HILTON HERAUF

MODERN ADVANCED ACCOUNTING IN CANADA

EDITION

7

MODERN ADVANCED ACCOUNTING IN CANADA

EDITION

7

Murray W. Hilton, FCA

University of Manitoba

Darrell Herauf, CPA, CA, CGA

Carleton University

McGraw-Hill Ryerson

Connect. Learn. Succeed.

The McGraw-Hill Companies

McGraw-Hill Ryerson

Connect. Learn. Succeed.

Modern Advanced Accounting in Canada
Seventh Edition

ISBN-13: 978-0-07-105152-1
ISBN-10: 0-07-105152-X

1 2 3 4 5 6 7 8 9 0 TCP 1 9 8 7 6 5 4 3

Printed and bound in Canada

Director of Product Management: *Rhondda McNabb*
Product Manager: *Keara Emmett*
Executive Marketing Manager: *Joy Armitage Taylor*
Product Developer: *Amy Rydzanicz*
Supervising Editor: *Cathy Biribauer*
Senior Product Team Associate: *Christine Lomas*
Photo/Permissions Researcher: *Robyn Craig*
Copy Editor: *Julie van Tol*
Proofreaders: *Rohini Herbert, Rodney Rawlings*
Production Coordinator: *Scott Morrison*
Cover and Inside Design: *Liz Harasymczuk*
Composition: *Laserwords Private Limited*
Cover Photo: © *Howard Sandler/Dreamstime.com*
Printer: *Transcontinental Printing Group*

Library and Archives Canada Cataloguing in Publication Data

Hilton, Murray W.
Modern advanced accounting in Canada / Murray W. Hilton, Darrell Herauf.—7th ed.

Includes index.
ISBN 978-0-07-105152-1

1. Accounting—Canada—Textbooks. I. Herauf, Darrell II. Title.
HF5635.H486 2013 657'.046 C2012-906472-6

About the Authors

Murray W. Hilton, FCA

Murray Hilton holds the rank of Senior Scholar at the University of Manitoba where he has continued to teach in the MBA programs since his retirement in 2002. For 35 years he was Professor of Accounting at the university's Asper School of Business, teaching graduate and undergraduate courses in financial accounting. A Chartered Accountant with business degrees from the University of Saskatchewan and Oregon State University, he has published five advanced accounting books. In addition, he has been active in university and faculty administration, having previously served as Head of the Department of Accounting and Finance and as Director of the Master of Accountancy Program. He is currently the Director of the Centre for Accounting Research and Education. Murray has also been very involved in the accounting profession, teaching CA and CMA courses for many years, and serving on numerous national and provincial committees of both accounting bodies. He has on two separate occasions been a member of the National Examination Board of the Society of Management Accountants of Canada. In 1991, he received the FCA designation from the Institute of Chartered Accountants of Manitoba, and in 1994 he was made an honorary member of the Society of Management Accountants of Manitoba. For relaxation, he enjoys reading, golfing, and fishing.

Darrell Herauf, CPA, CA, CGA

Darrell Herauf teaches graduate and undergraduate courses in financial and managerial accounting at the Eric Sprott School of Business, Carleton University. A Chartered Accountant and a Certified General Accountant with a business degree from the University of Saskatchewan, this co-author of *Modern Advanced Accounting in Canada* is also the author of testbanks for several financial accounting textbooks. He is the recipient of numerous teaching awards, and participates on many committees at the university. Darrell has been involved in professional accounting education at the Institute of Chartered Accountants of Ontario for over 25 years in a variety of roles, including teaching, developing case/program material, and serving as a member of the Examinations subcommittee. For more than 25 years, he has been involved with the Certified General Accountants Association of Canada as national examiner, course author, and consultant. For relaxation, he enjoys cycling and skating.

Contents in Brief

Contents

CHAPTER 5 Consolidation Subsequent to Acquisition Date 202

CHAPTER 6 Intercompany Inventory and Land Profits 287

Preface

Welcome to the seventh edition of *Modern Advanced Accounting in Canada.* This book's well-deserved reputation for being the most current, concise, and technically accurate advanced accounting text on the market has not only been maintained but has been improved upon in this new edition. This edition is 100 percent compliant with International Financial Reporting Standards (IFRSs), not only with regard to the typical advanced accounting topics of business combinations and foreign currency transactions, but also for the topics studied in intermediate accounting and other courses. It also contains the reporting requirements for private enterprises and not-for-profit organizations. All of the extracts from financial statements are now taken from Canadian entities.

The book reflects standards that are expected to be in effect as of January 1, 2014, based on standards approved by the IASB or based on exposure drafts that were outstanding as of December 31, 2012. We have made every effort to illustrate and explain the requirements of the current standards at the time of publication, anticipating how these might change, what the effects of the changes will be, and what they will mean to the industry, professionals, and students.

We have also continued the presentation of advanced accounting topics that has been so well received by such a large number of instructors and students. Emphasis on the direct approach of preparing consolidated financial statements along with the "building block" development of the basics of consolidations has been maintained and strengthened. The working-paper approach is illustrated in Chapters 3 through 5, either in the body of the chapter or in the appendices.

