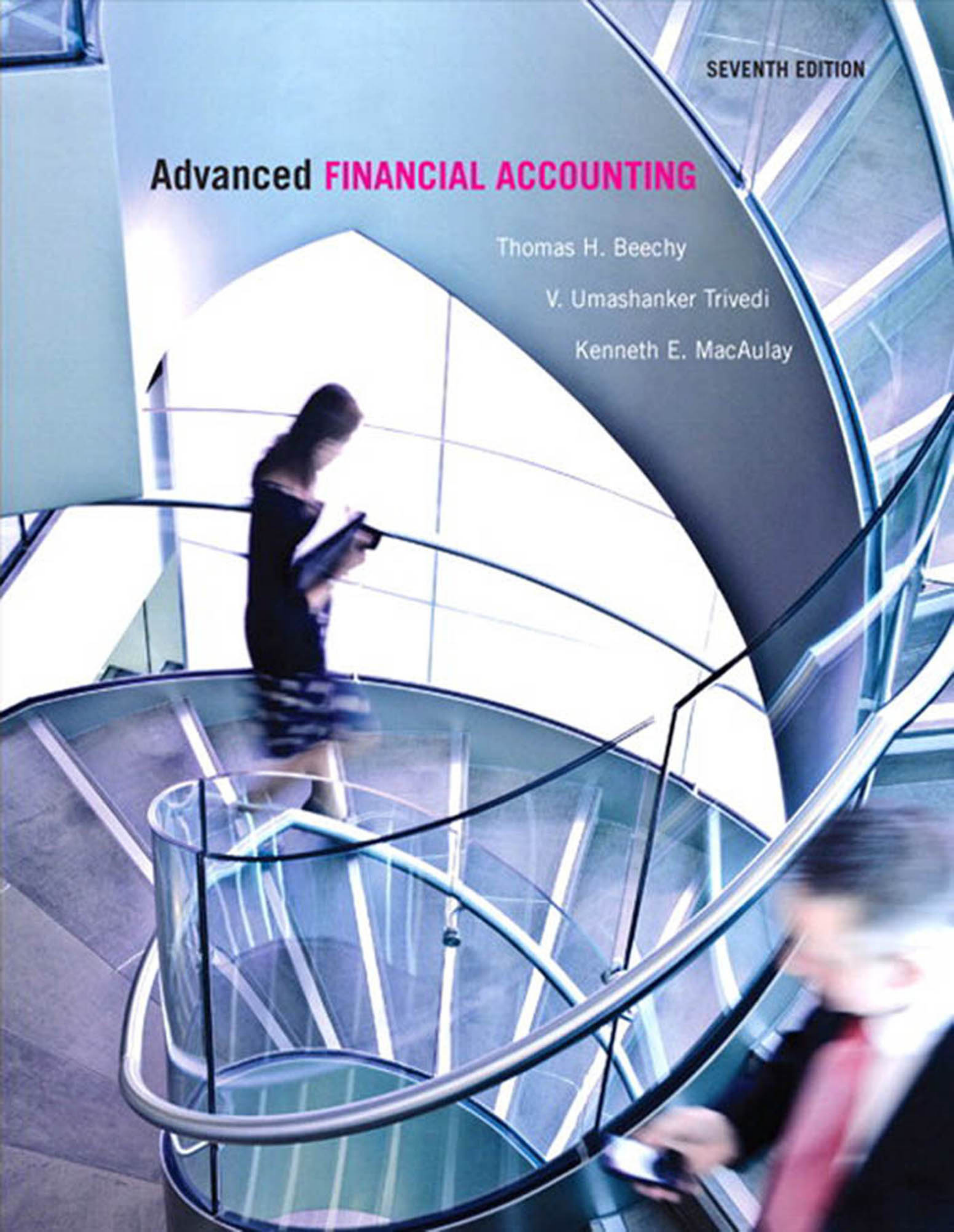

SEVENTH EDITION

Advanced FINANCIAL ACCOUNTING

Thomas H. Beechy

V. Umashanker Trivedi

Kenneth E. MacAulay

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Brief Contents

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About the Authors

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Tom Beechy has been in the forefront of Canadian accounting publishing for many decades. This is the seventh edition of the first Canadian-authored advanced accounting university textbook, initially published in 1984. Professor Beechy also is co-author of a major Canadian intermediate accounting text, now in its sixth edition. Tom immigrated to Canada from the United States more than 40 years ago after acquiring degrees from George Washington University, Northwestern University, and Washington University (St. Louis) and after teaching at the Illinois Institute of Technology for 10 years. After his arrival in Canada, he joined the Schulich School of Business, where he is Professor Emeritus of Accounting as well as Director of International Academic Development. Tom loves to travel and can often be found in Europe or Asia (especially in China). He is a classical music fanatic, and also enjoys dance, theatre, movies, and novels.

