, and solutions are not obvious. Management biases—either internally prompted (by the desire to maximize bonuses, for example) or externally prompted (by the desire to meet analysts' earnings expectations, for example)—are the starting point of many ethical dilemmas. These biases sometimes lead to an emphasis on short-term results over long-term results and place accountants (both inside and outside the company) in an environment of conflict and pressure. Basic questions such as “Is this way of communicating financial information transparent?”, “Does it provide useful information?”, and “What should I do in this circumstance?” cannot always be answered by simply following GAAP or the rules of the profession. Technical competence is not enough when decisions have an ethical side.

Doing the **right thing** and making the right decision are not always easy. What is right is not always evident, and the pressures to “bend the rules,” “play the game,” or “just ignore it” can be considerable. In these cases, self-interest must be balanced with the interests of others. The decision is more difficult because no consensus has emerged among business professionals as to what constitutes a comprehensive ethical system.

This process of **ethical sensitivity** and choosing among alternatives can also be complicated by time pressures, job pressures, client pressures, personal pressures, and peer pressures. Throughout this textbook, ethical considerations are presented to make you aware of the types of situations that you may encounter in your professional responsibility. Many believe that accountants play the role of a conscience in the capital marketplace. That is our challenge and opportunity. Throughout the text, we will refer to specific ethics-related issues with an ethics

⁵¹Sarbanes-Oxley Act of 2002, Section 106 (2002).

⁵²www.cpab-ccrc.ca.

⁵³CSA Multilateral Instrument 52-109, 52-110, and 52-108. A multilateral instrument is an instrument that has been adopted by one or more CSA jurisdictions.

⁵⁴CSA revised National Instrument 51-102, “Continuous Disclosure Obligations.” A national instrument is an instrument that has been adopted by all CSA jurisdictions.

icon. The cases at the end of each chapter focus on professional judgement and accounting policy choices. They also include ethical considerations.

Standard Setting in a Political Environment

When it comes to influencing the development of accounting standards, the most powerful force may be the stakeholder. **Accounting standards are affected by political action, not just careful logic or research findings.** As part of their mandate, standard setters include stakeholders as members, giving them a **formal voice** in the process. Furthermore, through due process, interested parties can comment on proposed changes or new standards. This is generally a good thing.

However, stakeholders may want particular economic events to be accounted for or reported in a particular way, and they may fight hard to get what they want. They know that the most effective way to influence the standards that dictate accounting practice is to participate in formulating them or to try to influence or persuade the formulator. This is not necessarily optimal since the stakeholders who make themselves heard the loudest may get their way, to the detriment of others.

Should lobbying by stakeholders play a role in setting financial accounting and reporting standards? The AcSB and IASB do not exist in isolation. Standard setting is part of the real world, and it cannot escape politics and political pressures. That is not to say that stakeholders should not have a say. Since many accounting standards do have economic consequences, it is not surprising that special interest groups become vocal and critical (some supporting, some opposing) when standards are being formulated.⁵⁵ Given this reality, a standard-setting body must pay attention to the economic consequences of its actions; at the same time, however, it should not issue pronouncements that are motivated mainly by undue influence. While paying attention to their constituencies, standard setters should base their standards on sound research and a conceptual framework that is grounded in economic reality. Work done by the European Financial Reporting Advisory Group has resulted in some widely supported conclusions that standard setters should undertake an analysis of the impact of potential changes during the standard-setting process.

The standard-setting process is difficult enough when a standard setter is a national one such as the AcSB. The political nature of standard setting has increased as more and more countries have adopted IFRS. The IASB, for instance, has 14 members from many countries. It must consider the needs of all users when creating or changing standards. These user needs become more diverse as we consider the different political, cultural, economic, social, and legal settings of an increasing number of countries.

One political factor is how the standard-setting bodies are financed. The IASB has committed to four principles to ensure that the nature and amount of funding for standard setting do not result in politicization of the process. The principles are as follows per the IASB website.