Finally, as requested by instructors on behalf of their students, the following enhancements to problem material have been made in this edition:

- At least one new case has been added to each chapter to encourage critical thinking and classroom discussion. There are now five to seven cases in each chapter.
- All of the web-based problems have been changed to Canadian companies. These problems involve the analysis and interpretation of the recently published financial statements of public companies and not-for-profit organizations.
- One new self-study problem has been added to ten chapters, such that each chapter now has two self-study problems.
- The questions and/or solutions have been revised for approximately 55 percent of the end-of-chapter cases and problems.
- Finally, even more problems and questions can be found online for additional study on Connect.

New Features

- The financial statement disclosure examples in the body of each chapter have been changed to Canadian companies and to more recent years. The IFRS disclosure requirements are summarized, each followed by a real-life example from a public company or a not-for-profit organization.
- A new section on Analysis and Interpretation of Financial Statements has been added for each chapter. These sections compare the impact of different reporting methods on key financial ratios and illustrate and explain the interrelationship of financial statements.
- The following new IFRSs have been explained and applied in the appropriate chapters of the text: IFRS 10: Consolidated Financial Statements, IFRS 11: Joint Arrangements, IFRS 12: Disclosure for Interests in Other Entities, and IFRS 13: Fair Value Measurement.
- The titles and format of financial statements as traditionally used by Canadian companies are used in the illustrations throughout the body of the text, on the assumption that many Canadian companies will continue to use the same titles and format as used in the past. In the self-study problems and end-of-chapter material, both the format suggested by the IASB and the traditional format of Canadian companies are used.
- Major reorganization has occurred in Chapters 3, 4, 11, and 12. Substantial revisions have been made in eight chapters.

The following sections are provided at the end of all relevant chapters:

- *ASPE Differences.* This section highlights the differences in GAAP between accounting standards for private enterprises (ASPE) and IFRSs. There are sufficient illustrations throughout the text for the user of the text to know and apply both sets of GAAP.
- *U.S. GAAP Differences.* This section highlights the differences in GAAP between IFRSs and U.S. GAAP. Since the IASB and the FASB are working to merge their standards over the next few years, it is important to know where the differences lie so that we can anticipate where changes in IFRSs are likely to be made.
- Each chapter's *Summary* includes the following:
    - *Significant Changes in GAAP in the Last Three Years.* This section summarizes the major changes in GAAP since the publication of the sixth edition of the text.
    - *Changes Expected in GAAP in the Next Three Years.* This section summarizes the changes expected in IFRSs in the next few years, based on the projects currently on the IASB's work plan.

Organization

Chapter 1 begins with an overview of the conceptual framework for financial reporting. Most of this material was previously contained in the prologue. The remainder of the chapter presents a survey of international accounting practices. It includes a listing of major countries requiring or permitting the use of IFRSs for listed companies. Some of the major differences between IFRSs and U.S. GAAP are identified, and the convergence project between the FASB and the IASB to harmonize their accounting standards is described. Some of the major differences between IFRSs and ASPE are identified. A new self-study problem on U.S. GAAP differences has been added.

Chapter 2 commences with an overview of the CICA pronouncements that make up the "big picture." Readers are encouraged to revisit this big picture many times as consolidation topics are developed in later chapters so that they do not lose sight of the forest as they examine the myriad of details that make up the trees. The chapter continues with a comprehensive example to illustrate the fair value, cost, and equity methods of reporting investments in equity securities, and it concludes with two self-study problems that compare these different reporting methods. Coverage of the comprehensive example could be postponed until after Chapter 4 without breaking continuity or could be omitted altogether if it is felt that adequate coverage has occurred in previous intermediate accounting courses. The new standards on Fair Value Measurement (IFRS 13) and Financial Instruments: Classification and Measurement (IFRS 9) are briefly described.

Chapter 3 describes two forms of business combinations and three methods that have been proposed or used to account for business combinations. The direct and working-paper methods are used to illustrate the acquisition method of accounting for a business combination. The new definition of control is discussed and used as the criterion for preparation of consolidated financial statements. A new section on reporting depreciable assets is added. Reverse takeovers are covered in an appendix.

Chapter 4 examines the preparation of consolidated financial statements for non–wholly owned subsidiaries at the date of acquisition. The direct method is used in the body of the chapter and the working-paper method is used in the appendix. Four theories of consolidation are discussed and illustrated. All four theories are currently or have recently been required under Canadian GAAP. Accounting for contingent consideration and bargain purchases are also illustrated.

Chapter 5 covers the preparation of consolidated financial statements subsequent to the date of acquisition when the parent uses the cost method in its internal records. The amortization and impairment of the acquisition differential is explained and illustrated, including an application of the effective interest method. A new appendix on goodwill impairment is added. The parent's journal entries under the equity method are summarized. Ten basic steps in the preparation of consolidated statements are introduced and form the foundation for the consolidation topics in the chapters that follow. The direct approach is used in the body of the chapter. Appendix B illustrates the working-paper approach for the same examples used throughout the chapter.

Chapter 6 discusses and illustrates the accounting for intercompany revenues and expenses, as well as intercompany unrealized profits or losses in inventory and land. The revenue recognition, matching, and historical cost principles are used to explain the rationale for consolidation adjustments associated with the holdback and realization of intercompany profits. The consolidation adjustments when the entities use the revaluation model for reporting land are described in the appendix.

Chapter 7 discusses the elimination of intercompany profits in depreciable assets, the recognition of gains or losses resulting from the elimination of intercompany bondholdings, and the related income tax adjustments that are required. Two self-study problems are presented using the direct approach and involving the effective interest method for bond amortization. The consolidation adjustments when the entities use the revaluation model for reporting depreciable assets are described in the appendix.

