Chapter 5
Standards and Principles Surrounding the Financial Statements

Solution Outline for Problem 5.1

1. Simone’s jewellery business, although not incorporated, can be separated from her personal affairs.
2. A bank is a legal and economic entity, just as any other corporation.
3. This is a large economic unit, which can be considered to include all the individual corporations contributing to Exxon’s financial performance and position.
4. A university is not a “business” but is still an economic unit, quite aside from its nature as an educational and research institution.
5. Mato is a corporation and is therefore a legal entity for which financial statements can be prepared.
6. Ernst & Young is a partnership and is therefore a somewhat separate legal entity from its partners, being able to transact business, hire employees, etc., and generally operates as an economic entity separate from its partners’ personal affairs.
7. As in part 4, the city is not a “business” but is still an economic unit.
8. McDonald’s may be spread out all over the world, but its parts can be assembled into an accounting entity on similar arguments to those made for Exxon.

Solution Outline for Problem 5.2

Here are some ideas in response to the sentences. You may well think of several other concepts/principles and probably will make additional points about some of them.

1. Three concepts/principles related to this are fairness, reliability, and verifiability. Some effects on financial statements of these are: accountants are careful that all cash transactions and day-to-day events such as credit sales and purchases are reflected in the financial statements; considerable care is taken to minimize errors and omissions in the accounting system that underlies the financial statements; and auditors ensure that important financial statement data can be traced back to underlying events and evidence.

2. Four concepts/principles related to this are conservatism, fairness, matching and historical cost. Conservatism results (or should result) in financial statements that contain prudent, not overly optimistic, estimates of future cash inflows and outflows regarding present assets and liabilities. Fairness has the effect of keeping conservatism in bounds so that the financial statements are not pessimistic (which would be unfair to present owners and managers). Matching says that estimates affecting revenues should be done on comparable bases to those affecting expenses, so that the net income makes sense, so it puts some bounds on conservatism too. The historical cost principle requires that information presented in the financial statements is historical in nature and not forward looking. As with the study of history, the implication is that when one understands the past, one can attempt to predict the future, however not with any certainty.

3. Three concepts/principles related to this are conformance with GAAP, consistency, and comparability. Conformance with GAAP ensures that the company’s information is prepared in ways the user might expect, to permit meaningful analyses of its performance. The objective of consistency over time results in highlighting inconsistencies so that the user can consider their effects on the information. The goal of comparability refers directly to the idea of “relative performance” because if the previous two principles are met, the company can be evaluated by comparison to others like it, or to others the user might consider investing in or lending to.

4. Two concepts/principles related to this are disclosure and decision relevance. Disclosure has the effect of helping users understand how the accounting numbers were computed and thus helping them to make estimates of future effects. Decision relevance is a reminder that the financial statements should be useful both in past-oriented decisions (such as evaluating management’s performance or calculating bonuses) and in future-oriented decisions (such as whether to invest in or lend to the company).
5. Three concepts/principles related to this are fairness, reliability, and verifiability. The goal of all three is partly to minimize the effects of human error, biases, and wishes on the information by promoting objective, careful methods of preparing it and making it possible (in principle) for anyone else who prepares it to come up with, and agree with, the same information.

**Solution Outline for Problem 5.3**

Some preliminary comments, intended to generate ideas, are:

To the extent financial statement preparers likely benefit personally from an entity’s positive and favourable results, they are likely inclined to bias their reporting of an entity’s results of operations and financial position to favour their personal objectives, at the cost of objectivity and fairness to other users. Accounting standards serve to ensure that commonly recognized and applied measurement, disclosure and valuation methods are applied consistently over time and across entities, to mitigate adverse effects of self-serving financial statement preparers.

To the extent users may have varying levels of sophistication respecting understanding financial statements, recognized accounting standards serve to “level the playing field” by providing a common basis of measurement, disclosure and valuation of the impact of economic activities on an entity.

In order to gain and maintain investor and market confidence, communication about the results of operations and financial position of an entity must be consistent over time and across entities and this is accomplished through the existence and use of recognized accounting standards.

**Is a company free to do what it likes as long as it explains?**

- The standards can’t cover everything, so such an “out” makes sense to allow variations as long as they are clearly explained.
- But the result still has to meet the auditor’s “fairness” test, so companies are not unconstrained.
- Self-serving or over-optimistic presentations would be suspect.
- The company’s management is responsible for the contents of the financial statements and can be held accountable in a court of law, so gross violations of GAAP, even if explained, would be difficult to get away with.

It can be observed that many companies depart here and there from GAAP in order to present their information in a way believed to be better, so latitude is tolerated, in an effort to completely, accurately and timely reflect the economic reality of transactions.

**Solution Outline for Problem 5.4**

The tradeoff between relevance and reliability arises because of the demand for timely information. Since users are not willing to wait years for financial statements, during which time uncertainties about the collection of receivable and pension liabilities would be resolved, they must accept estimates made for some accounts, based on the information that is available now. Therefore, the estimate is unlikely to be completely accurate (i.e. reliable), but it reflects a more complete picture of the company’s current position and performance than if the estimate were not made at all (i.e. it is relevant).
## Solution Outline for Problem 5.5

Sections 5.2 and 5.3 contain a large number of concepts and principles; here are the main ones with a few words about why each is useful (paraphrased, brief and to the point, as Bob would want them).

<table>
<thead>
<tr>
<th>Term</th>
<th>Why Useful</th>
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</thead>
<tbody>
<tr>
<td>a. Objective</td>
<td>• Acknowledges that financial statements are supposed to be useful to various parties.</td>
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<tr>
<td></td>
<td>• Basis of the whole conceptual structure of financial statements.</td>
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<td></td>
<td>• Basis for judging adequacy of other terms below.</td>
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<td>b. Conformance with GAAP</td>
<td>• These are the accounting rules which must be followed in the preparation of financial statements.</td>
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<td></td>
<td>• They are called “generally accepted accounting principles” because they are based on principles used over time that have become the accepted way of doing accounting.</td>
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<td></td>
<td>• Because of this, most educated users of financial statements understand these rules.</td>
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<td></td>
<td>• Bob would like this because it means that his financial statements will be understandable to users such as his bank manager and potential investors.</td>
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<tr>
<td>c. Fairness</td>
<td>• The standard audit report states that the financial statements are “presented fairly” in accordance with GAAP.</td>
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<td></td>
<td>• This means that the financial statements are not 100% correct.</td>
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<tr>
<td></td>
<td>• It is generally impossible to prepare financial statements that are 100% correct because there is considerable amount of judgment involved in financial accounting. For example, estimates must be used in measuring warranty expense and bad debt expense.</td>
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<tr>
<td></td>
<td>• Bob may not like this because he might prefer that his financial statements be 100% correct.</td>
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<tr>
<td></td>
<td>• However, the concept of fairness means that there are no errors in the financial statements that would change any decision made by a user of the financial statements (see materiality).</td>
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<tr>
<td>Term</td>
<td>Why Useful</td>
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<tr>
<td></td>
<td>• Also note that the cost of the financial statements will be lower using the fairness criterion, than if the financial statements were 100% correct. Bob would like this.</td>
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<tr>
<td>d. Benefit/cost</td>
<td>• Bob would like this: acknowledges that financial accounting information should have a value to users that exceeds its cost.</td>
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<td></td>
<td>• Bob might not like the idea that different parties may get the benefits than bear the costs.</td>
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<tr>
<td>e. Materiality</td>
<td>• Useful information is that which makes a difference to someone's decision making.</td>
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<td>• Significance of policies, disclosures and potential errors is judged by this criterion, so that effort is not spent on unimportant things.</td>
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<tr>
<td>f. Understandability</td>
<td>• Here is something for Bob: accounting information is supposed to be understandable to those it is to help.</td>
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<td></td>
<td>• But accountants are entitled to assume users have some preparation, so Bob does not have to spend money to educate the users of his financial statements.</td>
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<tr>
<td>g. Relevance</td>
<td>• Like other criteria above, this idea is that the accounting information should be useful to those it is intended for.</td>
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<td></td>
<td>• Bob should be aware that the information is intended to help people decide, not to make their decisions for them.</td>
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<tr>
<td></td>
<td>• To be relevant, information should help people predict or learn and should arrive in time to be helpful in their decisions, which is why there often is time pressure in the preparation of Bob's financial statements.</td>
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<tr>
<td>h. Reliability</td>
<td>• If people can't rely on the information, it won't be useful to them.</td>
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<td></td>
<td>• Bob relies on his people to meet his expectations, so he should understand this.</td>
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<tr>
<td>Term</td>
<td>Why Useful</td>
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</table>
| i. Verifiability | • Independent people should be able to determine that the accounting information is appropriate.  
• This feature is very important to the credibility of financial statements and is supported by the auditing function. |
| j. Matching | • These involve matching the expenses necessary to earn revenue in a period, to the revenue of that period.  
• Bob would like this because it will give him a better idea of the future earnings potential of his business than if matching had not been used.  
• It also may give him an indication of areas within his business which might be improved. |
| k. Neutrality | • The accounting information should not be biased toward (or away from) any particular person.  
• This allows anyone to rely on Bob's financial statements without concern that they may tell a biased story. |
| l. Conservatism | • The information in financial statements should not be optimistically assembled if there is uncertainty.  
• This conflicts with neutrality but is thought to be useful because it reflects care and prudence. |
| m. Comparability | • Financial statements are more useful if they permit different companies to be compared, such as Bob's and similar businesses, to better judge financial performance and position. |
| n. Consistency | • Each company's statements tell a more useful story over time if they are consistently prepared from one year to the next. |
| o. Disclosure | • This includes notes and account descriptions which clarify and extend some of the information contained in the income statement, balance sheet and cash flow statement.  
• Bob may not like this if he would prefer not to disclose some of the information. For example, he may not want competitors to gain a competitive advantage from use of the information. |
Term | Why Useful
--- | ---

