

# CHAPTER 1

## THE CANADIAN FINANCIAL REPORTING ENVIRONMENT

### SUMMARY OF QUESTION TYPES BY LEARNING OBJECTIVE AND LEVEL OF DIFFICULTY

Item	LO	LOD	Item	LO	LOD	Item	LO	LOD	Item	LO	LOD
<b>Multiple Choice–Conceptual</b>											
1.	1	M	9.	2	M	17.	6	M	25.	7	E
2.	1	E	10.	2	H	18.	6	M	26.	8	E
3.	1	E	11.	3	E	19.	6	H	27.	9	M
4.	1	E	12.	4	M	20.	6	M	28.	9	M
5.	1	E	13.	4	H	21.	6	E	29.	9	H
6.	1	M	14.	4	H	22.	6	M	30.	9	E
7.	2	M	15.	4	M	23.	6	E			
8.	2	E	16.	5	M	24.	6	M			
<b>Exercises</b>											
31.	1	M	34.	3	H	37.	6	H	40.	9	H
32.	2	H	35.	3	M	38.	6	M	41.	9	H
33.	3	E	36.	4	H	39.	7	M			

Note: E = Easy      M = Medium      H = Hard

**SUMMARY OF LEARNING OBJECTIVES BY QUESTION TYPE**

Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type
<b>Learning Objective 1</b>											
1.	MC	3.	MC	5.	MC	31.	Ex				
2.	MC	4.	MC	6.	MC						
<b>Learning Objective 2</b>											
7.	MC	8.	MC	9.	MC	10.	MC	32.	Ex		
<b>Learning Objective 3</b>											
11.	MC	31.	Ex	33.	Ex	34.	Ex	35.	Ex		
<b>Learning Objective 4</b>											
12.	MC	13.	MC	14.	MC	15.	MC	36.	Ex		
<b>Learning Objective 5</b>											
16.	MC										
<b>Learning Objective 6</b>											
17.	MC	19.	MC	21.	MC	23.	MC	37.	Ex		
18.	MC	20.	MC	22.	MC	24.	MC	38.	Ex		
<b>Learning Objective 7</b>											
25.	MC	39.	Ex								
<b>Learning Objective 8</b>											
26.	MC										
<b>Learning Objective 9</b>											
27.	MC	28.	MC	29.	MC	30.	MC	40.	Ex	41.	Ex

Note: MC = Multiple Choice    Ex = Exercise

## CHAPTER STUDY OBJECTIVES

**1. Explain how accounting makes it possible to use scarce resources more efficiently.**

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.

**2. Explain the meaning of “stakeholder” and identify key stakeholders in financial reporting, explaining what is at stake for each one.**

Investors, creditors, management, securities commissions, stock exchanges, analysts, credit rating agencies, auditors, and standard setters are some of the major stakeholders. See Illustration 1-3.

**3. Identify the objective of financial reporting.** 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.

**4. Explain how information asymmetry and bias interferes with the objective of financial reporting.** Ideally, all stakeholders should have access to the same information in order to ensure that good decisions are made in the capital marketplace. (This is known as information symmetry.) However, this is not the case—there is often information asymmetry. Of necessity, management has access to more information so that it can run the company. It must also make sure that it does not give away information that might harm the company, such as in a lawsuit where disclosure might cause the company to lose. Aside from this, information asymmetry exists because of management bias whereby management acts in its own self-interest, such as wanting to maximize management bonuses. This is known as moral hazard in accounting theory. Information asymmetry causes markets to be less efficient. It may cause stock prices to be discounted or costs of capital to increase. In addition, it might detract good companies from raising capital in the particular market where relevant information is not available (referred to as adverse selection in accounting theory). The efficient markets hypothesis is felt to exist only in a semi-strong form, meaning that only publicly available information is assimilated into stock prices.

**5. Explain the need for accounting standards.** 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.

**6. Identify the major entities that influence the standard-setting process and explain how they influence financial reporting.** The Canadian Accounting Standards Board (AcSB) is the main standard-setting body in Canada for private companies, pension plans, and not-for-profit entities. Its mandate comes from the Canada Business Corporations Act and Regulations as well as provincial acts of incorporation. For public companies, GAAP is International Financial

Reporting Standards (IFRS) as established by the International Accounting Standards Board (IASB). Public companies are required to follow GAAP in order to access capital markets, which are monitored by provincial securities commissions. The Financial Accounting Standards Board (FASB) is also important as it influences IFRS standard setting. Private companies may choose to follow IFRS. Public companies that list on U.S. stock exchanges may choose to follow U.S. GAAP.

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

**8. Explain the significance of professional judgement in applying GAAP.** 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.