Funding should be:

- **Broad-based:** It should not rely on one or a few sources.
- **Compelling:** Constituents should not be allowed to benefit from the standards without contributing to the process of standard setting.
- **Open-ended:** Financial commitments for funding should not be contingent upon any particular outcomes that may infringe upon independence in the standard-setting process.
- **Country-specific:** Funding should be shared by the major economies on a proportionate basis.⁵⁶

⁵⁵“Economic consequences” in this context 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. The resulting behaviour of these individuals and groups could have harmful financial effects on the providers of the financial information (enterprises). For a more detailed discussion of this phenomenon, see Stephen A. Zeff, “The Rise of Economic Consequences,” *Journal of Accountancy*, December 1978, pp. 56–63.

⁵⁶These principles were established in 2006. The IFRS Foundation’s 2020 income including contributions and revenues from sale of products, was £30.1 million. Twenty percent of this was from sale of products, and the majority of the remainder was from stakeholder contributions.

The challenge for standard setters is to find a balance between letting stakeholders have a voice and not bowing to undue political pressures. You might find it interesting to follow along as a standard is being set. Information such as IASB minutes, presentations to the IASB, exposure drafts, discussion papers, and comment letters are all available on the IASB website (www.ifrs.org). You will see that some spirited discussion takes place and there are many dissenting views.

Principles versus Rules

As mentioned in this chapter, Canadian, U.S., and international accounting standards are becoming increasingly interrelated. All parties are committed to converging toward a high-quality set of standards, but there are still many issues that standard setters must deal with. One key issue is the **principles versus rules** debate regarding GAAP.

U.S. GAAP has historically been more prescriptive (even though it is based on principles) and thus has leaned toward the rules-based approach. **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. There is also a tendency for companies to interpret the rules literally. Many companies take the view that, if there is no rule for a particular situation, they are free to choose whatever treatment they think is appropriate (within reason). Similarly, many believe that as long as they comply with a rule, even in a narrow sense, they are in accordance with GAAP. Some accountants, auditors, lawyers, and companies favour a GAAP body of knowledge that is more prescriptive because it may be easier to **defend** how to account for a particular item.

Unfortunately, the rules-based approach does not always emphasize the importance of communicating the **best** information for users. Just because a practice is defensible does not mean it provides the best information.

IFRS and ASPE are more 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 principles to the business facts. In a principles-based body of knowledge, bright-line tests are minimized. **Bright-line tests** are often numeric benchmarks for determining accounting treatment. For instance, when determining how to account for a lease under Section 3065 (ASPE), there is a test that looks at whether the lease term is greater than or equal to 75% of the economic life of the asset. The trouble with bright-line tests is that they create a distinctive threshold that is either met or not. Reality is not so clear-cut.

The challenge for standard setters is to ensure that the body of knowledge:

- rests on a cohesive set of principles and a conceptual framework that are consistently applied
- is sufficiently flexible to be of use in many differing business situations and industries
- is sufficiently detailed to provide good guidance but not so big as to be unwieldy

Throughout the text, we will focus on the development of professional judgement within a principles-based GAAP system (IFRS and ASPE). The cases at the end of each chapter are particularly good for helping you understand how to apply GAAP and deal with choice and ambiguity.

Conclusion

Financial reporting is standing at the threshold of some significant changes. Is the accounting profession up to the challenge? We believe that the profession is reacting responsibly and effectively to correct the shortcomings that have been identified and to move forward with a new vision. Because of its great resources and expertise, the profession should be able to develop and maintain high standards. This is and will continue to be a difficult process that requires time, logic, and diplomacy. Through a well-chosen mix of these three ingredients, however, the accounting profession will continue to be a leader on the global business stage.

Review and Practice

Summary of Learning 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 restrict good companies from raising capital in a 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 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 U.S. Financial Accounting Standards Board (FASB) is also important because 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.

Practice Problem

At the completion of Bloom Ltd.'s audit, the president, Judy Bloom, asks about the meaning of the phrase "in conformity with IFRS" that appears in your audit report on the management's financial statements. Judy observes that the meaning of the phrase must include something more and different than what she thinks of as "standards." Judy is curious about the pronouncements that are encompassed in IFRS and asks, "if there are different types of pronouncements, which are more authoritative than others?"