**p. Timeliness**
- On the other hand, Bob may like this if it increases understandability of his financial statements.
- In order for financial statements to provide information useful to users, they must be provided to those users on a timely basis.
- Bob would like this because he likely doesn't wish to wait for information which he needs to make decisions.

**q. Trade-off**
- All the above ideas are fine in themselves but they may not always indicate the same action, so sometimes there must be a choice between them.
- As Bob knows from his experience in business, sometimes practical compromises must be made in accounting as in other parts of life.

**Solution Outline for Problem 5.6**

This is a short look at a concept that is both practically and conceptually troublesome. Auditing texts and some research studies provide more insight into materiality for those interested in pursuing it further.

The president is right that different users may have different ideas about what is material. Materiality is a user-oriented concept: if something in the financial statements would affect a user’s decision or evaluation, it is material to that user. The problem for the auditor trying to judge fairness is how to figure out what would matter to various known and potential users. It would not be practical to ask them all when doing the audit, so the auditor must rely on general estimates of what is important and judgment about who among known and potential users might be sensitive to what.

One way to make such a judgment is to examine the enterprise’s financial performance and position and identify items in the financial statements that everyone who is interested in the enterprise would be sensitive to. In addition, general criteria such as percentage of income or of assets can be used to screen errors and judge effects of alternative accounting policies.

However, the auditor's materiality standard is unlikely to suit everyone, as the president suggests. Therefore, there is an unavoidable responsibility on each person relying on financial statements to become informed about the enterprise and to make some judgment about what is or is not important. Unfortunately, errors and effects which the auditor thought were not material will likely not be disclosed, so we must hope that the auditor's materiality criterion is stricter than that of all, or most, users, so that disclosure will result and the users can then make their own assessments of the materiality of the errors and effects. (On the other hand, too strict a criterion might mean the auditor is doing more work, worrying about more things, than users want. As the auditor charges a fee, users such as shareholders may not want the enterprise to bear the extra cost of a strict criterion. Is finding a $2.00 error worth $100.00 of auditor time? Most users would say not.)
Solution Outline for Problem 5.7

The questions asked in this problem are quite deep: they engage the attention of many sophisticated and high-priced people. In this introductory stage of students' knowledge, the questions should be used to generate interest and discussion rather than definitive answers. Here are some ideas; discussion will raise more.

1. Regulation's advantages:
   • work out solutions in advance to save companies the trouble and costs of solving accounting problems on their own;
   • prevent “undesirable” actions by companies which may be motivated to do things others would disapprove of;
   • by publicizing the regulations, educate users and preparers as to the appropriate or approved methods;
   • regularize the production and use of accounting information by minimizing conflict and confusion (like having stop signs at intersections);
   • impose society's or government's will on the accounting system (putting the needs of the group ahead of those of individual companies: an advantage not everyone would agree with!);
   • increase the power of accountants and auditors as the interpreters and custodians of accounting regulations.

2. Some ways that there might be sufficient value (following from the sort of points in Part 1):
   • if the net value to society outweighs the cost to that company (efficiency, prevention of error, smoothing of the system, etc.);
   • if the remote owners of the company value the information more than do the managers of the company;
   • if the company misperceives or mismeasures costs and benefits;
   • if the company would be tempted to abuse the system if left to make its own accounting choices.

3. This could be argued from both sides. Stability has the advantages of imposing order and therefore trying to obtain the sort of social advantages, such as efficiency, education and regularization, suggested above. On the other hand, accounting regulations, like other social decisions, must be set by fundamentally political processes: there are no “right answers” for all cases and all times. As this book has emphasized, conditions do change and if accounting is to be most useful, it and its standards must change with the conditions.

4. Some reasons why such phenomena persist:
   • even complicated standards can't cover everything;
   • it is unlikely to be worthwhile (cost-effective) to try to expand standards to cover everything: like highway speeding, some violations may be acceptable as long as most people comply;
   • some companies may risk penalties because they feel the advantages outweigh the risks;
   • standards are human creations and are subject to flaws;
   • such phenomena may be “seen through” by most people, who therefore may consider them harmless and not worth the effort to stop them.
Solution Outline for Problem 5.8

Some preliminary comments, intended to generate ideas, are:

Advantages of international accounting standards:
- Frequency and extent of globalization of companies has increased, necessitating commonality in measurement, disclosure and valuation methods of reflecting economic reality of transactions.
- Across the globe, significant variation exists in sophistication of markets, investors and accounting standards. The sharing of accounting standards by sophisticated countries through the establishment of and compliance with international accounting standards with developing countries allows an earlier and more fulsome adoption of globally recognized accounting standards, and a greater efficiencies in global markets.

Disadvantages of international accounting standards:
- Developing countries may lack the legal, professional and financial structures that support sophisticated accounting systems required to comply with international accounting standards.
- Sophisticated countries’ accounting standard setting bodies may be reticent to adopt international accounting standards (IAS) if they feel IAS do not reflect the spirit and intent of domestic standards, or because of a perception that sophisticated standards will become “watered down” to accommodate less developed economies and markets (lowest common denominator).

Solution Outline for Problem 5.9

Through the double-entry accounting system, increases (or decreases) in assets will result in increases (or decreases) in liabilities or increases (or decreases) in equity in order for the balance sheet to remain in balance. Therefore, changes in assets and liabilities can affect the net income since it is a component of equity.

For example, the cost of a capital asset is allocated to income over time through amortization expense. Net income over the capital asset’s life is affected both by the decision of how to value the asset initially and how quickly the asset will be amortized. The valuation concept of conservatism will result in a charge to income when an asset’s value has declined below its original cost.

From the other side, income measurement also affects the balance sheet. When revenue is recognized on the income statement, an asset is created, either cash or accounts receivable. When an expense is recognized to match with the corresponding revenue, an asset is decreased (e.g., bank balance) or a liability is created.

