

Solutions to assigned exercises/problems (Winter 2012)

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WA 1-6

(a) The term "generally accepted accounting principles" in the auditor's report includes not only the narrow notion of specific principles associated with accounting (e.g., historical cost principle, revenue recognition principle) but also specific policies (methods), practices, procedures, and rules used to determine what is included in the statements, how amounts are determined (measurements made), how items are classified, and what disclosures are made (e.g., notes). Necessarily, the GAAP referred to incorporates all the sections in the *CICA Handbook* as well as Accounting Guidelines, Background Information and EIC Abstracts, among others. Beyond this, the "principles" applied reflect what is supported by Canadian literature other than the *CICA Handbook*, or standards of the IASB or foreign countries (particularly the U.S.). When going outside the *CICA Handbook*, or when interpreting its contents when acceptable alternatives are permitted or a recommendation is somewhat general, professional judgement must be used to establish that a "principle" used is justifiable and appropriate to a situation.

(b) & (c) Generally accepted accounting principles are those principles (regardless of whether or not their use is limited) that have substantial authoritative support. Whether a given principle has authoritative support is a question of fact and a matter of judgement. The accountant and auditor are both responsible for collecting the available evidence of authoritative support, and judging whether it is sufficient to bring the practice within the bounds of generally accepted accounting principles.

The basic source of generally accepted accounting principles in Canada the *CICA Handbook*. The Canada Business Corporations Act establishes this as the basic document setting the laws of the country with regard to financial accounting standards and disclosures for companies incorporated under it. While it is of primary importance, the *CICA Handbook* frequently leaves plenty of room for judgement regarding what the standards are and, therefore, other sources of authoritative support are significant.

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These other sources of authoritative support may be found in the published opinions of committees of professional organizations, and the opinions of practitioners and academics in articles, textbooks, and expert testimony. Similarly, the views of stockbrokers, commercial and investment bankers, as well as the views of regulatory commissions influence the general acceptance of accounting principles and, hence, are considered when determining whether an accounting principle has substantial authoritative support. Business practice also is a source of evidence and, because they influence business practice, the Income Tax Act and various federal and provincial documents are sources of evidence as well. Finally, International Accounting Standards and standards of other countries, particularly the U.S., are of importance.

- (d) The auditors' report provides the auditor's opinion that the financial information presented is materially in accordance with GAAP. Canadian GAAP provides guidance through the *CICA Handbook*, which tends to be broad in scope and often identifies various acceptable alternative accounting practices. Interpretation and judgement are required to determine which alternatively acceptable treatment is the most appropriate in the circumstances. Also, the *CICA Handbook* does not provide guidance on all accounting issues. Therefore, to solve problems in areas where the *CICA Handbook* is not specific or has no information, professional judgement must be used. This professional judgement must be exercised by the accountant in preparing the financial information and by the auditor in determining if the requirements of GAAP are met. Management must interpret GAAP and determine whether sufficient disclosure of the pertinent facts has been provided. The materiality guideline tries to quantify the level of information that would impact or change a user's decision and is a subjective measure that must be applied by management and the auditor.

The OSC refers to "full, true, and plain disclosure" which refers to the communication skills of accountants and management regarding disclosures as well as the actual information provided. Disclosures through notes are an integral part of the financial statements, and disclosure requirements are governed in part by the requirements of regulators such as the OSC, which may go beyond GAAP requirements. Necessarily such disclosures concentrate on elaboration and explanation of complex aspects and preparers and auditors, as experts, do their best to present such detail in a clear and understandable way. Successful communication is difficult to achieve and may suffer from ambiguous or poor wording. Certainly, communication is an extremely important aspect of accounting.

WA 1-7

- (a) In the U.S. the Sarbanes-Oxley Act enacted by Congress aims at improving the accuracy and reliability of corporate disclosures by requiring chief executive and financial officers to certify quarterly and annual reports. Its provisions include new rules for auditors, conflicts of interest guidelines and review of the efficacy of the rules-based system of public accounting in the US.

In Canada, the Canadian Public Accountability Board (CPAB) was established to develop, codify and implement auditing, quality control, and independence standards and rules. Stronger independence rules now exist for auditors, for example there must be a rotation of auditors every 5 years. If there is an accounting restatement, CEO's and CFO's must forfeit bonuses and profit sharing. The effectiveness of the financial reporting internal control systems must be reported by management and auditors must assess and report on these internal controls. Audit committees must be made up of independent members and members with financial expertise. Companies must disclose whether there are codes of ethics with respect to their senior financial officers.

- (b) Other options include tighter accounting standards and new regulatory measures intended to strengthen the independence and improve the accountability of external auditors.

The profession is also pushing regulators to promulgate tougher disclosure standards for management discussion and analysis reports. The Ontario Securities Commission has developed new securities regulations in response to tougher US auditor rules. Echoing some of the key provisions in Sarbanes-Oxley, the new rules call for five-year engagement partner rotations, a prohibition on financial ties between audit team members and client firms, as well as strict limits on how firms perform nonassurance services for audit clients and what services may be provided. This is echoed by the CICA's new standard for auditor independence. Those rules speak directly to the sorts of non-arm's length relationships that dramatically undermined Arthur Andersen's ability to provide investors with an objective analysis of Enron's murky financial condition.

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- (c) **The strengths of government regulation include an independent verification on the financial reporting process and provide assurance and increased investor confidence that financial reporting is monitored. Government regulation however, interferes with the free market economy and the self-regulating nature of financial reporting. It will also lead to higher costs and does not necessarily imply a fully independent verification since government objectives do not always mesh with those of the economy. This could in turn lead to more politicization of the standard-setting process. Geographically-bound governments also do not address the issue of huge multi-national companies. Additional government regulation does not guarantee that another Enron-type situation will not reoccur. If corporate managers are determined to misrepresent results and commit fraud, additional government regulations will likely not prevent this from happening.**

Developed from the article “After Enron”, by John Lorinc, CA Magazine, December 2002.