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

**MULTIPLE CHOICE—Conceptual**

<b>Answer</b>	<b>No.</b>	<b>Description</b>
d	1.	Accounting characteristics
a	2.	Nature of financial accounting
c	3.	Definition of financial accounting
b	4.	Definition of management accounting
d	5.	Efficient use of resources
c	6.	Capital allocation process
b	7.	Stakeholders in the financial reporting environment
d	8.	Preparation of audited financial statements
a	9.	Auditor's responsibility
c	10.	Causes of subprime lending crisis
b	11.	Objectives of financial reporting
c	12.	Preparation of biased information
c	13.	Existence of information asymmetry
b	14.	Efficient markets hypothesis
d	15.	Management bias
b	16.	Reduction of information asymmetry
c	17.	Responsibility of the AcSB
a	18.	Oversight of AcSB
c	19.	Authority over accounting standards in the U.S
d	20.	Development of financial reporting standards in Canada
b	21.	Adoption of IFRS
d	22.	Activities and authority of the OSC
b	23.	Use of ASPE
a	24.	IASB's standard setting process
c	25.	Primary sources of GAAP under ASPE
d	26.	Exercise of professional judgement
b	27.	SOX
c	28.	Rules-based vs. principles-based approach
c	29.	Changing financial reporting environment
a	30.	Advancement of technology on financial reporting

**EXERCISES**

<b>Item</b>	<b>Description</b>
1-31	Effective capital allocation
1-32	Stakeholders in the financial reporting environment
1-33	Objectives of financial reporting
1-34	Entity vs. proprietary perspective
1-35	User needs
1-36	Information asymmetry
1-37	Role of securities commissions and stock exchanges
1-38	Standard setting
1-39	Source of GAAP
1-40	SOX and standard setting
1-41	Challenges facing financial reporting

## MULTIPLE CHOICE—Conceptual

1. The essential characteristic(s) of accounting is (are)
  - a) communication of financial information to interested internal parties only.
  - b) communication of economic information to external parties.
  - c) identification and measurement of financial information only.
  - d) identification, measurement, and communication of financial information.
  
2. Financial accounting is concerned with the process that culminates in
  - a) the preparation of financial reports.
  - b) specialized reports for inventory management and control.
  - c) specialized reports for income tax calculation and recognition.
  - d) reports on changes in stock prices and future estimates of market position.
  
3. Financial accounting can be broadly defined as the area of accounting that prepares financial statements to be used
  - a) by parties internal to the business enterprise only.
  - b) by investors only.
  - c) by parties both internal and external to the business enterprise.
  - d) primarily by external users and Canada Revenue Agency.
  
4. Management accounting can be broadly defined as the area of accounting that communicates financial information
  - a) to investors only.
  - b) to parties internal to the business enterprise only.
  - c) to parties both internal and external to the business enterprise.
  - d) primarily to external users and Canada Revenue Agency.
  
5. Whether a business is successful and thrives is determined by
  - a) free enterprise or competition.
  - b) competition and markets only.
  - c) markets and competition only.
  - d) markets, competition and free enterprise.
  
6. Which of the following is correct?
  - a) Reported accounting numbers do not affect the transfer of resources.
  - b) Credit rating agencies use accounting information to assess their assets.
  - c) Efficient capital markets promote productivity and encourage innovation.
  - d) Efficient capital markets promote productivity but do not encourage innovation.
  
7. Stakeholders who help in the efficient allocation of resources include
  - a) investors and creditors.
  - b) financial analysts and regulators.
  - c) creditors and auditors.

- d) management and auditors.
8. Audited financial statements are prepared by
- auditors.
  - financial analysts.
  - Canada Revenue Agency.
  - management.
9. The auditor's *primary* responsibility is to
- review financial statements and discuss them with management.
  - prepare financial statements.
  - report to Canada Revenue Agency.
  - report to standard setters.
10. The widely publicized subprime lending crisis was NOT caused by
- capital market participants who acted in their own self-interest.
  - a lack of transparency.
  - the practice of securitizing assets.
  - a lack of investor understanding of the investment's true risk.
11. Objectives of financial reporting do NOT include
- providing information that is useful to users in making resource allocation decisions.
  - providing information about the liquidation value of an enterprise.
  - providing information about an entity's economic resources, obligations, and equity/net assets.
  - providing information about changes in an entity's economic resources, obligations, and equity/net assets.
12. The preparation by some companies of biased information is sometimes referred to as
- conservative financial reporting.
  - full disclosure of all material facts.
  - aggressive financial reporting.
  - stewardship.
13. Where information asymmetry exists, the capital market may attract the wrong kind of company. This is known as
- moral hazard.
  - conservative accounting.
  - adverse selection.
  - an inefficient marketplace.
14. The "efficient markets hypothesis" proposes that
- market prices reflect information known only to internal stakeholders.
  - market prices reflect all information about a company.
  - market prices reflect information known only to external stakeholders.