Solution Outline for Problem 5.10

Some points that might be made:
- As in other areas of society like health and education, standards provide some protection against abuse;
- It is not easy to figure out how to prepare good financial statements, so GAAP help preparers do a good job;
- The existence of GAAP help everyone’s efficiency because once you know GAAP, you don’t have to take the time and money to solve every problem from the beginning;
- GAAP help make various companies comparable to each other and comparable to themselves over time, thus clarifying performance measurement;
- There is a credibility problem if managers prepare information about their performance on any basis they like, so GAAP help good managers because users are more likely to believe the information;
- GAAP provide rules ahead of time, which makes for a smoother system than if there were no rules and dissatisfied people had to sue or fight each other after the information came out;
- Without GAAP, therefore, there would be chaos, lack of trust and, overall, much less useful information.
**Solution Outline for Problem 5.11**

You might blurt out ideas like those in the list below. If you have more, that's great!

a. Think about the users of the financial statements and which way of preparing and presenting the information would be most helpful for them.

b. Think about the company and its circumstances, and which way of preparing the financial statements would most suit it and report its position and performance most appropriately.

c. Think about the basic concepts behind GAAP (such as fairness and comparability) and how these can be met in the company's financial statements. These concepts are reasonable attempts to produce good financial reporting, and they're not especially mysterious or complicated.

d. Look at how other businesses like this one prepare their statements. They probably have similar circumstances and financial reporting objectives.

e. Discuss the accounting with the company's auditor, who is likely to be both an expert and helpful about how to make the company's financial statements appropriate and fair.

**Solution Outline for Problem 5.12**

1. If a potential investor is using financial statements to decide whether or not to invest, he/she needs assurance that the numbers fairly represent the company's performance and position and properly reflect the risk involved in the investment.

2. The notion of “fairness” indicates to the investor that the financial statements are not necessarily one hundred percent accurate. However, the financial statements are free of “material” errors, that is, large errors that would affect the investor's decision of whether or not to invest.

3. The investor would like to compare the current performance and position of a company with the prior year (the financial statements provide comparative data from the prior year to enable this) and with other companies (GAAP helps companies in the same industries be comparable by recommending accounting policies and financial presentation).

4. Consistency is related to comparability. The fact that a company must use consistent accounting policies from year to year (and restate prior years if the accounting policies change) helps the investor study the trend in financial performance and position over time. Also, the separate disclosure of unusual and extraordinary items helps the investor compare the consistency of usual operating results from year to year.

5. A potential investor is unlikely to want to invest if the company is not a going concern, that is, if it expected to go under. Therefore, if no information is provided to the contrary, the amounts on the balance sheet are based on historical costs rather than liquidation values.

6. Conservatism is important to a potential investor because it means that assets, revenues and income shouldn’t be overstated and liabilities, expenses and losses shouldn’t be understated. For example, a company’s balance sheet reflects reliable and verifiable historical costs rather than other values that are difficult to substantiate.

7. The potential investor requires the financial statements to be available on a timely basis so that the information in them is still relevant to his/her investment decision.

8. Disclosure is important to the investor so that the financial statements are understandable, through the grouping of accounts, the group descriptions, and additional notes and narrative that provide supplementary information about the financial statements and the company’s operations.
Solution Outline for Problem 5.13

This problem, from the 1979 national CA exam, has been included to raise an interesting issue and remind students that many issues are considered even by qualified practitioners to be unsettled. Great sophistication should not be expected of introductory accounting students! Here is the “suggested approach” published by the 1979 national CA examination board. The italicized comments tie the suggested approach to the concepts in Sections 5.2 and 5.3.

1. Arguments for one set of GAAP for all businesses

   a. Measurement: This issue is common to all enterprises. It could be argued that deferred (future) taxes, lease capitalization, consolidation, etc., are valid to any size of entity, and that true or good measurement is neutral and not limited to any one size business. (Income measurement, Balance sheet valuation)

   b. Confusion: Permitting the use of more than one set of GAAP could lead to confusion on the part of financial statement users; credibility would decline accordingly. Small business GAAP statements could be misinterpreted by the unknowing reader. (Comparability, Reliability)

   c. Differentiation issue: Valid distinctions between large and small businesses may be difficult. What would the criteria be - sales? assets? equity? number of shareholders? Some private companies are larger in dollar sales, assets, etc., than many public companies.

   d. The ultimate solution may be to have one set of measurement rules for all businesses, with expanded disclosure requirements for specific enterprises. (Disclosure, Particular circumstances)

   e. If small entities do not want to follow GAAP, they should prepare non-GAAP statements and live with any qualifications in the accountant's comments or auditor's report.

2. Arguments for separate GAAP for small businesses

   a. Varying user needs: Generally the statement user group is different for small businesses than for large, for example:
      
      Small - income tax, bank, owner/managers, etc.
      Large - security exchanges and dealers, potential investors (public), etc.
      - comparability to other large corporations is essential, particularly corporations in their own industry, but comparability to small private corporations is not.

      The users of small business financial statements are less interested in the accountant's measure of earnings with its various cost allocations. Other variables, such as cash flow and liquidity, are often more critical to the success of a small venture. For example, small businesses often question the need for accounting depreciation and amortization separate from income tax depreciation. (Usefulness, Relevance)

   b. Cost: Small businesses often have little or no internal control staff and must bear the cost of engaging public accountants to prepare complex accrual-based statements -statements that users find neither understandable nor useful. (Cost - benefit)
c. Present practice: Exceptions currently exist in the Handbook, which suggests that there is double application of GAAP. To have two sets would merely be an extension of present practice.

Solution Outline for Problem 5.14

This is very much a discussion question; students should exercise their imaginations and try to picture the manager's role and viewpoint in this situation. Here are some of the points that may arise in such a discussion.

1. **Hold top managers responsible even if they disagree**
   i. Formally, they are responsible for the financial statements whether they like it or not;
   ii. Authoritative standards are intended to be followed by those affected: full agreement is not expected all the time, but compliance is (we stop at stop signs not because we want to, necessarily, but because we are required to);
   iii. Such compliance helps to produce comparability, consistency, fairness and other characteristics of good information that benefit society as a whole even if individual companies are not particularly benefited;
   iv. Even from top management's point of view, having good accounting information makes comparing this performance to that of other companies or other times more meaningful and useful;
   v. Managers may have different preferences than users, and standards are intended to help users by considering their needs and giving them some power to receive better information than management might want to provide.

2. **Don't hold top managers responsible if they disagree**
   i. The disagreement may be good reason, for example information that competitors could use against the company may be forced out, reducing the performance the managers are responsible for;
   ii. General standards are never going to fit every company's circumstances, so some judgment to vary from the standards in order to produce information relevant to a particular company must be expected;
   iii. The managers may want to release more than the standard requires, so they should not be held to treating the standard as the maximum;
   iv. It may be very costly for a particular company to figure out the information called for by the standard and so some cost-effective approximation might make sense;
   v. Having fixed standards may conflict with the freedom we expect in our society: after all, managers may be sued, fired or otherwise penalized for poor reporting, so not everything has to be specified in advance in standards.
Solution Outline for Problem 5.15

Students’ answers may contain some of the following points. The conclusion reached could support either side.

Solutions should be imposed:
- increase the comparability of financial statements between companies
- increase the confidence of the users that the financial statements have not been manipulated to show desired results
- standard setters may speak for the greater good, therefore altering management’s decision-making
- may be good for society

Guidelines should be provided:
- not all organizations are the same and so what works for one may not necessarily be appropriate for another
- the environment in which accounting information is demanded changes so fast that the rules would not be able to keep up
- guidelines can be used to apply to new and old situations
- if the standards alter management’s behavior, it is not clear if management is in fact making the decisions or if standard setters are responsible; difficult to judge management’s performance.

Solution Outline for Problem 5.16

1. Standards harmonization would be a good idea because it:
   - Helps investment in both countries because investors will get similarly based financial information.
   - Helps companies operating in both countries reduce their accounting costs by having only one set of standards to follow instead of two.
   - Helps reduce embarrassment of companies showing different results just because of different accounting rules.
   - The more-developed country can aid the less-developed one in creating good standards.
   - You will probably think of more good reasons!

2. Likely obstacles arising during the meeting might include:
   - Legal and regulatory differences between the countries.
   - Different stages of economic development may bring different priorities for what should be done in accounting.
   - Similarly, different national priorities when it comes to financial or accounting changes.
   - Cultural differences about the role of accounting standards, regulation, etc.
   - Objections by the less-developed country to the likely more complex and sophisticated Canadian standards (educational and other costs).
   - Objections by Canadians to “watering down” Canadian standards in reaching a compromise with the other country.
   - Potential government concerns in both countries about the economic impact of changes in standards and complications such as income tax assessment.
   - Again you will probably think of more obstacles!
Solution Outline for Problem 5.17

This question addresses the issue of international harmonization. Currently, the international accounting standards exist in addition to the differing national standards. Not only are there differences between nations, but between each country and the international standards.