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Preface

Welcome to the latest edition of *Advanced Financial Accounting!* Since 1984, this book has guided students through the complexities of business combinations, consolidations, and financial reporting for business enterprises, non-profit organizations, and governments. This book is about more than just technical knowledge. Our goal is to help students develop a professional approach to accounting issues.

To help students demonstrate their professional competencies, we offer a variety of cases at the end of each chapter as well as a range of numerical problems. The cases address advanced accounting issues within realistic contexts. Using these cases, students can practise exercising their professional judgment. Most chapters have at least one *multiple competency* case wherein students are encouraged to apply their technical knowledge in a real-world setting over a wide range of issues.

New Features

In this edition, we have retained many pedagogic features of previous editions and added new features that will enhance students' learning experience:

- **Learning Objectives** will help to focus students' attention on the main issues of each chapter.
- The material in each chapter is **linked** to the Learning Objectives.
- **Reality Check** boxes highlight applications in practice as well as point out significant findings from empirical research.
- **Concept Check** boxes enable students to self-test their own understanding of important issues and concepts as they proceed through each chapter.
- **International Financial Reporting Standards** are explained and applied through examples in the main body of each chapter. **IFRS terminology** is used throughout.
- **Accounting standards for private enterprises (ASPE)** are explained in a separate section at the end of each chapter, whenever ASPE differs from IFRS.
- **Proposed Change boxes** highlight changes in accounting standards that are being considered by the IASB and that may become reality by the time students reach their professional examination stage.
- The **direct method** of consolidation is used more extensively in this edition, within each consolidation chapter. However, for those who find a worksheet approach more understandable, a worksheet solution for every chapter example is available online, on the book's **Companion Website (CW)**.
- The **MEAR steps for consolidation** provide students with an effective method for remembering the steps in the consolidation process; MEAR is introduced in Chapter 3 and further developed in the following consolidation chapters.
- **Graphic exhibits** in the consolidation chapters complement and highlight the discussion in these chapters in a visually appealing manner.
- The quantity of **self-study problems** has been increased.

- Marginal icons direct students to a greatly enhanced **Companion Website**.
- A list of **relevant IFRS and ASPE accounting standards** is provided at the end of each chapter.
- **Online appendices** discuss specialized aspects of consolidation that are less essential for a thorough professional understanding of those topics, as well as additional issues of fund accounting.

Text Updating

Synopsis. **Chapter 1** presents the basic structure of accounting standards in Canada as they apply to all types of organizations, private and public. We explain the role of accounting objectives, and we stress the importance of accounting estimates. While most of the accounting standards discussed in this book eliminate any choice of accounting policy, the reality is that the standards allow for a lot of latitude in making estimates that ultimately can have a significant impact on reported financial results. The chapter also develops the theme of international comparability, or the lack thereof.

Chapters 2 through 6 explain the complex issues and process of consolidation and accounting for business combinations. These chapters constitute the core of the book—for most people, this is what advanced accounting is all about. We have revised and updated these chapters, while ensuring the text remains highly readable.

The main focus of these chapters is on the *acquisition method* required under IFRS and particularly on the entity approach. This focus allows students first to obtain a clear and firm understanding of the consolidation process, and then to expand their understanding to the other complexities of consolidation. A supplementary discussion of the parent-company extension approach (an available option within IFRS) is included later in each chapter. Throughout these chapters, the equity method is compared to the results of consolidation.

The direct method of consolidation is used throughout the book. We use a unique step-by-step approach, the **MEAR steps to consolidation**, that we first introduced in the previous edition. This approach takes the student through a logical progression of steps that will work in all consolidation situations. The MEAR steps divide the consolidation process into self-contained parts, allowing students to approach the process of consolidation in an organized and structured manner. Thus, these steps allow students to focus on a specific task, such as the calculation of the amortization of fair value increments in later years, retained earnings, net income of the subsidiary, or non-controlling interest. These self-contained sections replicate the types of problems that students will often encounter on professional exams. We believe that students will find the *MEAR steps to consolidation* easy to follow and apply.

We believe that focusing on the direct method for illustrations within the text chapters is another feature that makes the difficult consolidation material manageable and easy to understand. However, the worksheet-method solutions for the chapter illustrations are now presented in the Companion Website for those students and instructors who prefer this method.