Instructions

- a. Describe the pronouncements that comprise IFRS.
- b. Explain to Judy how a company determines which type of pronouncement takes precedence when deciding the recognition, valuation, and disclosure related to a particular program.

Solution

- a. International Financial Reporting Standards are the standards and interpretations issued by the IASB and its predecessor body, the IASC:
 - International Financial Reporting Standards (IFRS)
 - International Accounting Standards (IAS)
 - International Financial Reporting Committee Interpretations (IFRIC)
 - Statements of the Interpretations Committee (SIC)

While the Conceptual Framework for Financial Reporting underlies all these pronouncements, the Conceptual Framework itself is not an IFRS accounting standard.

- b. The IASB sets out a hierarchy of sources that make up IFRS generally accepted accounting principles (GAAP). These are, in descending order:
 1. When there is a specific standard that applies (use those listed in [a] above).
 2. If there is no specific IFRS standard, then management applies professional judgement in determining what is GAAP, considering the conceptual framework and accounting standards used for similar transactions and events.
 3. Other sources might be referred to. These include, for example, pronouncements of other standard-setting bodies that use a similar conceptual framework, the accounting literature, and accepted industry practices.

Any company indicating that it is preparing its financial statements in conformity with IFRS must comply with all these standards and interpretations.

Key Terms

Accounting Standards Advisory Forum, p. 1-15

Accounting Standards Board (AcSB), p. 1-12

Accounting Standards for Private Enterprises (ASPE), p. 1-12

Accounting Standards Oversight Council (AcSOC), p. 1-13

accrual-basis accounting, p. 1-7

adverse selection, p. 1-10

aggressive accounting, p. 1-10

bright-line tests, p. 1-26

Canadian Institute of Chartered Accountants (CICA), p. 1-13

Canadian Public Accountability Board (CPAB), p. 1-24

capital allocation, p. 1-4

Chartered Professional Accountants of Canada (CPA Canada), p. 1-13

conservative accounting, p. 1-10

CPA Canada Handbook, p. 1-13

data governance, p. 1-21

decision-usefulness approach, p. 1-6

due process, p. 1-13

efficient markets hypothesis, p. 1-10

entity perspective, p. 1-6

ethical dilemmas, p. 1-24

financial accounting, p. 1-3

Financial Accounting Standards Board (FASB), p. 1-12

financial reporting, p. 1-3

financial statements, p. 1-3

GAAP hierarchy, p. 1-17

generally accepted accounting principles (GAAP), p. 1-6

general-purpose financial statements, p. 1-6

IFRS Advisory Council, p. 1-15

IFRS Discussion Group (IFRS DG), p. 1-14

IFRS Foundation, p. 1-14

information asymmetry, p. 1-9

information symmetry, p. 1-9	management bias, p. 1-10	Public Company Accounting Oversight Board (PCAOB), p. 1-23
institutional investors, p. 1-7	managerial accounting, p. 1-3	Securities and Exchange Commission (SEC), p. 1-12
International Accounting Standards Board (IASB), p. 1-12	moral hazard, p. 1-10	stakeholders, p. 1-5
IFRS Interpretations Committee (IFRIC), p. 1-15	objective of financial reporting, p. 1-6	stewardship, p. 1-11
International Financial Reporting Standards (IFRS), p. 1-12	Ontario Securities Commission (OSC), p. 1-12	Toronto Stock Exchange (TSX), p. 1-16
	professional judgement, p. 1-18	value creation, p. 1-21
	proprietary perspective, p. 1-7	
	provincial securities commissions, p. 1-12	

Exercises, Problems, Problem Solution Walkthrough Videos, Data Analytics Activities, and many more assessment tools and resources are available for practice in Wiley's course resources.

Note: **Enabling Competencies** Completion of this end-of-chapter material will help develop CPA enabling competencies (such as ethics and professionalism, problem-solving, and decision-making and communication) and technical competencies. We have highlighted selected items with a specific integration word mark and material in Wiley's course resources has been linked to the competencies. All cases emphasize integration, especially of the enabling competencies. The brief exercises, exercises, and problems generally emphasize problem-solving and decision-making.