Chapter 8 discusses the preparation of the consolidated cash flow statement and such ownership issues as subsidiaries with preferred shares, step purchases, reduction of parent's interest, and indirect holdings. In all situations, the direct approach is used. The chapter concludes with two self-study problems involving changes in ownership and preferred shares.

Chapter 9 examines other consolidation reporting issues, including special-purpose entities, deferred income taxes and business combinations, and segment disclosures. The accounting for joint arrangements is illustrated both under the equity method in the body of the chapter and under proportionate consolidation in the appendix. A new self-study problem on deferred income taxes pertaining to business combinations has been added.

Chapter 10 introduces the topic of foreign currency and four different perspectives in which currencies can be viewed. Foreign currency transactions are discussed, as are the concepts of hedging and hedge accounting. The handling of foreign currency gains and losses is illustrated, as are the accounting for fair value and cash flow hedges. The appendix describes how discounting can be applied when determining the fair value of a forward contract.

Chapter 11 concludes the foreign currency portion of the text by examining and illustrating the translation and subsequent consolidation of subsidiaries whose functional currency is the same as the parent's (i.e., integrated subsidiary) and whose functional currency is not the same as the parent's (self-sustaining subsidiary). The reporting of exchange gains and losses from the translation of self-sustaining subsidiaries in other comprehensive income is also illustrated. A new self-study problem has been added to illustrate the preparation of consolidated financial statements after translating the foreign operations under both the temporal and current-rate methods.

Chapter 12 discusses in depth the 13 not-for-profit sections in the *CICA Handbook*. The chapter concludes with a comprehensive illustration of the required journal entries and the preparation of financial statements using both the deferral method and the restricted fund method. Appendix 12A provides a real-life example of the deferral method by reproducing the financial statements of the United Way/Centraide Ottawa. Appendix 12B provides a comprehensive outline of the PSAB reporting requirements for federal, provincial, and local governments.

Connect

McGraw-Hill Connect™ is a web-based assignment and assessment platform that gives students the means to better connect with their coursework, with their instructors, and with the important concepts that they will need to know for success now and in the future.

With Connect, instructors can deliver assignments, quizzes, and tests online. Nearly all the problems from the text are presented in an auto-gradeable format and tied to the text's learning objectives. Instructors can edit existing questions and author entirely new problems; track individual student performance—by question, assignment, or in relation to the class overall—with detailed grade reports; and integrate grade reports easily with Learning Management Systems (LMS) such as WebCT and Blackboard.

By choosing Connect, instructors are providing their students with a powerful tool for improving academic performance and truly mastering course material. Connect allows students to practise important skills at their own pace and on their own schedule. Importantly, students' assessment results and instructors' feedback are all saved online, so students can continually review their progress and plot their course to success.

Connect also provides 24/7 online access to an eBook—an online edition of the text—to aid them in successfully completing their work, wherever and whenever they choose.

Key Features

Simple Assignment Management

With Connect, creating assignments is easier than ever, so you can spend more time teaching and less time managing.

- Create and deliver assignments easily with selectable end-of-chapter questions and testbank material to assign online.
- Streamline lesson planning, student progress reporting, and assignment grading to make classroom management more efficient than ever.
- Go paperless with the eBook and online submission and grading of student assignments.

Smart Grading

When it comes to studying, time is precious. Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it.

- Automatically score assignments, giving students immediate feedback on their work and side-by-side comparisons with correct answers.
- Access and review each response; manually change grades or leave comments for students to review.
- Reinforce classroom concepts with practice tests and instant quizzes.

Instructor Library

The Connect Instructor Library is your course creation hub. It provides all the critical resources you'll need to build your course, just how you want to teach it.

- Assign eBook readings and draw from a rich collection of textbook-specific assignments.
- Access instructor resources, including ready-made PowerPoint presentations and media to use in your lectures.
- View assignments and resources created for past sections.
- Post your own resources for students to use.

<u>eBook</u>

Connect reinvents the textbook learning experience for the modern student. Every Connect subject area is seamlessly integrated with Connect eBooks, which are designed to keep students focused on the concepts key to their success.

- Provide students with a Connect eBook, allowing for anytime, anywhere access to the textbook.
- Merge media, animation, and assessments with the text's narrative to engage students and improve learning and retention.
- Pinpoint and connect key concepts in a snap using the powerful eBook search engine.
- Manage notes, highlights, and bookmarks in one place for simple, comprehensive review.

Instructor Resources

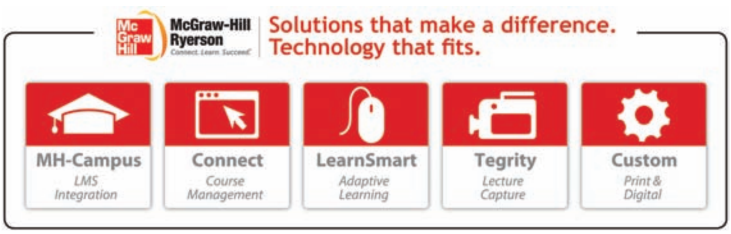
The following instructor resources are available online on Connect:

- **Solutions Manual:** This manual, prepared by the author, contains complete solutions to all the text's end-of-chapter review questions, cases, problems, and web-based problems.
- **Computerized Test Bank:** This test bank contains over 1,000 multiple-choice, true/false, and problem questions. Each test item is coded for level of difficulty and learning objective.
- **Microsoft® PowerPoint® Presentations:** These slides cover key concepts found in each chapter using outlines, summaries, and visuals.