We have also incorporated new graphic exhibits in the consolidation chapters to complement and highlight the discussion in these chapters in a visually appealing manner. Further, the *Reality Check* boxes in each of the consolidation chapters have been carefully chosen to highlight the most recent examples from practice of how the material is implemented in real life as well as findings from current research on related topics.

Chapter 7 steps back from the process of consolidation to look at its opposite—disaggregation. The chapter explains the issues involved in disaggregating consolidated reporting both for shorter periods and for separate business lines of a consolidated enterprise—interim and segmented reporting. The existing problem material in this chapter has been refreshed and several new problems have been added.

Chapters 8 and 9 deal with the second most important topic in the book—the impact of foreign currency transactions and investments. We have updated our discussions to include the most recent IFRS standards that became effective in 2013.

Chapter 8 introduces the topic of hedging and the accounting for hedges generally. The specific topic of hedge accounting focuses on anticipated transactions. Fair value and cash flow hedges are reviewed and examples provided. Two methods of recording hedges (the gross method and the net method) are illustrated for all examples involving hedges in the chapter. In Chapter 9, the translation of foreign operations is examined using the IFRS functional currency concept.

Both Chapters 8 and 9 conclude with a discussion of Canadian accounting standards for private enterprise. Most of the problem material in these two chapters is either new or revised.

Chapter 10 presents the latest developments and financial accounting standards for not-for-profit (NFP) organizations. The nature and characteristics of NFPs in Canada are introduced early in the chapter and used to provide additional insights in subsequent discussions of the accounting issues faced by NFPs. The basics of fund accounting and encumbrance accounting are also introduced in the chapter. In addition, the online Appendix 10A, "Fund Accounting," has been substantially lengthened to provide a fuller explanation of how fund accounting works. New material is introduced on recording encumbrances and budgetary accounts. In the appendix, we include a comprehensive problem illustrating the use of the restricted fund method.

Chapter 11 discusses financial reporting for governments. Governmental reporting is very different from accounting for NFPs, and yet this is the only major advanced accounting text to clearly make this distinction and to provide a separate chapter on public sector accounting. Information on the nature and characteristics of governments is introduced early in the chapter and used to inform subsequent discussions. The types of government organizations and the major public sector accounting issues are discussed. The new *statement of remeasurement gains and losses* is also introduced. The chapter concludes with a presentation and discussion of a comprehensive example of government financial statements.

Student Supplements

Companion Website—www.pearsoned.ca/beechy

The book's Companion Website offers a considerable amount of additional assistance to students:

- **Excel® templates** for some problems.
- **Worksheet solutions** to supplement the direct method for all in-text consolidation examples.
- **Additional self-study problems,** with solutions.
- **Practice quizzes** for self-testing.
- **Appendices** of additional material on tangential issues that relate to some chapters.
- **IFRS Updates** as needed as the IASB reconsiders old standards and issues new ones.

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As in the previous editions, much of the assignment material was drawn from the professional examination of Canada's three professional accounting bodies: CGA Canada, CICA, and SMA Canada. A few cases have also been included by the kind permission of the Institute of Chartered Accountants of Ontario. We are deeply indebted to all of these organizations for their cooperation and support in permitting us to use their copyrighted material. An acknowledgment appears at the end of each case or problem that was obtained from one of these four professional sources.

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Corrections

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Please report errors by email to tbeechy@schulich.yorku.ca, strivedi@schulich.yorku.ca, or kmacaula@stfx.ca.

Thank you for using *Advanced Financial Accounting*, Seventh Edition. We hope you will find it an enjoyable book from which to learn these complex topics.

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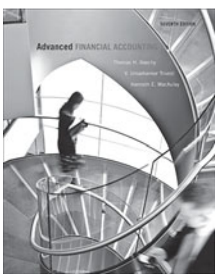
Advanced Financial Accounting,
Seventh Edition, by Beechy, Trivedi, and MacAulay



Student Resources

The modules in this section provide students with tools for learning course material. These modules include:

- Appendices 5A, 5B, 6A, 6B, and 10A
- Answers to the Concept Check Questions
- Worksheet solutions
- Excel templates
- Additional self-study problems
- Practice Quizzes
- IFRS Updates

In the quiz modules students can send answers to the grader and receive instant feedback on their progress through the Results Reporter. Coaching comments and references to the textbook may be available to ensure that students take advantage of all available resources to enhance their learning experience.

Instructor Resources

Instructors can access additional teaching tools including PowerPoint slides, an Instructor's Resource Manual, and a testbank through Pearson Canada's online catalogue. To get a password, simply contact your Pearson Canada Representative or call Faculty Sales and Services at 1-800-850-5813.