Are international accounting standards desirable?
- **Pro:** Many accountants and business people support the concept of international accounting standards. The IASB has a membership that covers a large number of professional accounting bodies from many countries. The number of international companies that operate in several countries is growing and many have shares that are traded in more than one jurisdiction.
- **Con:** Having international standards as the basis for capital market regulation, contracts, and performance assessment may be difficult since there are different economic and market conditions, particularly between developed and less developed countries. It is likely that some countries will prefer to continue to base these decisions on the national standards.
- **Even if** international accounting standards are desirable, that does not mean that they will be easy to achieve.
- **It is evident** that national standards are not always up to date so reaching consensus internationally will be even more difficult. It is likely that the international standards will not keep up with global changes.

How detailed or specific should they be?
- **Until now,** the international standards have tended to be more general in order to avoid specific conflicts with national standards. Therefore they have tended to have less impact than the more specific national standards. Auditors in their standard audit report make reference to compliance with GAAP. In many countries, including Canada, reference is made to which set of GAAP principles are being followed. Where financial reports are used in more than one country (e.g. Canada and US) the notes indicate differences in accounting principles between the two countries.
- **Although international standards** are desirable the likelihood is that they will continue to be less specific. As a result, national standards will continue to be the primary basis of financial reporting.

Solution Outline for Problem 5.18

This is a similar problem to 5.16*, except that here we are comparing Canada to other countries that are similarly economically developed.

Some points in favour of Canada setting its own accounting standards:
- **As mentioned in the problem,** Canada is big enough to carry its weight and should not hand the job over to others.
- If Canada sets its own standards, it would have the potential to be a leader rather than a follower.
- Changes would be made on a more timely basis, without having to get consensus from other countries.
- Even though Canada, the US and other countries may be similarly economically developed, there remain legal and regulatory differences between the countries.
- Canada and the other countries likely have different national priorities when it comes to financial or accounting changes.
- Canadian standards wouldn’t have to be “watered down” in order to reach a compromise with another country.
- It would be less complicated to assess the economic impact of changes in standards to such areas as income tax assessment.
Some points in favour of Canada using FASB or IASB standards:
- It would help foreign investment in Canada (and Canadian investments in other countries) because investors will get similar (i.e. comparable) financial information.
- It would help Canadian companies with operations in the US and other countries reduce their accounting costs by having only one set of standards to follow instead of two or more.
- It would reduce the cost to provincial and national accounting organizations of researching issues, gathering opinions about potential changes and issuing changes. This would lower the membership fees for Canadian accountants in these organizations.
- The United States has many more companies than Canada and so accounting issues may arise there before they would arise in Canada. FASB or IASB may resolve problems before Canada even knows they exist.
- It would help reduce the embarrassment of companies showing different results just because of different accounting rules.

Solution Outline for Problem 5.19

Again, there is no clear solution to this problem. Some points in support of each side are as follows:

Use same principles and formats:
- help investors understand the investment alternatives better if the markets are truly to merge
- more efficient to have a common measuring stick
- membership in NAFTA implies that common goals exist which could include financial accounting principles

Use different principles and formats:
- are the economies really so similar that the same standards make sense?
- in order for all members to agree, they would likely have to settle on the lowest common denominator of acceptable principles and formats
- legal rules may not make it possible to use the same standards

Solution Outline for Problem 5.20

1. fund balance replaces owners’ equity section
   - statement of revenues and expenditures instead of income statement
   - little or no amortization, lack of provision for long-term obligations, and lack of consolidation
2. not really a business any more, as its assets are being sold off rather than being used to earn income
   - the use of historical financial statements to evaluate its performance while in bankruptcy may not make sense
   - accrual accounting is probably less useful than just cash accounting
3. no owners; therefore, like governments, fund balance replaces owners’ equity section
   - lack of profit motive, so “net income” might not be meaningful to club members
   - probably lack of continuing management, as students come and go, so evaluation of any one year’s management’s performance using accounting information may be difficult
   - probably a focus on cash inflows and outflows rather than historical costs and accrual accounting estimates
Solution Outline for Problem 5.21

Not-for-profit organizations by definition do not exist to make money, but rather to fulfill certain goals and objectives for society. There are no owners, but still, members and non-members are still entitled to receive financial reports detailing the organization’s financial operations. More often than not, not-for-profit organizations are on a tight budget and resources must be allocated carefully.

Some ideas for financial information needs of members of CAAA or another not-for-profit organization:
- Are the membership fees charged being put to good use? Are resources being used in the most efficient way possible?
- Could expenditures be reduced in order for membership fee to be reduced?
- Are future expenditures likely to remain the same or will membership fees have to increase next year if more members do not join the organization?
- Besides membership fees, what are other sources of funds? Are there government grants that must be repaid if certain conditions aren’t met? Are there donations that must be used for specific purposes?
- Are facilities being kept up to date or must funds be set aside for future repairs or replacement?
- Is the organization reliant on volunteers to get things done, or must office staff be employed? Is there enough money to pay the office staff?

Transaction-based financial accounting and not-for-profit organizations:
- Transaction-based financial accounting is a good start; it captures the historical cost of expenditures and revenues and we can therefore produce a balance sheet and a statement of revenues and expenditures.
- However, it does not capture some of the information needs mentioned above. For example, it does not tell us if there are revenue sources that must be used for specific purposes. However, the financial reports can be organized in such a way (e.g. dividing the transactions into separate “funds”) to provide this information.
- The notes to the financial statements can provide details about things such as services provided by volunteers that may be difficult to quantify and record in the books.
Solution Outline for Problem 5.22

1. Ron, you do not have to follow GAAP. You can account for the club's affairs any way that you and the club members feel is appropriate, likely the simpler the better. However, if you need to use the financial statements to apply for loans or grants or want them audited, you will encounter some pressure to conform to GAAP, or at least to move in that direction.

2. It is hard to say for sure what the club's reasons were, but probably they included: (a) the club is not a business and so would not have had a reason to account like a business, for example there would not be a need to measure accrual accounting income but rather to make sure that expenditures did not exceed the revenue brought in; (b) the treasurers probably did not have much accounting training and so kept records and financial statements simple; and (c) recent years, non-business organizations have been encouraged to use business GAAP, but not to the point of obscuring what such organizations are about, and few are trying to earn “income” as businesses do and so few would have an income statement.

3. Yes, you can supplement the financial statements with whatever other information you feel would be useful to the members. Many such clubs do this. (Financial accounting does not prohibit any useful information, and supplementary audited or unaudited information is normal for businesses too.)

4. No, you don't have to have the financial statements audited. However, you may be asked to do so if you are using the statements to support applications for loans or grants or other external purposes. And for your own protection and peace of mind, you may wish to have the statements audited so that club members will trust them and your performance more.

Solution Outline for Problem 5.23

The following are general points that would apply to all five of the suggested organizations. More specific points could be added if one knows more about an organization.

Favouring the use of accrual accounting:
- measuring financial performance and position shouldn’t depend on what the goals of the organization are (e.g., to earn profit or to service members/society).
- therefore, the same augmentations to cash income should be made as for business accounting in order to make the financial statements meaningful.
- the financial statements would be easier to understand for users who are accustomed to accrual accounting which is the norm.

Opposing the use of accrual accounting:
- income measurement is not a goal, cash flow is more important.
- cash income is more easily compared to budgeted cash inflows and outflows for the year.
- not appropriate to put emphasis on the “bottom line” since the goals of these organizations are more abstract.
Solution Outline for Problem 5.24

The financial statements are a set and should be interpreted as such because all the statements are prepared, directly or (for the cash flow statement) indirectly, from the set of balanced accounts. Therefore, they are all portions of the whole set of accounts and the meaning of each is inextricably linked to the others. Some examples:

- Income on the income statement is produced by increasing net resources, so the revenues and expenses are linked to balance sheet accounts such as accounts receivable (uncollected revenue), accounts payable (unpaid expenses), and accumulated amortization (the sum of amortization expenses over time).
- Income is carried from the income statement to the retained earnings statement.
- Dividends on the retained earnings statement are reflected in the balance sheet as either a decrease in cash or an increase in the dividends payable liability.
- Net income from the income statement is used as the beginning figure on the cash flow statement, which itself is an analysis of changes in balance sheet accounts.
- No single statement can indicate all there is to know about a company’s integrated operations and activities.