<u>Superior Learning Solutions and Support</u>

The McGraw-Hill Ryerson team is ready to help you assess and integrate any of our products, technology, and services into your course for optimal teaching and learning performance. Whether it's helping your students improve their grades, or putting your entire course online, the McGraw-Hill Ryerson team is here to help you do it. Contact your Learning Solutions Consultant today to learn how to maximize all of McGraw-Hill Ryerson's resources!

For more information on the latest technology and Learning Solutions offered by McGraw-Hill Ryerson and its partners, please visit us online: **www.mcgrawhill.ca/he/solutions**.



Acknowledgements

This text includes the thoughts and contributions of many individuals, and we wish to express our sincere appreciation to them. First and foremost, we thank all the students in our advanced accounting classes, from whom we have learned so much. In many respects, this text is an outcome of the learning experiences we have shared with our students. Second, we wish to thank the technical checkers, Shari Mann, Ingrid McLeod-Dick, and Stephen Spector. The accuracy of the text is due in large part to their efforts. We also wish to thank the following colleagues for their invaluable advice:

Talal Al-Hayale, *University of Windsor*
Kiran Bisnauth, *Seneca College*
Chuck Campbell, *University of British Columbia*
Bill Dawson, *University of Western Ontario*
Pauline Downer, *Memorial University of Newfoundland*
Elizabeth Hicks, *Mount Saint Vincent University*
Stuart Jones, *University of Calgary*
Stephen Jussey, *Algoma University*
Michael Khan, *University of Toronto*
Deirdre Taylor, *Ryerson University*

Thanks also to the Canadian Institute of Chartered Accountants for granting permission to reproduce material from the *CICA Handbook* as well as questions from the Uniform Final Examinations (UFEs), and to the Certified General Accountants of Canada and the Certified Management Accountants for their permission to reproduce questions adapted from past examinations. Thank you to Peter Secord of St. Mary's University for all of his case contributions.

We are very grateful to the staff at McGraw-Hill Ryerson: Director of Product Management Rhondda McNabb, Product Manager Keara Emmett, Product Developers Amy Rydzanicz and Chris Cullen, and Supervising Editors Cathy Biribauer and Kara Stahl, who applied pressure in a gentle but persistent manner when we strayed from the project's schedule. Thanks also to Copy Editor Julie van Tol and Proofreaders Rohini Herbert and Rodney Rawlings, whose technical expertise was necessary to carry the project to its end.

And finally, we are grateful to our families for all of their support and encouragement.

Murray Hilton
Asper School of Business
University of Manitoba

Darrell Herauf
Sprott School of Business
Carleton University

1

CHAPTER

A Survey of International Accounting

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

LO1 Describe the conceptual framework for financial reporting.

LO2 Identify factors that can influence a country's accounting standards.

LO3 Identify the role that the IASB intends to play in the establishment of uniform worldwide accounting standards.

LO4 Identify the direction that the FASB intends to follow for public companies.

LO5 Describe how accounting standards in Canada are tailored to different types of organizations.

LO6 Analyze and interpret financial statements to assess the impact of different accounting methods on key financial statement ratios.

LO7 Identify some of the differences between IFRS and ASPE.

INTRODUCTION

Welcome to advanced accounting. We wish you a prosperous learning experience. We will study three major accounting topics: consolidations, foreign currency transactions and operations, and not-for-profit and government organizations. The topics are presented and illustrated in accordance with the generally accepted accounting principles (GAAP) that are expected to be in effect in Canada as of January 1, 2014. You may have had some exposure to these topics in your previous accounting courses. We will build on this prior knowledge and the conceptual framework studied in intermediate accounting while we develop a thorough understanding of these selected topics.

Prior to the 1990s, the study of accounting principles in Canada focused on the *CICA Handbook - Accounting* (hereafter referred to as *CICA Handbook* or *Handbook*) and involved very little, if any, thought or discussion of accounting standards in other parts of the world. But since then, rapid changes have taken place throughout the world, and even more drastic changes are coming. Canadian companies now view the entire world as their marketplace; not only are they exporting their products to more countries than ever before, but they are also establishing factories and offices in foreign locations. Companies that used to raise capital strictly in their home countries are now finding that capital markets are available to them

Canadian companies are now able to raise capital resources on the world's marketplace.

around the world. Because their shares trade on stock exchanges, they are often required to prepare financial reports using accounting principles of countries other than Canada. Many accounting firms have offices throughout the world, and there are abundant opportunities for their Canadian staff members to transfer to these offices. With all these changes taking place, an accounting education that takes a narrow, parochial view is clearly inadequate. Canadian students of accounting need to be fully aware of what is happening in the rapid movement toward worldwide accounting standards, and it is imperative that the textbooks of today address this topic.

Before embarking on the study of the major topics in this book, we will review the role of accountants and the objectives of reporting. Then, we will survey the accounting principles and practices used in a sample of other countries. It is hoped that this exposure to other countries' standards will help us understand the future direction of standards in our own country.