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Chapter 1

Setting the Stage

Learning Objectives

After studying this chapter, you should be able to:

LO 1 identify the four different types of reporting entities and the distinguishing characteristics of each;

LO 2 explain the origin and location of the different sets of accounting standards that apply to different types of organizations; and

LO 3 identify the obstacles to international comparability under International Financial Reporting Standards.

1.1 WHAT IS ADVANCED ACCOUNTING?

LO 1
Identify the four different types of reporting entities and the distinguishing characteristics of each

In previous accounting courses, you've learned how to apply most financial accounting reporting standards as they apply to profit-oriented enterprises, both public and private. However, there are a few complex topics that your earlier financial accounting courses touched upon very lightly, if at all. The purpose of *Advanced Financial Accounting* is to fill those knowledge gaps.

Advanced Financial Accounting is the detailed study of three major topics:

- accounting for business combinations and preparing consolidated financial statements;
- accounting for foreign currency transactions and foreign operations; and
- financial reporting by non-business organizations—not-for-profit organizations and governments.

In this introduction, we first will briefly introduce each of these topics. Then we will take a broader look at the full range of financial accounting standards in Canada.

Consolidations

Almost certainly, every financial statement that you have ever seen is a *consolidated* statement. We're sure you've noticed the word "consolidated" in each statement title, such as *Consolidated Statement of Comprehensive Income*, and you undoubtedly have a general idea what it means: *consolidated statements include the assets, liabilities, revenues, expenses, and cash flows for the parent company plus all of its subsidiaries*. It may seem excessive to devote half (or more) of a course to this simple concept. However, that simple concept disguises the complexities that underlie consolidated statements.

Consolidated statements do not report on a "real" corporation. Instead, they report on all of the assets theoretically under control, directly or indirectly, by the shareholders of the parent company. The fictional entity portrayed in consolidated statements does not exist as an identifiable legal entity. Thus, consolidated statements are sometimes referred to as an *accounting fiction*. By this we don't mean that consolidated statements aren't useful, but simply that they are an abstract construction. As such, they must be used with caution.

Any professional accountant or qualified financial analyst should understand how consolidated statements are prepared. Many accounting estimates and assumptions are necessary to prepare financial statements for a "consolidated" entity that, legally, does not even exist! Although consolidated statements are an accounting fiction, every professional accountant must clearly understand why and how they are created. An accountant must also be able to explain the limitations of consolidated statements to potential users.

The process of consolidation can lead to a plethora of "What if?" questions. In this book, we try to resist pursuing obscure and/or improbable scenarios. Just as in other areas of financial accounting, it is not possible (or wise) to get into great detail. We all need to know the basic approaches and complexities of business combinations and consolidations, but we don't need to be experts at every detail, any more than we need to be experts at every possible facet of revenue recognition or pension accounting. In *Advanced Financial Accounting*, we will give you an overview, not an exhaustive reference book.

International Operations

We all are aware that the scope of business is increasingly international. Even relatively small companies are affected by international trade, even if it's only by purchasing inventory or raw materials from foreign suppliers in a foreign currency. Most large companies have substantial operations in one or more foreign countries. For example, Montreal-based Bombardier had 2011 revenue of about $18 billion, but less than 6% of that revenue was from its Canadian operations. Bombardier does business around the world and operates factories in Germany, the United Kingdom, the United States, China, France, Spain, and many other countries.

How can Bombardier combine transactions and consolidate subsidiaries operating in US dollars, Canadian dollars, euros, British pounds sterling, and Chinese renminbi? Not only are Bombardier's many "offshore" companies operating in host countries with different currencies, but each subsidiary also is operating internationally itself. The impacts of foreign operations show up in many ways in consolidated financial statements, some of which represent genuine risk exposure and some of which are just the mechanical results of the consolidation process. You need to know the difference.

Non-Business Organizations

What happens when a corporation or organization is not driven by the profit motive? When profit ceases to be the motivation for an organization's existence, neither its operations nor its financial statements are driven by "bottom line" thinking. Not-for-profit

(NFP) organizations and governments are substantial segments of the world's economic activity, contributing 20–30% of employment in most countries. An accountant's or financial analyst's knowledge is not complete until he or she understands the very significant differences between profit-oriented enterprises and non-business organizations.

It is likely that your accounting education so far has focused exclusively on business enterprises. All business enterprises have similar accounting and reporting needs and can use a common private-enterprise accounting framework. Businesses comprise most of the world's economic activity. In contrast, NFPs and governments operate in many different ways and are engaged a wide variety of activities that have no parallel in business.