Brief Exercises

- BE1.1 (LO 1)** How does accounting help the capital allocation process?
- BE1.2 (LO 1)** Identify at least three major stakeholders that use financial accounting information and briefly explain how these stakeholders might use the information from financial statements.
- BE1.3 (LO 1)** What are the major objectives of financial reporting?
- BE1.4 (LO 1)** Describe what is meant by information asymmetry.
- BE1.5 (LO 1)** How does information asymmetry hurt investors in the capital marketplace?
- BE1.6 (LO 2)** What is the value of having a common set of standards in financial accounting and reporting?
- BE1.7 (LO 1)** What is the likely limitation on "general-purpose financial statements"?
- BE1.8 (LO 2)** What are some of the developments or events that occurred between 1900 and 1930 that helped bring about changes in accounting theory or practice?
- BE1.9 (LO 2)** Which organization is currently dominant in the world for setting accounting standards? Explain.
- BE1.10 (LO 2)** Explain the role of the Canadian Accounting Standards Board (AcSB) in establishing generally accepted accounting principles.
- BE1.11 (LO 2)** What is the role of the Ontario Securities Commission (OSC) in standard setting?
- BE1.12 (LO 2)** What are some possible reasons why another organization, such as the OSC or the Securities and Exchange Commission (SEC), should not issue financial reporting standards?
- BE1.13 (LO 2)** What are the sources of pressure that change and influence the development of accounting principles and standards?
- BE1.14 (LO 3)** Some individuals have argued that all Canadian companies should follow the same set of accounting principles. Explain why there are multiple sets of standards in Canada.
- BE1.15 (LO 3)** If you were given complete authority to decide this, how would you propose that accounting principles or standards be developed and enforced?

BE1.16 (LO 3) If you had to explain or define “generally accepted accounting principles,” what essential characteristics would you include in your explanation?

BE1.17 (LO 3) Explain the difference between primary and other sources of GAAP.

BE1.18 (LO 4) The chair of the Financial Accounting Standards Board (FASB) at one time noted that “the flow of standards can only be slowed if (1) producers focus less on quarterly earnings per share and tax benefits and more on quality products, and (2) accountants and lawyers rely less on rules and law and more on professional judgement and conduct.” Explain his comment.

BE1.19 (LO 4) Some individuals have argued that the AcSB and the International Accounting Standards Board (IASB) need to be aware of the economic consequences of their pronouncements. What is meant by “economic consequences”? What are some of the dangers if politics play too much of a role in the development of financial reporting standards?

BE1.20 (LO 4) What is the difference between principles-based and rules-based accounting standards? In which category does IFRS belong? ASPE? Explain.

BE1.21 (LO 4) One writer recently noted that 99.4% of all companies prepare statements that are in accordance with GAAP. Why then is there such concern about fraudulent financial reporting?

BE1.22 (LO 4) Some foreign countries have reporting standards that are different from standards in Canada. What are some of the main reasons why reporting standards are often different among countries?

BE1.23 (LO 4) How are financial accountants pressured when they need to make ethical decisions in their work? Is having technical mastery of GAAP enough to practise financial accounting?

BE1.24 (LO 4) What are some of the major challenges facing the accounting profession?

BE1.25 (LO 4) The Sarbanes-Oxley Act was enacted to combat fraud and curb poor reporting practices. What are some key provisions of this legislation? Are these provisions in effect in Canada?

BE1.26 (LO 4) Explain the impact of digitization of information on the accounting profession.

BE1.27 (LO 4) What challenges does big data present to auditors providing an opinion on a company's financial statements?

BE1.28 (LO 4) Big data is becoming foundational to real-time business decision-making, thus increasing the reliance on data governance. What is data governance and how does it impact the integrity of data?

BE1.29 (LO 4) SUSTAINABILITY Stakeholders are increasingly concerned with environmental, social, and governance (ESG) issues. If you were given authority to develop financial reporting standards, what 3 ESG factors would you include in the disclosure requirements? Explain.

Cases

Refer to the Case Primer in Wiley's course resources to help you answer these cases.

CA1.1 Sherry Tsang has just started up a small corporation that produces clothing. She has applied for and received a government grant. The grant will automatically be renewed as long as the business shows a profit at year end. Sherry will prepare the financial statements on her own because she is trying to control costs. The bank has lent Sherry money and is waiting for the year-end statements to determine whether it will renew the loan.