L01 The Conceptual Framework for Financial Reporting

Professional accountants provide a variety of services ranging from accounting to tax planning to assurance to business consulting. In this course, we will focus on financial accounting; that is, providing general-purpose financial information to external users such as investors and creditors. These users usually have limited financial resources to invest in an entity. They wish to invest where they can earn the highest return with the lowest amount of risk. The general-purpose set of financial statements (balance sheet, income statement, cash flow statement, and notes to the financial statements) will be used by the external users to help them make their resource allocation decisions and to assess the stewardship of management. The general-purpose reports are not the only source of information used for decision making but provide a good starting point.

In most cases, users want to receive the general-purpose financial statements prepared in accordance with generally accepted accounting principles (GAAP) because by following these principles, the information is relevant, reliable, understandable, and comparable. However, there are times when users may want or require special-purpose financial reports that do not follow GAAP. For example, entities may need to prepare non–GAAP-based statements for legislative or regulatory purposes, or for contract compliance. Or, a prospective lender may want to receive a balance sheet with assets reported at fair value rather than historical cost. As accountants, we are able to provide financial information in a variety of formats or using a variety of accounting policies because we have the skills and abilities to produce this information. If we do provide fair-value-based financial statements, we cannot say that the statements were prepared in accordance with GAAP. We would simply state that the statements were prepared in accordance with the policies described in the notes to the financial statements.

GAAP encompass broad principles and conventions of general application, as well as rules and procedures that determine accepted accounting practices at a particular time. The process of developing GAAP is political. Both preparers and users of financial statements have an opportunity to comment on a proposal for a new accounting standard before it becomes generally accepted. If a new requirement is preferred by the preparers but not accepted by users, it is unlikely to become part of GAAP. Therefore, as we study existing accounting practices and proposed changes, we need to continually evaluate whether information provided by a reporting entity will satisfy users' needs.

In most cases, the users of the financial statements have access to information about the entity in addition to that provided in the financial statements. For example, the owner of a private company may also be the manager and would have intimate knowledge of the company. In such cases, the owner/manager may place less reliance on the financial statements than outside investors in public companies do. In other situations, the owner may not understand the financial reporting for complex transactions such as business combinations. In both of these situations, the owners may feel that the costs of complying with some of the complex sections of the *Handbook* are not worth the benefit. They may prefer to issue more simplified statements. The Canadian Institute of Chartered Accountants (CICA) recognized this difference in users' needs. In 2002, differential reporting was incorporated in the *Handbook* whereby qualifying enterprises could choose to apply differential reporting options and still be in compliance with GAAP. In 2011, these differential options were eliminated and replaced with a *Handbook* that is now segregated into different parts for different types of organizations.

Financial statements should cater to the needs of the users.

The *Handbook* is divided into different parts to cater to different types of reporting entities.

The *CICA Handbook* is an authoritative document in Canada because many legal statutes require its use. For example, companies incorporated under the Canada Business Corporations Act and certain provincial Companies Acts are required to prepare financial statements in accordance with the *CICA Handbook.* Publicly traded companies are required to submit financial statements that comply with GAAP to the securities commissions under which they are registered.

The *CICA Handbook* provides the accounting and reporting requirements as well as explanations and guidance for most transactions and events encountered by an entity. When an entity following International Financial Reporting Standards (IFRSs) encounters transactions or events that are not explicitly addressed by the standards, the entity should adopt accounting practices that are consistent with the spirit of the IFRSs and consistent with the financial statement concepts. These concepts are described in the "The Conceptual Framework for Financial Reporting," which is a document found just prior to the IFRSs in Part I of the *Handbook.* Entities that are reporting under Accounting Standards for Private Enterprises (ASPE) should adopt accounting practices that are consistent with Section 1000: Financial Statement Concepts, in Part II of the *Handbook.*

The financial statement concepts describe the principles and assumptions underlying the preparation of financial statements. They are very important parts of GAAP because they provide the framework for the development and issuance of other financial accounting standards. The main items included in this document are as follows:

- The objective of general-purpose financial reporting
- Qualitative characteristics of useful financial information
- Underlying assumptions
- Definition, recognition, and measurement of the elements of financial statements

You will probably recognize most of the concepts and remember studying them in your intermediate accounting courses. If you can explain the accounting practices learned there in terms of these basic concepts, you should have no trouble applying these concepts in the new situations we will encounter in this course. If you do not understand or cannot explain accounting requirements in terms of these basic concepts, it is never too late to start. As you study the accounting

All accounting practices should be able to be traced back to and supported by the conceptual framework.

requirements in this course, try to understand them in terms of the basic concepts and principles that the *Handbook* describes.

By gaining a broad understanding of the logic and basic principles behind the accounting requirements, you will develop confidence and be able to apply these basic principles in a wide variety of situations. Rather than simply accepting accounting practices or memorizing specific requirements in the *Handbook*, you will begin to understand the logic of the requirements and evaluate whether these are consistent with the basic financial statement concepts. You will soon realize that most of the requirements in accounting can be understood, developed, and derived from these basic principles and concepts. Then, in turn, you will be able to use professional judgment to apply these basis principles to whatever situation you may encounter.

Professional Judgment

Lots of judgment is involved when preparing financial statements.