An oft-heard comment is that "governments and NFPs should be run like a business." The difficulty with trying to run an NFP or government like a business is that they are *not* businesses. Business enterprises have identifiable products or services that are sold or delivered to specific, identifiable customers or clients. There is nothing so specific about NFPs or governments. Certainly, there are "products," such as cancer research and road repair, but there is no identifiable "customer" to whom these products are sold. Nor do the "customers" normally pay for the product, at least not directly. Thus, the essential cost–revenue link that underlies all business activity does not exist in NFPs or governments.

While it is true that some segments of NFP and government activity *are* like businesses, such as a museum gift shop or a city electrical utility, these activities are a minor part of both NFPs and governments. Those business-type enterprises can and should be accounted for as a business because they have the essential cost−revenue relationship.

Therefore the final two chapters discuss the nature of accounting for *non-business activities* of NFPs (Chapter 10) and governments (Chapter 11). Many accounting graduates will find themselves involved in non-business organizations as professional accountants, as advisors, as board members, or simply as educated citizens who should be fully aware of NFP and government accounting issues.

Concept Check 1-1

1. Why might we refer to consolidated statements as *fictional* statements?
2. Why does an international corporation have greater accounting challenges than does a company operating in only one country?
3. Why is it a mistake to claim that a not-for-profit organization should be "run like a business"?

1.2 A NEW WORLD ORDER IN ACCOUNTING

The year 2011 was a pivotal year in accounting history. For the first time, most industrialized and developing countries began using International Financial Reporting Standards (IFRS). Nations (mostly in Europe) have been using IFRS for several years, but more joined the user group in 2011, including Canada.

This commonality sounds wonderfully simple and consistent. As we will discuss a little later, however, international accounting standards do not necessarily provide the consistency and comparability that we might assume they do.

As well, despite the appearance of widespread commonality among nations, IFRS may have quite limited application in many countries:

- IFRS usually is required only for preparing *consolidated* financial statements; a nation's laws may require parent corporations to issue their own separate-entity *non*-consolidated statements using that nation's legislated reporting framework.
- IFRS usually applies only to *publicly accountable* companies—primarily companies with debt or equity securities traded on public markets; private companies usually have a different reporting regime even though large private companies are competing for capital in the private capital markets.
- IFRS seldom is applied to not-for-profit organizations, although large-scale organizations may choose to use IFRS if it best satisfies the needs of that organization's financial statement users.

LO 2

Explain the origin and location of the different sets of accounting standards that apply to different types of organizations

Indeed, Canada is one of the many nations that require IFRS only for certain companies, not for all. In the next section, we will review the current situation in Canada and the post-2011 role of the CICA's Accounting Standards Board.

1.3 ACCOUNTING STANDARDS IN CANADA

Prior to the adoption of IFRS, the *CICA Handbook* contained the accounting standards for all Canadian companies, public and private, as well as for not-for-profit organizations. Those standards of the Canadian Institute of Chartered Accountants (CICA) were generally applicable to all Canadian corporations because the national and provincial corporations acts require auditors to report in accordance with Generally Accepted Accounting Principles (GAAP), and GAAP was defined as compliance with the *CICA Handbook*.

For a long time, the CICA's Accounting Standards Board (AcSB) developed its own standards, although always with an eye on what other countries were doing, particularly the United States. For a while in the late twentieth century, the AcSB's official policy was to harmonize with the US standards. Keeping step with the USA's Financial Accounting Standards Board (FASB) was intended to make life much easier for the tiny proportion of Canadian companies that had to report to the US Securities and Exchange Commission (SEC) because their securities are traded in the USA. Those companies would then not have to reconcile their Canada-based statements with US standards.

Eventually, the AcSB realized that constantly adjusting Canadian standards to meet ever-changing US standards was a rather futile endeavour. Also, a series of huge US corporate accounting scandals (e.g., Enron, WorldCom) caused people around the world to realize that perhaps US standards weren't as "high quality" as had always been proclaimed. Simultaneously, the idea of worldwide acceptance of IFRS for multinational stock exchange listings began to take shape.

Consequently, the AcSB decided that Canada should also adopt IFRS. In a world increasingly characterized by international commerce, separate Canadian standards began to look like an anachronism. The year 2011 was chosen for full conversion to IFRS for Canadian publicly accountable enterprises, partially because several other countries had promised to convert in that same year.