Solution Outline for Problem 5.25

GAAP requires a certain minimum level of disclosure in addition to the financial statements themselves. Some disclosures are more voluntary. Here are some reasons why the additional information is provided:

- There can be a choice of accounting policies in certain situations and so it is desirable to let the users know which is being used, e.g. how capital assets are being amortized.
- In order to make the financial statements appear uncluttered, some details are omitted, for example the components of capital assets. If it is a large (“material”) amount, the components would be disclosed in the notes.
- Due to the historical nature of the financial statements, events may occur after the year-end date that aren’t reflected in the numbers but that will affect future operations. For example, if the company’s main building was damaged in an earthquake after the year-end, the users of the financial statements would want to know about it.
- There may be relationships with parties that are not at arms length and therefore perhaps not recorded in the books at fair market value. The users would want to know this when making comparisons of the financial statements with other companies.
- Five or ten year comparative data is useful to identify trends that aren’t apparent when looking at two years of financial statement data.
- The management discussion and analysis is important for management to explain the results of the year and where the company is headed in the future. Management wants to present the company in a positive light, so this should be read with a grain of salt.
Solution Outline for Problem 5.26

Some advantages of a continuously updated Web page rather than a printed annual report:

- More timely and up-to-date information. Annual reports can take a while to produce.
- Annual reports can also be very expensive to produce and distribute. On-line information can be accessed at any time by whoever needs it.
- Users would be able to assemble the electronic information that they need to more easily fit their needs.

Some disadvantages:

- Technical glitches could make the information inaccessible when it is needed. Potential investors may pass if they can’t get the information they need quickly.
- Competitors and other parties would also have easy access to information.
- There are security issues when information is accessible on the Web. Hackers may be able to access confidential information or maybe alter the information that is presented.
- If there is no year-end, day-to-day accounting would have to be more accurate in order to make the information useful. Complex adjustments that are often just made at year-end (e.g. pension expense) would have to be made more frequently.
- It could end up being more expensive because users would expect the same high quality effort that goes into an annual report, only they would expect it all the time. If this wasn’t provided continuously, the company’s results could be misinterpreted.

Solution Outline for Problem 5.27

The annual report’s financial information includes four statements: the balance sheet, the income statement, the statement of retained earnings, and the cash flow statement. They are important as a summary of a company’s business transactions for the year, supplemented by adjustments for incomplete transactions and estimates about future effects. No single statement is the “most important” - they need to be read and interpreted together. Financial performance, both in an economic (“accrual”) sense and according to cash flows, is reported and can be analysed and to some extent projected into the future. The balance sheet takes this performance information and adds it to the company’s financial position at the end of last year, producing a summary of the company’s financial position as accumulated over the company’s whole life. The income statement shows the results of operations from the resources utilized in the balance sheet. The statement of retained earnings earnings rolls the net income from the income statement into the cumulative summary of income, and includes other movements in retained earnings for the period, like dividends and contributed surpluses. The cash flow statement recasts the information in the prior three statements into the sources and uses of cash for the period. Without these statements, considered in their totality, investors would be unable to evaluate the performance of companies they invest in.

If an investor doesn’t have the time to study all these statements, the annual report usually contains ratios, trends, charts, and other information to help digest the financial data. To help with this, the notes to the financial statements contain supplementary information to support the figures in the financial statements and to explain information that may not be contained in the financial statements, such as unsettled lawsuits. If there is an item on the financial statements that you would like to know more about, the notes may help you.

Summary comparative data going back five or ten years usually supplements the traditional financial statements. This information is useful if you want to know more about the company’s past, since the financial statements themselves typically provide two-year comparative information. The additional comparative data may or may not give insights into where the company is headed in the future, but you can examine past trends.
The management discussion and analysis section of the annual report is useful in trying to understand the company’s current position and what its plan are for the future. However, this section, being prepared by management, tends to focus on the image that management wants to present, so it should be read in conjunction with the more objective financial statements.

The auditor’s report is important in determining how much reliance you can place on the fairness of the information contained in the financial statements. You should examine the wording of the auditor’s report to ensure that the auditors did not have a concern about their fairness. The wording of the auditor’s report will also indicate whether or not an audit was actually performed. It may actually be a “review engagement report,” whereby less detailed verification procedures were performed and which is less reliable than an auditor’s report.

Solution Outline for Problem 5.28

1. Independence is considered necessary so that it will not matter to the auditors what the financial statements say. Independence helps to ensure that the auditors will bring a detached, professional view to their task. If the auditors were not independent, they might “want” the results to turn out a certain way so that they were better off (for example, if the audit fee was a percentage of net income, then the auditors might go along with methods that make income higher because they would benefit). Auditor independence helps ensure the statements are reliable, objective and verifiable.

2. Independence is difficult to maintain for several reasons. First, the auditors would not have the audit job the next year if the company were to fail, so they are likely to prefer that the company continue to exist, and might be tempted to agree to accounting methods that hide problems. Second, the auditors have to work closely with management, and may depend on management for other business (e.g., tax or accounting advice) that is nice to have and oftentimes, more lucrative. Third, though the auditors are officially appointed by the shareholders, a recommendation by management that the auditors be reappointed (or not) is likely to be accepted by the shareholders, who are not usually very close to the company or to the auditors. Fourth, the auditors are human and get to know and like the people they work with, such as the company management and employees, and usually would like such people to succeed—it’s hard to be detached all the time.

Solution Outline for Problem 5.29

1. The text has a lot to say about this. Basically the auditor adds credibility to the financial information by reducing bias (increasing fairness and objectivity), reducing error, promoting adherence to standards of presentation, classification and calculation, and being willing to stand up for the result (taking responsibility). The audit is important in verifying that management has acted appropriately or at least in verifying how management has acted as stewards of the investor’s share of the company. Since the audit adds credibility investors can have confidence in the financial information. This should help the investor who wants to trade shares to someone else, or the investor who is interested in buying shares.

2. The standard auditors’ report consists of three paragraphs: the introductory, scope and opinion paragraphs. The scope paragraph describes the audit process. The opinion paragraph explains the auditors’ view that the financial statements are fairly stated and in accordance with GAAP. It would be a useful exercise to try to restate the auditor's report in plain English, for example a somewhat more complete version of “Here's what we reviewed, what we did and what we found”.

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3. Part 1 covered this at a general level. Specifically for the investor, presuming one who is not involved in management, the auditors' report is an important link in verifying that management has acted appropriately (or at least, verifying how management has acted) as stewards of the investor's share of the company. The credibility added to management's financial statements should help the investor who wants to trade shares to someone else, or the investor who is interested in buying shares, have confidence in the financial information. The auditors' report therefore should assist the capital market to function validly and smoothly.

This may be debated, but the idea it is that the capital market forms expectations about companies and if information comes out that is in accord with expectations, the market does not see this as “news” and so does not respond. The market therefore looks for information inconsistent with expectations. The standard form of auditors' report can be seen as consistent with this: if the market expects most companies to be okay, then it would wish to be alerted to information consistent with this. So if the auditors' report is standard, then this is no news; but if there are variations from this, readers should be alerted to the possibility that this is news to be considered in evaluating the company and its securities.

4. Some limitations:
   • value is limited by the value of the financial statements themselves, for example the future is not predicted, nor is all important information in them;
   • the auditors' report is not an opinion on the quality of management or the viability of the company;
   • no claim is made to detect or prevent fraud (unless the fraud were so large as to affect fairness of the overall financial statements, an unlikely prospect);
   • the auditors must sample records and internal controls because it would be too expensive for the auditors to check everything, therefore the sampling might have missed something.

Solution Outline for Problem 5.30

1. Whether this is a threat to independence depends on the relationship, it is fine to be friendly with the client, however it is important to maintain some distance from clients. If the relationship results in an inability on Roger's part to objectively perform his work then his/her independence is compromised.

2. An audit includes procedures designed to determine whether effective controls are in place to ensure the accuracy and completeness of the accountancy information produced by the computer system. The redesign of the system would have included implementation of such controls. It is difficult to take an unbiased view of work performed by your own firm. This may jeopardize independence. On the other hand since Pat's accounting firm designed the system this may result in a more efficient audit because of enhanced understanding of how the system works.

