

# CHAPTER 2

## Solutions to Problems

### Problem 2.1

Value-based management uses a variety of techniques to measure increases in shareholder value, which is assumed to be the primary goal of all business organizations. Shareholder value refers to the economic value of an investment by discounting future cash flows to their present value using the cost of capital for the business. To achieve shareholder value, a business must generate profits in their markets for goods and services (product markets) that exceed the cost of capital (the weighted average cost of equity and borrowings) in the capital market.

### Problem 2.2

The responsibilities of the board include setting the company's strategic goals, providing leadership to senior management, monitoring business performance, and reporting to shareholders. This means the board should set the company's strategic aims and ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance.

The role of a Board is to provide leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. These controls include many accounting controls including budgets, capital expenditure evaluations, etc.

Under governance legislation, the financial reports of a company are the responsibility of the directors. Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy the financial position of the company at any time and to ensure that financial reports comply with generally accepted accounting principles. They are also responsible for safeguarding the company's assets and for taking reasonable steps to prevent and detect fraud.

### Problem 2.3

Shareholder value analysis emphasizes the processes by which shareholder value is achieved. Shareholder value can be determined by using such measures as total shareholder return, market value added, shareholder value added, and economic value added. This form of value analysis compares cost with the value to the customer. Consequently, improving shareholder value is inextricably linked with both strategy and accounting.

In practice, the pursuit of shareholder value (or economic value added) can be achieved through the introduction of new or redesigned products and services, the management of costs, the development of performance measurement systems, and improved decision making.

### **Problem 2.4**

An audit of financial statements is an examination of the accounting records of a company carried out by an independent auditor to ensure that the records have been properly maintained, the financial statements do not contain any misrepresentations, and the statements and other financial information fairly represents the organization's financial position.

Auditors carry out their audits in accordance with Canadian Auditing Standards. An audit normally includes examination of evidence relevant to the amounts and disclosures in financial reports, an assessment of significant estimates and judgments made by directors in preparing the financial reports, and an opinion as to whether the accounting policies are appropriate, consistent, and adequately disclosed.

### **Problem 2.5**

The objectives of the audit committee are to:

- Help directors meet their responsibilities, especially for accountability
- Provide better communication between directors and external auditors
- Enhance the external auditor's independence
- Increase the credibility and objectivity of financial reports
- Strengthen the role of the outside directors by facilitating in-depth discussions among directors on the committee, management, and external auditors

### **Problem 2.6**

Under governance legislation, the directors are responsible for the financial reports of a company. This involves taking responsibility for keeping proper accounting records that disclose with reasonable accuracy the financial position of the company at any time and to ensure that financial reports comply with generally accepted accounting principles. They are also responsible for safeguarding the company's assets and for taking reasonable steps to prevent and detect fraud.

In the process of preparing the financial statements, directors are responsible for selecting suitable accounting policies and applying them consistently. When required to make judgments and estimates, the board must ensure they are reasonable and

prudent. Further, directors must prepare financial reports under the assumption the company is a going concern.

This is not to say the directors are the individuals that actually prepare the financial statements. This is almost always delegated to professionals, managers and other employees; however, the responsibility always remains with the directors.

## **Chapter 2 Questions**

- 2.1 Explain the idea of value-based management and how shareholder value relates to the interaction between product and capital markets.
- 2.2 Explain the key issues in corporate governance as they relate to accounting.

## Chapter 2

### Answer Key for Self-Test Questions

S2.1 a

S2.2 b

S2.3 b

S2.4 d

S2.5 d

S2.6 a