Does that mean Canada is out of the standard-setting business? No. It does mean that Canada has fully adopted IFRS for publicly accountable enterprises; but public companies and other publicly accountable enterprises constitute a very small proportion of

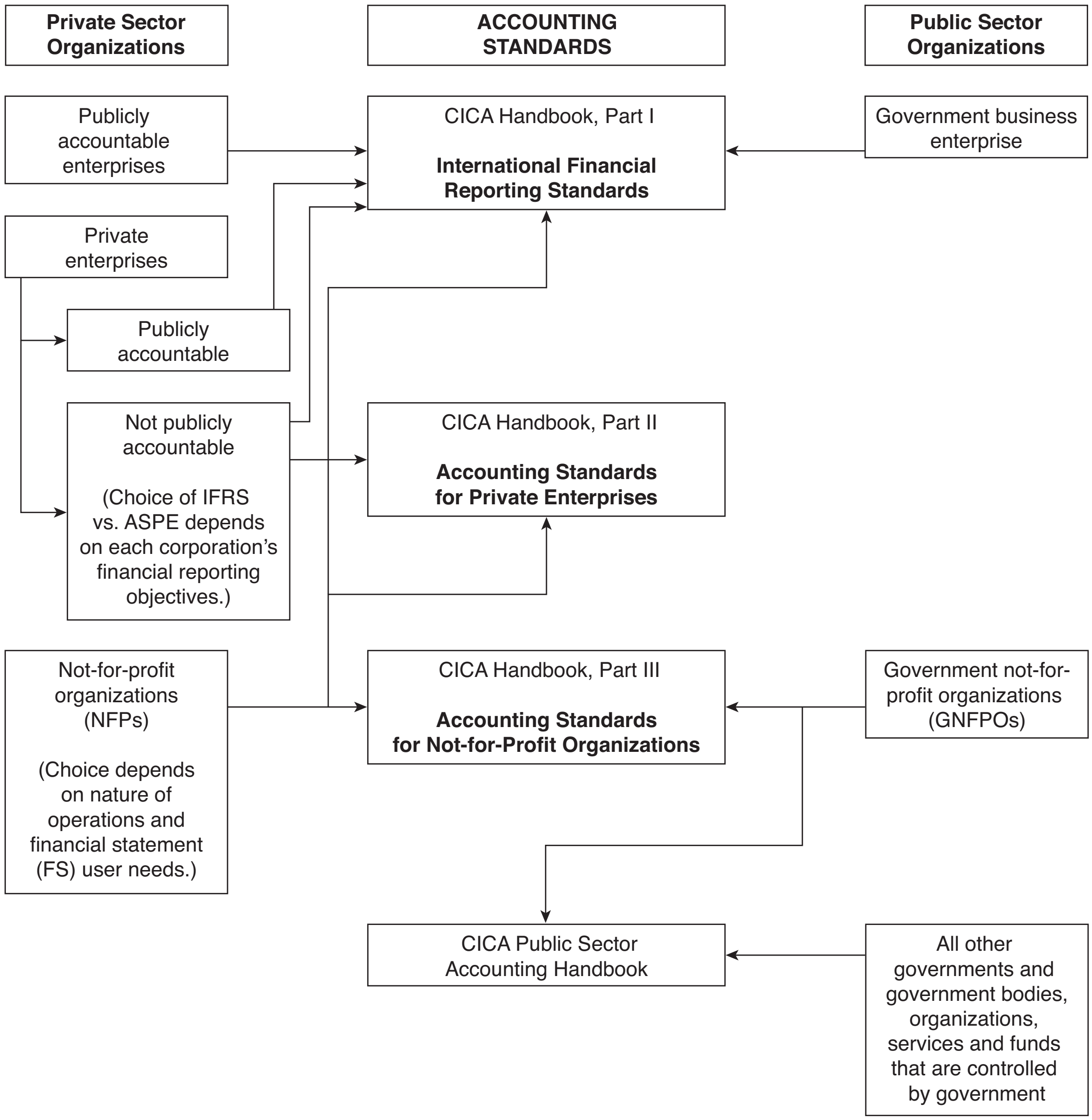

Exhibit 1.1 **Overview of Canadian Accounting Standards**

Canadian corporations. Therefore, the CICA has a four-pronged approach to accounting standards:

1. Public and publicly accountable enterprises (e.g., fiduciary organizations such as investment funds and private banks) will follow IFRS for their consolidated, general-purpose, publicly issued financial statements. The standards for publicly accountable enterprises are included in the CICA *Handbook, Part I*. The standards in Part I are exactly the same, word for word, as the International Accounting Standards Board (IASB) standards. They are included in the CICA *Handbook* only to satisfy certain legal reporting requirements that are contained in the various corporations acts and securities acts of the federal and provincial governments.