Judgment is the ability to make a decision in situations where the answer is not clear-cut. Professional judgment is the ability to make decisions for issues encountered by professionals in carrying out their day-to-day responsibilities. Judgment is a skill developed over many years of study and learning from one's experiences. Professional judgment is derived from knowledge and experience in the profession. It is not something that is learned from rote or memorization of requirements or answers to certain problems. It often involves making choices between meaningful alternatives and the ability to understand the consequences of one's actions.

In the preparation of financial statements, there are three main areas where judgment needs to be applied. First, accounting policies such as when to recognize revenue and whether or not to consolidate a special-purpose entity involve making a decision after considering various methods. The method adopted for a particular company must be appropriate for that company based on its existing situation. For example, if Company A is selling to customers with poor credit history and without obtaining any security for the receivables from these customers, it would be appropriate to recognize revenue when cash is received. If competitors were selling to customers with very high credit ratings, it would be appropriate for them to recognize revenue when the goods are delivered. The professional judgment of an accountant will take these factors into consideration and recognize that although one method is appropriate for the competitors, another may be more appropriate for Company A.

Judgment is involved when adopting accounting policies, making estimates and writing the notes to the financial statements.

Second, judgment is involved in making accounting estimates of many kinds. What is the estimated useful life of property, plant, and equipment? What is the recoverable amount for goodwill? Will a forward contract be effective as a hedge of expected sales for the next three years? The answers to these questions are not clearly defined. In the classroom, we are usually provided with this information, but in the real world, we must gather data and make our own assessment. Whether we feel that the company can continue as a going concern or not would likely have a material difference on the valuation of goodwill and the bottom line on the income statement.

Third judgment is involved in deciding what to disclose and how to disclose it in the notes to the financial statements. For example, in disclosing a contingent liability resulting from a lawsuit, the company could simply say that it has been sued but no provision is made in the financial statements because it feels that the lawsuit has no merit. Or, it could provide details of the lawsuit and give some probabilities of different outcomes in the note.

Is there too much latitude in accounting? Do the financial statements ever portray the complete facts? One could argue that there is no latitude because accountants are not free to randomly select any reporting method. They must represent faithfully what really happened and what really exists using the generally accepted conceptual framework. If the revenue has been earned, then the revenue should be recognized. If the expenditure will provide a future benefit, then the cost of the expenditure should be recognized as an asset. Latitude is necessary so that the accountant can choose the methods to reflect the real situation. If the requirements are written too rigidly, companies may be forced to use methods that do not reflect their own situations.

If accountants take their jobs seriously and have high ethical standards, they will present the financial statements as reliably as possible by using appropriate accounting policies, by making the best estimates possible, and by making honest and forthright statements in the notes to the financial statements. They will use judgment to fairly present the financial position and financial performance of the entity. Otherwise, the individual accountants and the entire accounting profession will lose credibility.

Financial statements should present what really happened during the period: that is, they should tell it how it is.

In this course, we will have an opportunity to develop our judgment skills and to exercise judgment through the use of cases. The cases provide realistic scenarios where conflicts exist and choices must be made. The answers are not usually clear-cut. In fact, different valid answers can be defended. For these cases, it is how you support your recommendation that is important, as opposed to what your final recommendation is. You will need to apply basic principles and use judgment to come up with an answer that "tells it how it is" as accurately as possible. In so doing, you will be developing the skills required of a professional accountant.

A Survey of International Accounting

GAAP have varied in the past from country to country around the world. If a detailed study had been made of the accounting practices used by every country in the world, it would probably have concluded that very few countries used exactly the same standards for external financial reporting purposes. Some comparisons would have yielded minor differences; others would have shown substantial ones. Differences existed in terminology and style of presentation, as well as in methods of measurement and disclosure.

In past years, the variety of accounting principles being used throughout the world was large.

Differences in measurement ranged from departures to the historical cost principle to varying standards within the historical cost model. A variety of methods existed worldwide for measuring and reporting inventories, research and development costs, fixed assets, leases, computer software, and deferred income taxes. Income-smoothing devices varied from country to country. In Canada and the United States, GAAP allowed little opportunity to smooth income, while in other countries income-smoothing devices were allowed under GAAP or were encouraged by government regulation. This was often accomplished by setting up reserves, which are special equity accounts, and using them to transfer amounts to and from the statement of comprehensive income as needed. Inadequate disclosures often masked the real effect on yearly income measurements.

Asset revaluations have long been acceptable in many countries. Circumstances for these revaluations range from price-level-adjusted historical costs, used to counteract distortions resulting from very high inflation rates, to the regular or periodic adjustment of asset measurements to current replacement costs. Even under historical costs, great variations have existed in yearly measurements. The accounting for the asset of goodwill, which arises as a result of one company

Asset revaluations have been a common practice in many countries.

buying another business, is a prime example. Practices included the immediate write-off of purchased goodwill to equity, capitalization with amortization over greatly varying periods, capitalization without amortization (thus, leaving it on the balance sheet forever), and capitalization and write-off to income only when there was evidence of impairment.

Not only were there differences in measurement, but there were often also differences in the presentation and description of elements in financial statements. For example, in many countries, long-term assets were, and continue to be, presented before current assets on the balance sheet, and shareholders' equity appears before liabilities.

Information disclosed is often more voluminous in other countries than that required in Canada.