Instructions

- a. **Ethics** Discuss the ethical issues of Sherry preparing her own financial statements.
- b. Which GAAP should she follow? Explain.

CA1.2 Ethics When the AcSB issues new standards, the implementation date is usually 12 months after the issue date, but early implementation is encouraged. A company controller, Paula Prentice, is discussing with her financial vice-president the need for early implementation of a standard that would result in a fairer presentation of the company's financial condition and earnings. When the financial vice-president determines that early implementation of the standard will lower the reported net income for the year, he discourages Paula from implementing the standard until it is required.

Instructions

Discuss the ethical issues of the financial vice-president's request.

(CMA adapted)

CA1.3 Verity Retail Limited is a private company experiencing cash flow difficulties. It hired new management to turn the company around. The company then went public and the shares sold at \$15 per share. However, within months the share price plummeted, and Beatle Clothing Inc. acquired the company for \$1 per share when Verity was close to bankruptcy.

Instructions

- Which GAAP should the company have followed when it went public? Explain.
- Who were the stakeholders in this situation, and how were they affected when the share price plummeted?

CA1.4 Finance The National Credit Rating Agency downgraded the credit rating of Grand Limited by two levels from BB to B+. The credit rating agency was concerned about the company's ability to refinance portions of its debt. Both BB and B+ are considered "junk" bonds and are below the BBB- category, which is the lowest grade that many pension and mutual funds are allowed to hold.

Financial statement analysis indicates that the company's financial profile has weakened due to tight debt covenants and the resulting cash flow restrictions.

Instructions

- Discuss whether the credit rating agency is a stakeholder from Grand's perspective.
- Ethics** Discuss any bias that Grand might have when it issues its financial statements.

CA1.5 SUSTAINABILITY Save the Trees (STT) is a not-for-profit organization whose mandate is to keep cities green by planting and looking after trees. STT is primarily funded by government grants and must comply with a number of criteria to obtain additional funds. One such requirement is that the entity prepare financial statements in accordance with GAAP.

Instructions

- Identify who the stakeholders are in this case and explain why they are stakeholders.
- Which GAAP should the entity follow and why?

Research and Analysis

RA1.1 Standardized versus Voluntary Disclosure

Some critics argue that having different organizations establish accounting principles is wasteful and inefficient. Instead of mandating accounting standards, each company could voluntarily disclose the type of information it considers important. In addition, if an investor wanted additional information, the investor could contact the company and pay to receive the desired information.

Instructions

Comment on the appropriateness of this viewpoint.

RA1.2 Politicization of Standard Setting

Some accountants have said that the development and acceptance of generally accepted accounting principles (that is, standard setting) is undergoing a "politicization." Some use the term "politicization" in a narrow sense to mean the influence by government agencies, particularly the securities commissions, on the development of generally accepted accounting principles. Others use it more broadly to mean the compromise that results when the bodies that are responsible for developing generally accepted accounting principles are pressured by interest groups (securities commissions, stock exchanges, businesses through their various organizations, financial analysts, bankers, lawyers, and so on).

Instructions

- What are the arguments in favour of the politicization of accounting standard setting?
- What are the arguments against the politicization of accounting standard setting?

(CMA adapted)

RA1.3 Accounting Standard-Setting Models

Three models for setting accounting standards follow:

1. the purely political approach, where national legislative action decrees accounting standards
2. the private, professional approach, where financial accounting standards are set and enforced by private, professional actions only
3. the public/private mixed approach, where standards are set by private-sector bodies that behave as though they are public agencies and the standards are mostly enforced through government agencies

Instructions

- a. Which of these three models best describes standard setting in Canada? Explain your choice.
- b. Why are companies, financial analysts, labour unions, industry trade associations, and others actively interested in standard setting?
- c. Cite an example of a group other than the AcSB that tries to establish accounting standards. Why might such a group want to set its own standards?