2. Canadian accounting standards for private enterprise are contained in the *CICA Handbook, Part II*.
3. NFP accounting standards are contained in the *CICA Handbook, Part III*, as previously was the case, with special sections devoted to the unique reporting requirements and issues of NFPs.
4. The Public Sector Accounting Board (PSAB) will continue to make recommendations for both senior (i.e., national, provincial, and territorial) and municipal governments, which are published by the CICA in the *Public Sector Accounting Handbook*.

The relationships between organizational types and Canadian accounting standards are diagrammed in Exhibit 1.1.

The clearest relationship is for publicly listed corporations and publicly accountable private enterprises. They must report on the basis of IFRS; there is no option.

Private enterprises that are not publicly accountable have a choice. They can use either IFRS or Accounting Standards for Private Enterprises (ASPE). The choice will be based on the company's reporting objectives, which in turn are based on who are the most important users of the company's financial statements.

For example, if the company is competing for capital with publicly listed companies (e.g., through the private equity or debt markets), it makes sense to use the same reporting framework as its competition in the capital markets, that is, IFRS. Similarly, if a private enterprise's management is contemplating becoming a public company (via an initial public offering [IPO]) sometime in the future, the company should use IFRS so that the necessary financial reporting information is readily available.

Alternatively, if the company has little or no need for external capital, or if it is dealing with sophisticated Canadian institutional investors such as Canadian banks and pension funds, the simpler ASPE will usually be the preferred choice.

Not-for-profit organizations (NFP) have the choice of reporting under either (1) IFRS, (2) ASPE, or (3) the not-for-profit accounting standards in the *CICA Handbook, Part III*. As you will see in Chapter 10, there are also accounting choices to be made within the frame-work contained in Part III of the *CICA Handbook*, particularly between two basic reporting approaches: (1) the deferred revenue approach and (2) the restricted fund approach. The choice depends on the nature of the NFP's operations, the source of its funding, and the organization's reporting objectives.

Canadian governmental reporting standards are developed by the Public Sector Accounting Board. Unlike the CICA, the PSAB has no ability to impose its accounting and reporting recommendations on governments or governmental organizations. The PSAB standards are recommendations, rather than rules. Only the governmental legislatures can impose standards. However, the PSAB works closely with provincial Auditors General and ministers of finance in formulating the standards. Governmental reporting is discussed in Chapter 11.

An interesting aspect of government accounting is that different parts of a government may use different standards depending on their function. Some government enterprises function as a business, such as innovation centres or major public utilities, and such organizations should apply IFRS, since they are competing with profit-oriented business enterprises.

On the other hand, some units of the government are functioning as NFP organizations, in which case they may follow not-for-profit standards instead of PSAB standards.

All other components of government, including the general operations for the citizenry, should use the PSAB recommendations.

Over the next 11 chapters, this book will explain and illustrate the four threads of Canadian financial reporting.

1.4 THE ROLE OF REPORTING OBJECTIVES

Each reporting organization chooses its accounting and reporting policies by considering the often-conflicting needs of the statement users on the one hand, and the motivations of the preparers on the other. *Users* include shareholders, bankers, employees, creditors, Canada Revenue Agency, and regulatory agencies. The *preparers* are the managers, both senior managers and the accountants. The auditors are not the preparers—they audit what management has done. Auditors can and should challenge management to defend its accounting choices, and they can make recommendations. Nevertheless, it's the responsibility of managers to set accounting policy.[1]

In most of the topics covered in this book, there really is little or no choice available in accounting policy, except for a private enterprise's choice between IFRS and ASPE. Even then, the choice has little impact on business combinations, consolidations, foreign currency translation, and foreign operations. IFRS and ASPE are largely the same in these major areas.

Although the choice of *accounting policies* is highly constrained, a major area of discretion and judgment is in the many *accounting estimates* that management must make, especially when it involves business combinations, either domestic or foreign. As you will see in the coming chapters, fair values often must be "determined." But how is that determination made?

For example, when one corporation buys another, the initial measurement of the purchase price can have a substantial long-term effect on the consolidated earnings as amortization, depreciation, and successive-years' "fair values" are determined. Accounting policy choice may be limited by accounting standards, but measurement methods often are very imprecise and can be manipulated to suit the preparers' objectives and motivations.

As you learn about business combinations and consolidations in the following chapters, try to keep the role of estimates firmly in mind. Remember that they are always just that—estimates—and estimates are derived from expectations about future events. Think about the impact of different measurements and allocations on the financial statements, and thus on users' perceptions of the consolidated entity's financial health and prospects.

Concept Check 1-2

1. What standard-setting approaches are used in Canada? What are the four "threads" of Canadian financial reporting?
2. When might a private enterprise choose to use IFRS instead of ASPE?
3. Can accounting standards completely eliminate the need for management judgment in accounting measurements? Explain.