3. There is no reason why this should be a threat to Roger's independence. Tax work is regularly performed by the same accounting firm that does the audit. This is efficient because information required to prepare the tax return would be included in the audit files. Separate billing of the work does not change the situation.

4. It is very common for clients to hire members of accounting firms who are auditors of clients. This could cause independence problems if Roger has a close personal relationship with his former assistant because Roger may not be able to objectively evaluate his former assistant's work. If Pat does not have a close personal relationship with his former assistant then it should not be an independence problem.
5. Rules of professional conduct do allow auditors to perform other services for clients as long as doing so does not impair independence. However, this situation could threaten Roger’s independence for the following reasons:
   - Selling other services such as consulting to a client may increase the influence on the auditor to conform to management's desires.
   - The magnitude of the fees charged for other services as compared to the annual audit fee is relevant when evaluating the effect these other services may have on auditor independence and objectivity.
   - Low price on the audit may result in lower quality audit work: this would indicate lack of independence and objectivity.

Solution Outline for Problem 5.31

Auditors are primarily responsible to the shareholders of the company. The Board of Directors of the company hires auditors, however the Board of Directors usually hires them on the advice of management, therefore one might say that the auditors are hired by management.

Auditors shouldn’t be held responsible for market responses when actual earnings per share differ from the analysts’ predictions because the financial statements are management’s responsibility.

Market investors would expect auditors to report impartially on how the managers have performed, i.e. how the managers have managed the assets and liabilities of the company on behalf of the owners (the shareholders).

Since management essentially hires auditors, it may be difficult for the auditors to remain independent of management and report impartially on management performance to shareholders.

Solution Outline for Problem 5.32

- Objectivity and neutrality—users need to be able to rely on the financial statements; their confidence is enhanced if the accountant/auditor has no interest in the results disclosed.
- Governed by professional standards and code of ethics—there are consequences if members of the profession do not follow the standards and codes of ethics; in extreme cases, the professional status of an individual can be revoked.
- Entrance is limited to competent members who can pass the examination process; again, the users’ confidence is enhanced knowing that the auditor/accountant is an expert in his/her field. Most accounting associations require some demonstration of continued competence, especially among members who offer their services to the public.
- Legally protected status and related responsibilities—being a professional provides some status and income, but there are repercussions if the concomitant responsibilities are not met, including fines, dismissal from the professional association, even jail.
Solution Outline for Problem 5.33

Overall, there is support that the two comments are not valid. However, there is no clear answer and you may very well have thought of points that support the validity of these tricky items. Some points are as follows:

1. Professional judgment
   - GAAP often permits a choice among acceptable alternatives
   - the accountant must be knowledgeable in order to recognize first, that a choice is available, and second, the support for or against each alternative before making his or her decision
   - there is often no “right answer

2. Public responsibility
   - by signing an audit or other report to the shareholders, the auditor or accountant is taking a certain degree of responsibility for the fairness of the financial statements
   - there may be a great number of users who are relying on the financial statements and they may sue the accountant if the statements are misleading
   - accountants must serve their clients (management) but they are in effect working for the shareholders (public) and must protect their interests

Solution Outline for Problem 5.34

Students could start by reviewing the two stories and discussing whether or not they agree with the outcomes. There is no right or wrong answer here, but some thoughts are as follows:

1. Professional accountant in trouble with law was ejected from the professional organization
   - Even if the unlawful event had nothing to do with his/her job as an accountant, society is unlikely to put its trust in professional accountants that break the law. It is very important for the reputation of the profession that the public continue to view professional accountants as trustworthy because of the seriousness of the audit function. Society would wonder, if a professional accountant breaks the law, is he/she also capable of “cooking the books?”
   - In this case, you could say that the professional accountant has been held to a higher standard than other citizens because his/her ability to earn the same level of income has been damaged by the ejection from the professional organization.
   - Is this fair?
     - Perhaps yes, because the accounting/auditing function relies heavily on good judgment to ensure financial statements are fairly stated.
     - Perhaps no, maybe one error of judgment shouldn’t have such a devastating effect on his/her career.

2. Professional accountants fired from firm, but no action from professional organization
   - The activities in their private lives are questionable, but society is less likely to assume that these behaviors would carry over into their professional work. Their employer did not approve of their activities and had the right to terminate them, but the fact that they were professional accountants may have been irrelevant.
   - In this case, the professional accountant has not been held to a higher standard. A construction company may also terminate employees who engage in questionable activities in their private lives. Companies do not want unfavourable media coverage if these events become public.
• Is this fair?
  • Perhaps yes, it wasn’t illegal so why should it matter if they engage in activities outside of work that are of no concern to anyone else.
  • Perhaps no, because again, the accounting/auditing function relies heavily on good judgment to ensure financial statements are fairly stated. By engaging in activities that aren’t generally accepted by society, their judgment in deciding what is fair for users of financial statements may also be questionable.

**Solution Outline for Problem 5.35**

1. Professional ethics
   • accounting is not a pure or natural science, rather it is a behavioural science. Therefore, there is much professional judgment required
   • dilemmas may arise in applying judgment because accountants are human and not always completely independent of the impact of a decision (they want to keep management happy because they pay their bills)
   • the bookkeeping side of accounting can be viewed as fairly technical, however there are many different ways that a transaction can be recorded. Similarly, the application of GAAP may occur in many different ways (eg. Method of amortizing capital tangible assets).

2. Written codes of ethics
   • the accounting profession’s code of ethics provides guidelines if an accountant is uncertain how to act in certain situations
   • judgment is required to apply the rules, since they can’t apply to every ethical dilemma that an accountant may encounter
   • the code of ethics is a supplement to one’s own morals

Overall, there is support that the two comments are not valid. However, there is no clear answer and you may very well have thought of points that support the validity of these tricky items.

**Solution Outline for Problem 5.36**

There is no right or wrong answer but students should discuss both sides of the issue and make a conclusion that is consistent with their discussion.

In favour:
• Increased knowledge of the client would simplify the evaluation of audit procedure results for “fairness.”
• If you have other employees/partners in your firm, you could assign the audit to them to avoid any loss of objectivity on your part.

Against:
• Loss of objectivity is likely. There would be a temptation to overlook audit problems to keep the consulting contract that has a much higher fee.
• For example, if the company was facing financial problems, you may agree with the president if he/she wanted the financial statements to reflect Losser as a going concern.
Conclusion:
- It would be advisable to decline the contract. Even if other employees could perform the audit, the firm overall would likely lack objectivity since the loss of the consulting contract would have a large impact on the firm's profitability. If the president values your advice that much, he/she would be willing to give you the consulting contract alone, without the audit engagement.

**Solution Outline for Problem 5.37**

Some discussion points:
- Business considerations drive people to ethical or unethical, as the case may be
- Good business sense may cause ethical behavior in the long run
- Good ethics can be marketed as part of the product. For example, the Body Shop’s cosmetics may be more expensive than some brands, but customers are willing to pay more knowing that the products are not tested on animals
- The right incentives can motivate people to behave ethically
- Doing the right thing may not be good for business
- Accounting is limited in that it doesn’t incorporate all relevant issues into the net income measure of performance. For example, the cost of pollution is excluded
- Some things in life are beyond “business” - ethics, morals etc. come from upbringing, religion, etc.

**Solution Outline for Problem 5.38**

Some of the many points that might be made:
1. a. If the market responds quickly and efficiently to information, it indicates the efficient allocation of capital resources. Money flows toward viable companies and away from less viable ones. So, accounting information assists in this allocation process.
   b. There are systematic and unsystematic (company-specific) risks in a stock market. Accounting information can help in assessing the latter.
2. a. Information is helpful to monitoring managers’ “stewardship” role in their companies, and in maintaining contractual arrangements. Accounting therefore assists in the effective administration of contracts in the economy.
   b. Changes in the contractual arrangements will cause changes in the accounting information that is required. Accounting’s use responds to the nature of the control/administration role assigned it.

**Solution Outline for Problem 5.39**

This question can be answered in many ways. Students may be cynical and state that accounting is not appropriate for either purpose. Or students may say that external reporting is the most important, or that monitoring and control is. Whatever the position, make sure they can support it with cogent arguments.