- d) information asymmetry is required.
15. Which of the following does NOT describe a cause of management bias?
- the need to comply with contracts, such as debt covenants
  - the desire to meet financial analysts' expectations
  - the tendency to downplay negative events
  - the desire for all stakeholders to have access to all information
16. The problem of information asymmetry can be reduced by
- aggressive accounting.
  - accounting standards.
  - adverse selection.
  - only focusing on positive events.
17. As of 2011, the responsibilities of the Accounting Standards Board (AcSB) in Canada relate to setting standards for
- publicly accountable entities only.
  - both publicly accountable entities and private enterprises.
  - private enterprises, not-for-profit entities and pension plans.
  - not-for-profit entities and pension plans only.
18. In Canada, the body that has the responsibility of overseeing the Accounting Standards Board (AcSB) is the
- Accounting Standards Oversight Council (AcSOC).
  - International Accounting Standards Board (IASB).
  - Canadian Institute of Chartered Accountants (CICA).
  - Financial Accounting Standards Board (FASB).
19. In the United States, the body that has the final authority over accounting standards is the
- Financial Accounting Standards Board (FASB).
  - International Accounting Standards Board (IASB).
  - Securities Exchange Commission (SEC).
  - Accounting Standards Oversight Council (AcSOC).
20. In Canada, the body which is NOT instrumental in the development of financial reporting standards is the
- Accounting Standards Board (AcSB).
  - Financial Accounting Standards Board (FASB).
  - International Accounting Standards Board (IASB).
  - American Institute of Certified Public Accountants.
21. The adoption of International Financial Reporting Standards in Canada is an example of
- the impact of technology on user's needs.
  - the impact of globalization on capital markets.
  - ethical behaviour.



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

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

- a) The OSC reviews and monitors the financial statements of companies whose shares are listed on the Toronto Stock Exchange
- b) The OSC issues its own disclosure requirements for listed companies.
- c) The OSC has the ability to fine or delist companies.
- d) The OSC issues financial accounting standards for Canadian companies.

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

- a) Private enterprises usually have less complex business models.
- b) Private enterprises that are “going public.”
- c) Private enterprises usually have fewer users.
- d) Private enterprises’ financial statement users tend to have first-hand information.

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

- a) appointing trustees to the IFRS Foundation
- b) development of an Exposure Draft
- c) provision of strategic advice by the IFRS Advisory Council
- d) public consultation

25. Under ASPE, the primary sources of GAAP include

- a) accounting textbooks and journals.
- b) International Financial Reporting Standards.
- c) the CICA Handbook and appendices.
- d) research studies.

26. The exercise of professional judgement does NOT involve

- a) the use of knowledge gained through education.
- b) the application of knowledge gained through experience.
- c) the use of ethical decision making.
- d) aggressive accounting.

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

- a) help prevent fraud and poor financial reporting practices.
- b) ensure the act was applied internationally.
- c) enable the SEC to increase its policing efforts.
- d) introduce new independence rules for auditors.

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

- a) the body of knowledge is smaller.
- b) the importance of communicating the best information to users is emphasized.

- c) since it is more prescriptive, it may be easier to defend how to account for a particular item.
- d) companies frequently do not interpret the rules literally.

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

- a) increased demand for accountants and the impact of technology
- b) globalization and the unethical actions of accountants
- c) the growing number of institutional investors who want more information regarding environmental and social issues
- d) increased use of the Internet

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

- a) Users of financial information will have access to more information.
- b) The quality and reliability of the information may be compromised.
- c) Equal and fair access may be at issue.
- d) Internet reporting will increase costs.

**MULTIPLE CHOICE ANSWERS—Conceptual**

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Item
1.	d	6.	c	11.	b	16.	b	21.	b	26.	d
2.	a	7.	b	12.	c	17.	c	22.	d	27.	b
3.	c	8.	d	13.	c	18.	a	23.	b	28.	c
4.	b	9.	a	14.	b	19.	c	24.	a	29.	c
5.	d	10.	c	15.	d	20.	d	25.	c	30.	a

## EXERCISES

**Ex. 1-31** Effective capital allocation

Explain the advantages of an effective capital allocation process.

**Solution 1-31**

An effective capital allocation process encourages innovation, promotes productivity, and provides a platform for buying and selling securities and obtaining and granting credit.

**Ex. 1-32** Stakeholders in the financial reporting environment

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

**Solution 1-32**

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

**Ex. 1-33** Objectives of financial reporting

What are the objectives of financial reporting by business enterprises?

**Solution 1-33**

The objectives of financial reporting are to provide information

1. that is useful to investors, members, contributors, creditors and other users in making their resource allocation decisions and/or assessing management stewardship.
2. to help users in evaluating an entity's economic resources, obligations and equity/net assets and the changes to these items.
3. to help users evaluate the economic performance of an entity.