RA1.4 Continuous Reporting Model

The increased availability and accessibility of information has had a major impact on the process of financial reporting. Most companies have websites and make available to stakeholders a significant amount of financial information, including annual reports and other financial data. This has sparked the question of whether companies should use a continuous reporting model instead of the current discrete model where financial statements are generally issued only quarterly and annually. Under a continuous reporting model, the company would make more information available to users in real time or perhaps on a “delayed” real-time basis (such as weekly).

Instructions

What are the pros and cons of a continuous reporting model? Consider the various stakeholders in the capital marketplace.

RA1.5 Government Regulation

The capital marketplace’s reaction to past and more recent corporate failures has been to increase the amount of government regulation.

Instructions

- a. Identify what steps Canada and the United States have taken to increase government regulation of the capital marketplace.
- b. What other options to strengthen the capital marketplace might be available to stakeholders?
- c. What are the strengths and weaknesses of government regulation in this area?

RA1.6 Stakeholder Information Needs

Financial statements can be a valuable tool for the many parties interested in a company’s performance. Consider a public company in Alberta that drills for oil and sells it to refineries in the United States. The company prepares its financial statements using IFRS and publishes the statements on its website.

Instructions

Who are the stakeholders and what information would be most relevant to these stakeholders?

RA1.7 Ethics Limits on Disclosure

There are numerous situations where the management of a company may want to disclose more or less information about its operations. Consider a manufacturer that is preparing for the launch of a new product line. The information available to management may include the product’s projected release date, the associated costs, the product price, and the results of any market research performed to determine expected sales.

Instructions

Why might management want to share the information above with the public? Why might they try to keep this information private? What is the impact of management’s decision on those outside of the organization?

RA1.8 Ethics SUSTAINABILITY Disclosure Decision and Sustainability Reporting

It is a goal of standard setters to develop accounting standards that provide comparability across organizations and over time. However, there are instances when professional judgement must be used in determining the correct amount of disclosure. Assume the role of an accountant working as an advisor for ABC Inc., a toy manufacturer. ABC has received reports that a particular toy may have led to children's injuries. At this time, the information available is inconclusive as to whether the toy caused the injury or whether it was a result of user error. Management must now decide whether to communicate the potential malfunction to the public or to wait for additional information.

Instructions

- Identify the reasons management would wait for additional information before making a public statement about the toy's safety.
- Identify the reasons management would communicate the potential defect to the public immediately.
- In your role as the accountant, what course of action would you recommend and why?
- What impact would choosing to report or not report have on the company's business model and its ability to sustain earnings in the future? (Consider this from the perspective of sustainability reporting.)

RA1.9 Funding Principles

The IASB has instituted four principles related to its funding model, to ensure that the funding it receives does not lead to politicization of standard setting. The principles specify that funding should be broad-based, compelling, open-ended, and country-specific. This model differs from the funding processes for the AcSB and FASB.

Instructions

- Discuss these four principles and what impact they have on the standard-setting process.
- What issues might arise if these principles did not exist?
- The AcSB and FASB do not have the same funding principles in place. Why might the same principles not work for the AcSB and FASB?

RA1.10 Real World Emphasis Canadian Coalition for Good Governance (CCGG)

The Canadian Coalition for Good Governance (www.ccg.ca) was formed in 2002 and represents a significant number of institutional investors in Canada.

Instructions

- What is the purpose of the CCGG?
- How does an institutional investor differ from other investors?
- In your opinion, what impact would the presence of a large number of institutional investors have on management's financial reporting decisions?
- Identify three current members of the CCGG. Go to these member companies' websites and identify some of their most significant investments. What total dollar value of investments does each have under management?

RA1.11 SOX and the CPAB

In 2002, the Sarbanes-Oxley Act (SOX) was passed in the United States to strengthen the capital marketplace. In the following year, there were many debates in Canada about whether the securities commissions here should adopt the same regulations. In the end, Canada did adopt a similar level of regulation with the introduction of the Canadian Public Accountability Board (CPAB).

Instructions

- Why was the Sarbanes-Oxley Act issued and what are its key components?
- What impact do you think the Act had on the U.S. capital marketplace?
- What was the major spillover effect in the Canadian regulatory environment?
- Since SOX and the CPAB have been in place, continuing pressure has been felt in a number of areas relating to auditor independence requirements. Identify three current and emerging issues the CPAB has studied and reported on. What is the CPAB's position?