One position is to say that financial accounting exists for both purposes, as outlined below:

1. Information for outsiders:
   - It allows comparisons by investors because each firm is reporting using the same guidelines (GAAP).
   - An independent auditor reviews the information to ensure that it fairly presents the financial position of the company.
   - The information is for everyone, because supposedly it is to be largely comprehended by general users who put some diligence into analyzing and understanding the statements.
2. Internal:
   - It assists in such areas as control over accounts receivable, inventory, and accounts payable, which are important for the successful conduct of business and management of the company.
   - Incentive plans can be based on the accounting information, which provides some control over managerial behavior.
   - Since the information is prepared for the owners (shareholders), it may eliminate some management bias and promote clearer evaluation of management performance.

Solution Outline for Problem 5.40

October 31, 2006
- Share prices will react on this date if the market expected earnings for the year to be different from the analysts' predictions. If the market expected higher earnings than those predicted, share price would go down. If the market expected lower earnings than those predicted, the share price would go up.

December 31, 2006
- Share price should not change because no new information has been released.

February 27, 2007
- Share price should go down, because based on the analysts' predicted earnings the market expected earnings per share to be higher than they actually were. This assumes that no other information about earnings was released between October 31, 2006 and February 27, 2007.

Solution Outline for Problem 5.41

1. “Stewards” managed the properties of the English aristocracy. Stewardship is important today in companies in which the owners are separate from the managers of the organization; in this sense, the managers are “stewards” for the owners and are responsible for running the company on the owners’ behalf.

2. Securities regulation arose over the last several hundred years because governments and the people they represented felt that too much fraudulent, incompetent, and otherwise unacceptable behaviour was going on in public companies and with their shares and other securities. It seems that such regulation continues to be important, and the regular, nearly daily, reporting of problems in the media indicate that regulation might need further tightening.

3. Authoritative accounting standards have developed largely over the last century. They are important in providing rules and guidelines that prevent each accountant from reinventing the wheel each time financial statements are prepared. The overall objective is to result in financial statements that are “fair” and therefore useful to the intended decision maker who is relying on the financial statements.

4. The harmonization of international standards is becoming increasingly important as the world becomes a global marketplace. The users of the financial statements need to be able to understand the content no matter which country the statements originated from.

5. Independence became more and more important in the last hundred years, especially after the Great Depression of the 1930s, because auditors had to be relied upon to form an objective part of the securities and financial reporting regulatory systems, and because investors and other users of financial information became both more competent in using the information and more skeptical about possible management-induced biases in it, and about possibly cozy relationships between auditors and client management.
6. Disclosure has increased in importance and volume with the increase in financial regulation and in business complexity. There is more to tell people about all the time, and less ability to fit it neatly into the double-entry accounting statements.

**Solution Outline for Problem 5.42**

This is a “what-do-you-think” type of question. Here are some thoughts (you'll think of more.

- Would manipulation occur if management were allowed to produce whatever information it wanted, using whatever principles it preferred? Would users be able to protect themselves without authoritative standards?
- Who is responsible for the “demand for standards”? The users? The preparers? Management?
- Having more GAAP rules would certainly make accountants busier and more valuable, but would it create any social benefits?
- What would happen if each individual firm had to report specific events in the same manner? Doesn't an event have a different impact on each firm? Can you imagine how large the CICA Handbook would have to be to accommodate each business event?
- Do users want the GAAP structure to ensure some degree of comparability and consistency among firms over time? Do GAAP heighten investor confidence?

**Solution Outline for Problem 5.43**

This problem has similar objectives to Problem 5.13. Here is an edited version of what the 1984 national CA examination board said about it. (Again, sophisticated answers are not expected of introductory accounting students!)

*Sample response (a)*

Although it is not possible for general purpose accounting reports to satisfy all of their many users, the process of setting standards is neutral in that it does not aim to favour any one group. The standard-setting committees represent a wide range of interests, not only large accounting firms. In addition, before a standard is officially accepted, it is distributed to all interested parties, including non-accountants. This ensures that groups affected by a prospective pronouncement will have an opportunity to present any objections. The standard-setting committees review the objections and may change the pronouncement and, possibly, even issue a re-exposure draft. Clearly, the intention is to obtain consensus among affected parties. (Exposure drafts are proposed changes to the CICA Handbook. They are circulated to obtain consensus before the changes become incorporated into the Handbook.)

Contributing to the appearance of neutrality associated with financial statements examined by CAs is the fact that the chartered accountancy profession operates independently of government, industry and investors and, therefore, is not responsible to any of those groups.

The chartered accountant's involvement with financial statements provides some assurance to users that the statements are not biased. In the opinion on the financial statements, the auditor attests that the financial position of the company is stated fairly. In fact, the notion of fair presentation is central to accounting theory. Accountants attempt to report the substance of transactions rather than their legal form. For example, the introduction of the Handbook section on leasing took the position that a lease that transferred the rights of ownership to the lessee was an asset, even though legally it was not. This position was taken so that companies could not omit liabilities form the financial statements through a legal arrangement.
Although there is often a range of possible accounting treatments in a situation, accountants must use professional judgment to satisfy themselves that the approach selected by management is fair in the circumstances and does not favour any particular group. The efficient market hypothesis suggests that simply disclosing information makes financial statements unbiased because users will interpret and use the information according to their needs. Therefore, a key criterion for financial statement preparation becomes full disclosure of all-important information.

Sample response (b)
Because accounting serves so many different users with differing objectives and information needs, it is impossible for accounting to be neutral in any given situation. The information needs of investors may differ from those of creditors, labour unions or governments, and it is not possible to provide adequate information to satisfy each by one set of general-purpose financial statements. Therefore, choices are made that will implicitly bias the statements towards a particular group.

The standard-setting process does not have an intentional bias to it - standard setters do not favour a particular group. In fact, the process attempts to obtain representations from a range of interests by distributing exposure drafts to all interested groups and by having representatives from outside the accounting profession sit on the standard-setting committees.

Despite the safeguards, the process will still favour some groups because of the influence they can exert. It is more likely that a large company or group of companies can have standards altered than small, unorganized investors can. Therefore, there may be an unintentional bias towards groups with the resources (time, money, etc.) to make their positions known to the standard setters. The standard-setting process has shown indications that it responds to external pressure. For example, the response to the outcry against the Handbook section on foreign currency suggests that if a group does not agree with a pronouncement, extensive pressure can have it revoked. Although such pressure can be viewed from the positive perspective that the application of the standard does not result in fair presentation, the possibility exists that pressure will be applied to achieve change because of self-interests.

Preparation of financial statements and the selection of accounting principles is the responsibility of a company's management. In Canada, considerable flexibility exists in some areas for the selection of accounting principles, estimates and amortization rates and periods. With such flexibility, the preparers of financial statements will make choices based on achieving their own goals. For example, the management of a public company may attempt to ensure smooth earnings growth.

Also, some of the basic underlying accounting principles effectively bias the presentation of accounting information. For example the concept of conservatism has the effect of reporting pessimistic values for net income and assets. The application of this principle when a choice exists, with the philosophy that users are better served, results in financial reports being biased towards an understatement of the performance and wealth of the enterprise.