[1] A discussion of both users' and preparers' reporting objectives is included in the Companion Website for this book. Refer to it if you feel the need for a review, or if you have not previously been exposed to reporting objectives.

LO 3
Identify the obstacles to international comparability under International Financial Reporting Standards

1.5 INTERNATIONAL STANDARDS—AN ILLUSION OF COMPARABILITY

The driving force behind adopting international standards has been the *international financial markets*—to enable companies to list their securities on multiple exchanges around the world. The underlying logic is that if every country adopts international accounting standards, it will be easy to compare the financial results of companies based in different countries.

That logic is attractive. If we all use the same reporting standards, the barriers of diverse national standards will fall. And that logic is correct to a certain extent—and comparability is certainly much better with IFRS. However, interpretation of financial statements under international standards will still be difficult. To some extent, comparability is an illusion. A financial statement user must be aware of many factors in a corporation's host country that will affect the company's financial reporting. In the following sections, we will briefly discuss the following four limiting factors:

1. Some jurisdictions may accept IFRS, but not *all* of IFRS. Although IFRS is used in about 100 countries around the world, they are not applied to the same extent in every country.
2. The quality of the accounting infrastructure varies among nations. The quality of the accounting infrastructure is defined by the quality of the accounting and auditing profession in that country, as well as by the effectiveness of the country's financial reporting enforcement mechanisms.
3. National factors can have a significant effect on proper interpretation of financial statements. Even when the full IFRS are formally adopted by a nation, some standards will inevitably be applied differently in different nations due to local circumstances.
4. IFRS usually apply only to public corporations—those that come under the jurisdiction of national securities regulators. Public companies compete with large private companies for financing in the private debt and equity markets, but the two types of companies most likely will be using different reporting standards.

When each nation used home-grown financial standards, users were automatically forewarned that the statements were not directly comparable. Statements from other countries looked different, used different terminology, and were arranged differently. And some statements were "missing"—for example, a cash flow statement was not generally required outside of Anglo-Saxon countries such as the United States, United Kingdom, Canada, and Australia. The new hazard is that, with international standards, users will be misled into thinking that inter-nation comparison is simple.

Although we will discuss all four limiting factors, we will place primary emphasis on the fourth factor because the vast majority of corporations in Canada are private, not public.

Uneven Adoption of IFRS

There are two basic ways in which national accounting standards are established:

1. By law or government regulation. Examples include most European countries, the EU, and China. These are known as *code-law* countries.

2. By the country's accounting profession or an independent non-government authority established within that country. Examples include the USA, UK, Canada, and Japan. These are known as *common-law* countries.

   Under either approach, a nation may not adopt IFRS completely.

- In code-law countries, a change to international standards requires legislation. When the IASB changes or amends international standards, a code-law country must pass new legislation before the change can become effective. New legislation may be slow in coming or may not be proposed at all for some individual aspects of IFRS.
- In common-law countries, legislation is not required, but the local standard-setter may balk at one or more aspects of an international standard and refuse to put that standard into effect.

When acceptance of IFRS is incomplete, we really don't have truly international standards. Instead we have something a little different. For example, in the European Union, companies are required to report their consolidated financial statements on the basis of IFRS, but only after each new or revised standard is accepted by the EU Parliament. Not all provisions of every IFRS are accepted. Thus, a company following IFRS as accepted in the EU will be using accounting standards that are not the same as those being used in common-law countries such as Canada or Australia. Reality check 1-1 gives an example of a company that uses IFRS as adopted by the EU.

Institutional Quality

To apply international standards effectively, a nation must have:

- professional and experienced preparers;
- quality auditing; and
- an effective enforcement mechanism.

Reality Check 1–1

Example of a Company Using EU IFRS

The 2011 annual report of the large mining group Rio Tinto discloses that the consolidated statements are prepared "in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union ("EU IFRS")."

Note 1 of the Rio Tinto financial statements lists the standards in which the EU IFRS differs in some respects from IASB IFRS:

- IAS 1 (amendment), "Presentation of financial statements"
- IAS 27 (revised), "Consolidated and separate financial statements"
- IAS 38 (amendment), "Intangible assets"
- IFRS 3 (amendment), "Business combinations"
- IFRS 5 (amendment), "Non-current assets held for sale and discontinued operations"
- Eligible Hedged Items (an amendment to IAS 39 Financial Instruments: Recognition and Measurement)
- IFRIC 17 Non cash distributions to owners
- IFRS 2 amendment, "Share-based payment"—Group cash-settled share-based payment transactions
- Improvements to IFRS 2009