Examples of areas where disclosure differences still exist are segment reporting, reporting financial forecasts, shareholder and environmental disclosures, and other value-added information. While many foreign multinational companies disclose the lines of business they are in and the geographical area in which they operate, there is still inconsistency in the level of detail provided. While the provision of financial forecasts is not common in North America, some companies in Europe do provide this information. Foreign companies often provide voluminous disclosures about their shares, shareholders' rights, and changes in shareholders' equity. Finally, while this is not required by accounting standards, multinational companies are increasingly providing information about environmental safety and protection issues and the ways in which they have added value to society by their distributions to owners, creditors, employees, and governments.

Differences in accounting standards have always existed, but they have been receiving greater attention in recent years because of the many changes taking place in the world economy. For example, the dismantling of the former Soviet empire has been accompanied by a shift from controlled to market-driven economies, and most of the countries in Europe have joined together to form the European Union (EU). The North American Free Trade Agreement allows the free flow of goods and services among Canada, the United States, and Mexico, and this agreement may soon be expanded to include some countries in South America.

Technology has improved the global flow of information.

In the midst of all this, there have been major advances in computer and communication technology that are dramatically improving the global flow of information and changing how business activities are conducted. As a result, foreign currencies now trade 24 hours a day in the world's financial centres. Accompanying this shift toward a global marketplace has been substantial growth in the size and number of multinational corporations. This growth has been achieved to a great extent by takeovers and mergers, often financed through the capital markets of *many* countries. Not only has there been a shift to a global marketplace for goods and services, but there has also been a shift toward a global capital market. Many of the world's stock exchanges now list foreign companies. There is also considerable activity involving mergers of stock exchanges from different parts of the world.

With such a global capital market comes the need to provide the suppliers of capital with useful accounting information. Fragmented accounting principles seriously compromise comparability, which is one of the key concepts associated with information usefulness. To counter this, securities regulators in foreign countries often require foreign companies listed on their stock exchanges either to prepare financial statements in accordance with their domestic accounting standards or to prepare reconciliations from foreign to domestic standards. For example, foreign companies listed on U.S. stock exchanges are required by the Securities and

Exchange Commission (SEC) to prepare reconciliations of net income measured in accordance with foreign GAAP to net income in accordance with U.S. GAAP, unless they use the IFRSs issued by the International Accounting Standards Board (IASB). Prior to the adoption of IFRSs in 2011, Canadian companies that were listed on U.S. stock exchanges also had to prepare these reconciliations. Exhibit 1.1 provides an extract from the 2010 financial statements of Encana Corporation, a leading North American natural gas producer. It shows the reconciliation of net income from Canadian GAAP to U.S. GAAP.

The SEC requires foreign companies to reconcile their earnings to U.S. GAAP unless they use IFRSs.

It is important to note that Encana's net income under Canadian GAAP was substantially different from net income under U.S. GAAP. The main difference in the Encana example is the impairment test for property, plant, and equipment. Under U.S. GAAP, future cash flows were based on the average price this past year and were discounted at 10%. Under Canadian GAAP, the future cash flows were based on forecast pricing and were not discounted. The extract below is only a small portion of Note 21. The entire note is seven pages long. It provides narrative explanations of the main reasons for the difference in net income and provides condensed financial statements under U.S. GAAP. With such a significant difference in net income and such extensive note disclosure, it is little wonder that there is pressure to develop one high-quality, worldwide accounting standard. These requirements substantially increase a company's costs of preparing financial statements. Investment analysts and other users then incur further additional costs when interpreting financial statements prepared under different standards. Because of these problems, many countries in the world have either recently adopted, or are seriously considering adopting IFRSs. However, there still are many countries that have not adopted IFRSs and may not ever do so. In order to fully understand the issues and how changes may occur in the future, we must first examine the major causes of differences in GAAP between countries.

Encana reported a significant difference between net earnings under Canadian GAAP and net earnings under U.S. GAAP.

The reconciliation of net income from a foreign country's GAAP to U.S. GAAP is very costly to prepare.

EXHIBIT 1.1 Extracts (in Part) from Encana's 2010 Financial Statements

For the years ended December 31	*Note*	*2010*	*2009*	*2008*
Net Earnings—Canadian GAAP		**$ 1,499**	$ 1,862	$ 5,944
Less:				
Net Earnings from Discontinued Operations – Canadian GAAP		**—**	32	(555)
Net Earnings from Continuing Operations – Canadian GAAP		**1,499**	1,830	6,499
Increase (Decrease) in Net Earnings from Continuing Operations under U.S. GAAP:				
Revenues, net of royalties		**—**	—	—
Operating	*D ii), H*	**(7)**	(16)	(46)
Depreciation, depletion and amortization	*B, D ii)*	**1,234**	(10,926)	(1,755)
Administrative	*D ii)*	**(3)**	22	(27)
Interest, net	*A*	**—**	—	(3)
Foreign exchange (gain) loss, net	*G*	**35**	128	—
Stock-based compensation – options	*C*	**—**	—	2
Income tax expense (recovery)	*E*	**(415)**	3,378	695
Net Earnings (Loss) from Continuing Operations – U.S. GAAP		**2,343**	(5,584)	5,365
Net Earnings (Loss) from Discontinued Operations – U.S. GAAP		**—**	32	(555)
Net Earnings (Loss) – U.S. GAAP		**$ 2,343**	$ (5,552)	$ 4,810

Source: http://www.sec.gov/Archives/edgar/data/1157806/000110465911007980/a11-4497_240f.htm#introduction_143230 Page 46.