Solution Outline for Problem 5.44

This is a controversial and deep issue. The purpose of including it in an introductory accounting text is to provide a perspective on some of the characteristics of traditional historical financial statements by considering what would happen if the information were forward-looking forecasts instead. (Auditors already do something like this in various circumstances, such as prospectuses, but the details should probably be left for an auditing course.)
Here are some questions that might be raised with respect to the concepts mentioned in the problem:

a. fairness  
   • probably can be judged by similar non-bias criteria as those used for historical statements;  
   • but forecasts inevitably require judgments about many unknowns, and identifying bias is not easy;  
   • probably fairness will be judged by users after the fact, after the results are in for the forecast period, and auditors may feel this would be unfair to them as there will always be error in forecasts and hindsight is always “clearer” than foresight;  
   • do auditors, at least as presently educated and experienced, have a comparative advantage in judging the fairness of prognostications?

b. independence  
   • the detailed knowledge needed to make and judge good forecasts may require the auditors to be “closer” to their clients than might be comfortable to users who want the auditors to have an independent perspective;  
   • would having attested to a forecast impair the auditors’ independence in reviewing the actual results the next year (e.g. would they feel the need to justify their position the year before, especially if the forecast turned out awry)?

c. measurement  
   • financial accounting's measurements are based on economic transactions and estimates related to those: would similar measurement principles apply to non-transactional forward-looking statements?  
   • would GAAP in general make sense as the basis for measuring projected performance (maybe so: if the performance will eventually be measured according to GAAP, perhaps it might as well be projected that way)?

d. comparability  
   • using standard financial statement format for the projections should help make them comparable to those of other companies or other years;  
   • since projections of the future are inevitably chancy so the actual figures are unlikely to come exactly true, perhaps it is the assumptions and methods used to make the projections, rather than necessarily the projections themselves, that should be comparable.

e. agency theory  
   • what role would projections play in contractual arrangements: do any of the company's arrangements depend at all on audited plans or forecasts, or would only specific contract-based forecasts be useful (e.g. in pension contracts, cost of living forecasts may be useful but net income forecasts may not unless there are implications to ability to pay promised amounts);  
   • would forecasts introduce motivations (e.g. for managers) that would complicate or interfere with the smooth functioning of present arrangements?

f. capital market  
   • as the capital market is interested in assessing future performance, forecast information should be useful to it, and audited forecasts should have added credibility as compared to what management may say on its own;  
   • but the forecasts have to be relative to factors and use assumptions that the market finds relevant and traditional-format financial statements may not meet this demand;  
   • many people already make forecasts and release them, so the capital markets would consider audited forecasts as having a marginal role to play in addition to, or perhaps replacing some of, the information already available: this could be a very small marginal role unless there is “news” (something at variance with the market's expectations) in the audited forecasts.
g. relevance • forecasts, as suggested above, may be relevant to some users and not others;
   • making one forecast relevant to various users’ demands may be difficult, just as making one set of financial statements already is.

h. reliability • difficult to make sure that forecasts are free of error because there aren't the opportunities for verification that exist with historical information;
   • will the auditor's reputation for reliability in the traditional role transfer (in users' perceptions) to this new role?

i. objectivity • similar issues as in fairness, independence, measurement, comparability and reliability.

Solution Outline for Case 5A

This case is included to facilitate students’ realizing that they can understand much of the world’s financial statements by thinking about the presentation ideas in Chapters 2-4 and the principles of Chapter 5 (including but beyond the “International Accounting Standards” material in section 5.5). The case can also supplement the discussions in homework problems 5.16*, 5.17, 5.18 and 5.19.

The case also sends students off to web pages to work on their navigation skills, though its questions can be used equally well if the instructor prefers to hand out a set of non-Canadian financial statements. Since no particular company is specified in the case, no set of points in response to the case’s questions is provided here. Instead, these are some ideas to assist the instructor in the case discussion:

• For the website, discuss how readily available the financial statements and related information items are, whether the financial statements are in English, what the path to such information is (e.g. via a marketing route, or an investor relations route, etc.). Does the website seem to invite inquiry or make it a challenge? How frequently updated is the information? Are there links to market data, research reports, outside rating agencies, etc.? What sorts of information about the company, its markets, its production operations, etc., are available on the web site and are they tied to the company’s financial statements (through an MD&A or otherwise)?

• For informativeness, compare the company’s statements to those of CPR or other Canadian companies in an overall sense. Are there quarterly reports, full sets of footnotes, generally informative disclosure? The case question refers to the country’s reporting format, so there is an assumption that the company is following another country’s GAAP – it would be useful to look at the auditor’s report and/or the accounting policy note to determine what GAAP the company is using. It may for example be using US GAAP even if it is not a US company.

• For presentation and specifics of the informativeness of the company’s statements, a fairly detailed comparison to what we’d expect in Canada should be useful. Some possible differences to watch out for include:
  o Terminology differences for various financial statement accounts, such as “turnover” instead of revenue or sales (students might have fun compiling such differences as part of getting used to understanding such statements);
  o Differences in the ordering of the accounts or even of a whole statement (e.g. the British put the current assets at the bottom of the balance sheet and the noncurrent assets at the top);
  o Differences in the structure or content of the statements (e.g. US companies have a statement of stockholders’ equity that contains much more than the Canadian statement of retained earnings, as noted in section 5.5);
  o Differences in use of supplementary information (some of these will just be company idiosyncrasies rather than international differences).
The discussion of harmonization could start from that in section 5.5, or could just be based on the degree of differences found and the extent to which those differences seem to make using the financial statements more difficult, or costly.

Many foreign auditors’ reports say quite different things, and imply different assurance, than do the Canadian ones described in section 5.8. Pointing out those differences and discussing or speculating on their import would be interesting.

Students’ knowledge of accounting principles is still fairly rudimentary after sections 5.2 and 5.3, but still they might be able to identify some differences, e.g. in valuation of assets (e.g. use of market values or re-valued assets) or long-term liability provisions. However, the hope would be that this case’s exercise would show students that similar accounting principles are used around the world. (Detailed review of the accounting policies note to the statements, if there is one, might be useful, though at this stage of the course, students don’t know much about accounting policy choices or the application of specific accounting principles, covered in later chapters.)

Solution Outline for Case 5B

The editorial is from almost 10 years ago, but its points are still very relevant to the present, almost prescient. It might be useful to start out by identifying points in the editorial that appear to be still on the mark and others that are less clear or even murky.

Some additional points for discussion:

- Is there really a GAAP gap? Are there only a few cases in which the use of GAAP doesn't make sense, while in the majority of cases it does? If there are only a few cases, are these the cases that receive the most attention from the media, creating a perceived rather than a real GAAP gap? Recent events may convince us that there really is a gap, but the media’s role in convincing us might still be pondered.

- The role of media is important in developing GAAP. Accountants can gain an understanding of user needs to develop accounting principles. As the economy and business evolve, accountants develop new methods for dealing with new situations. Media attention can guide accountants in identifying situations which may require GAAP’s codification of acceptable methods. Arguably, the recent roubles of Enron etc. have resulted in accountants and auditors paying more attention to problems in accounting and so have pushed the development of GAAP that would prevent or constrain problems reported in the media.

- Some of the examples of GAAP abuses discussed in the editorial are not necessarily abuses, e.g. reclassification of short-term investments, capitalization of certain expenses, cost versus equity method for subsidiaries. However, some of these have been central to recent abuses, such as WorldCom’s apparently improper capitalization of expenses. It is difficult to evaluate the sophistication one should expect of financial statement users. Is it possible to develop GAAP that will enable a user without any knowledge of accounting to understand financial statements?

- GAAP do not provide a guarantee of the financial health of an organization. Investors can make a decision to invest in a company or not. Will tightening the rules remove any of the risk that investors face? It might however be argued that loose GAAP actually hurt the markets because they increase investors’ scepticism and caution.

- If the rules are tightened will this result in financial statements which are not really representative of the operations and financial position of the organization? That is, is it possible to develop one set of rules that can be applied to any company in any industry and produce meaningful financial statements?

- Will increasing the number of rules result in the costs of producing financial statements outweighing their benefits?

- What role does professional judgement play in all of this? Would it be better if accountants just followed rules and didn't exercise professional judgement? Lately, there has been concern that auditors’ judgments are biased by business concerns, such as income to be earned from consulting contracts with companies they audit, so the incentives for good judgment may need to be strengthened.
• Are GAAP already too detailed? It is possible that in the US, the more detailed standards have led to some abuses because they provide a “recipe” for someone who wants to set up a business arrangement that meets the form of the rules but not their substance.

• Do accountants really think they can do anything at all? What about the role of auditors in auditing financial statements? Doesn't this put a constraint on the rules chosen by accountants? Regulators such as the SEC and OSC watch financial statements too, and there has already been mention of the media’s role in constraining poor behavior, or at least punishing it.

• Refer also back to the points raised by the accountants, such as:
  o GAAP can't remove risk;
  o GAAP mean generally accepted, not always hard and fast;
  o Rules cost money and can't deal with everything anyway;
  o Rules may improperly constrain appropriate reporting;
  o Accountants may look at GAAP as "the answer" instead of thinking carefully about what is appropriate.