RA1.12 Emerging Sectors

Given the legalization of cannabis in certain parts of North America, there has been growth in this business sector. CPAB inspected a total of 42 cannabis audit files over 2019–2020 and found significant findings in 22 of those files.

Instructions

Visit the CPAB website to view its “Auditing in the cannabis sector” report. What were the main findings?

RA1.13 Real World Emphasis Financial Reporting Pressures

What follows is part of the testimony from Troy Normand in the case of **WorldCom**, the U.S. telecommunications company that filed for bankruptcy in 2002 after an accounting scandal. He was a manager in the corporate reporting department and is one of five individuals who pleaded guilty to various fraud-related charges. He testified in the hope of receiving no prison time when he was ultimately sentenced.

Q: Mr. Normand, if you could just describe for the jury how the meeting started and what was said during the meeting?

A: I can't recall exactly who initiated the discussion, but right away Scott Sullivan acknowledged that he was aware we had problems with the entries, David Myers had informed him, and we were considering resigning.

He said that he respected our concerns but that we weren't being asked to do anything that he believed was wrong. He mentioned that he acknowledged that the company had lost focus quite a bit due to the preparations for the Sprint merger, and that he was putting plans in place and projects in place to try to determine where the problems were, why the costs were so high.

He did say he believed that the initial statements that we produced, that the line costs in those statements could not have been as high as they were, that he believed something was wrong and there was no way that the costs were that high.

I informed him that I didn't believe the entry we were being asked to do was right, that I was scared, and I didn't want to put myself in a position of going to jail for him or the company. He responded that he didn't believe anything was wrong, nobody was going to be going to jail, but that if it later was found to be wrong, that he would be the person going to jail, not me.

He asked that I stay, don't jump off the plane, let him land softly, that's basically how he put it. And he mentioned that he had a discussion with Bernie Ebbers asking Bernie to reduce projections going forward and Bernie had refused.

Q: Mr. Normand, you said that Mr. Sullivan said something about don't jump out of the plane. What did you understand him to mean when he said that?

A: Not to quit.

Q: During this meeting, did Mr. Sullivan say anything about whether you would be asked to make entries like this in the future?

A: Yes, he made a comment that from that point going forward we wouldn't be asked to record any entries, high-level late adjustments, that the numbers would be the numbers.

Q: What did you understand that to mean, the numbers would be the numbers?

A: That after the preliminary statements were issued, with the exception of any normal transactions, valid transactions, we wouldn't be asked to be recording any more late entries.

Q: I believe you testified that Mr. Sullivan said something about the line cost numbers not being accurate. Did he ask you to conduct any analysis to determine whether the line cost numbers were accurate?

A: No, he did not.

Q: Did anyone ever ask you to do that?

A: No.

Q: Did you ever conduct any such analysis?

A: No, I didn't.

Q: During this meeting, did Mr. Sullivan ever provide any accounting justification for the entry you were asked to make?

A: No, he did not.

Q: Did anything else happen during the meeting?

A: I don't recall anything else.

Q: How did you feel after this meeting?

A: Not much better actually. I left his office not convinced in any way that what we were asked to do was right. However, I did question myself to some degree after talking with him wondering whether I was making something more out of what was really there.

Instructions

Answer the following questions:

- a. What appears to be the ethical issue in this case?
- b. Was Troy Normand acting improperly or immorally?
- c. What would you do if you were Troy Normand?
- d. Who are the major stakeholders in this case?

RA1.14 **Data Analytics** Big Data, Data Analytics, and Artificial Intelligence

In the past two decades, our access to information has grown exponentially. With innovative technologies, we can access the internet quickly and cheaply, and storage and computing capabilities continue to increase.

As accountants, we must ask ourselves what this means to us as a profession.

Instructions

Terms such as big data, data analytics, and artificial intelligence are being used with increased frequency as the discussion around information and the internet continues.

- a. Define each of these terms by doing a quick online search. (See Chapter 3 for additional guidance.)
- b. How may each of these concepts be used in accounting and what opportunities do each of these concepts present to the profession?