LO2

Factors That Can Influence a Country's Accounting Standards

Many factors can influence a country's accounting standards. Usually, there is not one dominant factor. The following five factors can affect standards.

The Role of Taxation In some countries, income tax has a minimal effect on how net income is measured for financial reporting. For example, in Canada and the United States, companies often report net incomes on their operating statements that are substantially different from the taxable incomes they report on their tax returns. This has led to the GAAP concept of inter-period tax allocation. However, in some countries where such differences exist, full tax allocation has not always been used.

Accounting income and taxable income are virtually the same in some countries.

In other countries, taxation has a profound effect on how accounting income is measured. Accounting income will not differ much from taxable income if a country's tax statutes state that expenses must be recorded on the income statement if they are to be allowed as a deduction on the tax return. In countries where this is the case, the result is often the use of extreme conservatism in accounting measurements on the part of companies trying to keep their incomes as low as possible within the law. Germany and Japan are examples of countries whose tax laws have strongly influenced GAAP. In the United States, while taxable income and accounting income are different numbers, one area where consistency is required is the costing of inventory. If LIFO (last in, first out) is to be used for tax purposes, it must also be used for financial reporting.

Highly developed capital markets often result in the development of quality accounting standards.

The Level of Development of Capital Markets In countries where publicly traded debt and equity securities play a substantial role in the financing of business activities, accounting and disclosure standards tend to be much more extensive than in countries where this is not the case. This is because highly developed public capital markets tend to have fairly sophisticated investors who demand current and useful information from those who have received their capital. Canada, the United Kingdom, and the United States all have highly developed capital markets and strong accounting and disclosure standards. In countries where business financing tends to be private rather than public, there is less reliance on extensive accounting standards because the private suppliers of capital can demand and receive the information they need directly from the "consumers" of such capital. Japan is a prime example; there, corporate capital needs have been supplied by very large private suppliers, such as banks. However, it should be noted that when Japan's economy took a severe dive in the 1990s, many of Japan's major banks incurred massive loan losses that nearly bankrupted them; this was cited as a major contributor to the Japanese recession. Germany and Switzerland also have very large banks that satisfy much of the capital needs of business. Historically, a large number of businesses in Mexico were state owned, but in the 1990s, a change to private ownership resulted in a shift to financing through private and public capital markets.

Code law systems specify what individuals and corporations can do, while common law systems specify what cannot be done.

Differing Legal Systems Two different kinds of legal system are in existence today: code law systems and common law systems. Code law systems, which originated with the Roman Empire, contain very detailed statutes that govern a wide range of human activities. In general, they specify what individuals and corporations *can* do. Common law systems have less-detailed statutes and rely on the court system to interpret statutes and thus establish precedents through case law. In general, they specify what individuals and corporations *cannot* do (i.e., what is illegal).

In many common law countries, governments tend to take a hands-off approach to the setting of accounting standards. While there may be statutes requiring that companies make information available to the providers of capital, the *type* of information required is left to the private sector. In the United States, the SEC, which administers securities legislation, has given the right to develop accounting standards to a private group, the Financial Accounting Standards Board (FASB). In Canada, the *CICA Handbook* pronouncements constitute the accounting standards required by the provincial and federal Companies Acts and the Ontario Securities Commission (OSC). The United Kingdom also uses a private standard-setting body.

In Germany, France, and Japan, accounting standards are set by legal statutes.

In code law countries such as Germany, France, and Japan, the private sector is involved only in an advisory capacity, and accounting standards are reflected in legal statutes, often as protection for creditors and other capital suppliers. It should not be surprising to note that tax law also heavily influences accounting standards in these countries.

Ties between Countries Political and economic ties between countries have historically had some effect on accounting standards. For example, the accounting standards and professional accounting organizations of countries that were once colonies are often patterned after those of the "home" country. There have been strong similarities between the standards of India, South Africa, Australia, New Zealand, and Malaysia and those of Great Britain. During their early development, Canadian accounting standards were influenced by Great Britain's, but in later years, this influence shifted away from Britain to the United States due to the very strong economic ties that developed between those two countries. The formation of the European Union has certainly had an effect on the accounting standards used by its member countries. We will see more of this later.

High inflation rates often result in departures from historical cost measurements.

Inflation Levels The historical cost model, which implicitly assumes a relatively stable unit of measure, is used by many countries. However, the model is not useful when inflation rates are very high. Countries that have experienced high inflation rates often make financial reporting adjustments to counteract the effects of inflation. These adjustments involve price-level-adjusted statements, or a shift from historical costs to current-value accounting, or both. Many countries in South America that experienced inflation rates of 1,000% or more per annum in the 1980s and 1990s adopted inflation-based accounting. Inflation in most of these South American countries is now more reasonable and inflation accounting has been discontinued. Mexico used price-level accounting because of high inflation rates from 1983 to 2007. Canada, the United States, and the United Kingdom all experimented with the supplemental reporting of price level and current-value information in the 1970s when the inflation rate approached 20%. The experiment was not successful because of the high cost of providing such information and the general lack of comprehension on the part of financial statement users. All three countries abandoned the experiment when inflation declined.

Toward Accounting Harmonization and Convergence

The European Union, the IASB, and the FASB have been working toward accounting harmonization.

A truly global economy will require some sort of harmonized accounting standards if it is to function properly. Three organizations that have been working