**Ex. 1-34** Entity vs. proprietary perspective

Explain the difference between the entity perspective and the proprietary perspective.

**Solution 1-34**

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

**Ex. 1-35** User Needs

Explain why providing information to users is a challenging task.

**Solution 1-35**

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

**Ex. 1-36** Information asymmetry

In markets where information asymmetry exists, there can be adverse selection and moral hazard. Explain what these terms mean.

**Solution 1-36**

Adverse selection refers to *hidden knowledge*, where the capital marketplace may attract the wrong type of company, such as companies who have the most to gain from not disclosing information. Given this situation, companies who do fully disclose all information may choose not to enter the marketplace if they are aware of the presence of adverse selection.

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

**Ex. 1-37** Role of Securities Commissions and Stock Exchanges

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

**Solution 1-37**

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

**Ex. 1-38** Standard setting

Explain the relationship between Canadian GAAP and International Financial Reporting Standards (IFRS).

**Solution 1-38**

Since the decision to adopt IFRS was made, Canadian GAAP has been continuously adjusted (converged) to mirror IFRS. Even prior to that convergence, both standards were principles based (rather than rules-based).

**Ex. 1-39** Sources of GAAP

International Financial Reporting Standards (IFRS) are the primary source of GAAP for public enterprises in Canada. They are, however, insufficient to address all of the accounting issues

facing accountants. Explain why this is so and outline some other sources of GAAP that accountants use.

**Solution 1-39**

Although IFRS outline the specific accounting treatment for a multitude of items, for some items the guidelines are very general. Also, the business environment is complex and constantly changing and, therefore, some items may not be discussed at all. Thus, accountants must use IFRS in conjunction with other sources like professional judgement, pronouncements of other standard-setting bodies, accounting literature, and accepted industry practices.

**Ex. 1-40 SOX and standard setting**

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

**Solution 1-40**

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

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

1. company management to take responsibility for the appropriateness and fairness of the financial statements
2. public enterprises to have independent audit committees
3. management to report on the effectiveness of their internal controls
3. public accounting firms to be subject to CPAB
4. greater disclosures, such as ratings from rating agencies, legal proceedings, payments to stock promoters, details about corporate directors.

**Ex. 1-41 Challenges Facing Financial Reporting**

In North America, the financial reporting environment is changing at a very rapid pace. Briefly describe four challenges facing the accounting profession today.

**Solution 1-41**

1. Oversight in the capital marketplace. The Sarbanes-Oxley Act (SOX) instituted the Public Company Accounting Oversight Board (PCAOB), stronger independence rules for auditors, reporting on the effectiveness of the financial reporting internal control system, and disclosure of a code of ethics for senior financial officers.  
Canada has followed suit and developed the Canadian Public Accountability Board (CPAB). As well, the Canadian Securities Administrators (CSA) requires company management to take responsibility for the appropriateness and fairness of the financial statements, public companies to have independent audit committees, and public accounting firms to be subject to the CPAB. The CSA also requires much greater disclosures. The overall impact of these financial reforms has been to put more emphasis on government regulation and less on self-regulation.

2. Centrality of ethics. Accountants are central in making the capital marketplace efficient and effective. However, ethical dilemmas are common, often precipitated by management bias. It is not always easy to “do the right thing.” Pressure to bend the rules, play the game or “just ignore it” are often there. There is no consensus (yet) among accounting professionals as to what a comprehensive ethical system is, and so it is up to the individual accountant to maintain a high standard of ethics at all times.
3. Standard setting in a political environment. Since standard setting is part of the real world, accounting standards often arise from political action. The stakeholders who lobby the hardest may unduly influence new or revised accounting standards. This is not surprising since many accounting standards have economic consequences. Thus standard setters such as the IASB must consider the needs of all stakeholders when creating or changing standards. The challenge is to find a balance between letting stakeholders have a say while not bowing to undue political pressure.
4. Principles vs. rules. Rules-based, prescriptive systems (such as U.S. GAAP or the Canadian income tax system) have a significantly larger body of knowledge than a principles-based approach such as IFRS and ASPE. However, there is a tendency to interpret the rules literally with a rules-based approach, possibly because it may be easier to defend the accounting for a particular item. A disadvantage of the rules-based approach is that it may not always communicate the best information to the user. The principles-based approaches are based on professional judgement, resulting in carefully reasoned application of the principle to the business facts. Since the body of knowledge is smaller with principles-based approaches, the standard setters must ensure it rests on a cohesive set of principles and conceptual framework, which is sufficiently flexible, and sufficiently detailed to provide good guidance.

Other challenges are the impact of technology and integrated reporting.

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