Accounting Principles: Part I

By

Vern Krishna, CM, QC, FCPA

Accounting is the language of the world of finance and taxation. As with all languages, there are certain rules and conventions that we follow to make the language universally understandable and acceptable. We refer to these rules as concepts and principles, which also provide the foundation for calculations of taxable income under the *Income Tax Act ("Act")*. In this Part, we commence with general principles. In subsequent Parts, we will examine specific tax rules of accounting.

When accounting rules become generally accepted by business and the appropriate authorities, we refer to them an "generally accepted accounting principles" (GAAPs), which are essentially the rules within which accountants are supposed to operate. GAAPs comprise assumptions, principles, standards, rules and conventions for preparing and presenting financial statements. However, as with all languages, there can be misinterpretations and distortions, whether accidental or deliberate. Hence, finance is littered with accounting scandals.

Professionals rely upon accountants to explain the technical details of particular principles. For example, in a lawsuit involving the appropriate accounting treatment of inventory valuation, lawyers can rely on professional opinions on the appropriate principles to apply. However, although lawyers do not require technical expertise, they should be sufficiently familiar with GAAP and IFRS in drafting domestic and international contracts.

Sources of GAAPs?

In Canada, the Chartered Professional Accountants of Canada (CPA Canada), which publishes the *CPA Handbook* on accounting, is the leading source of Canadian GAAPs. The *Canada Business Corporations Act* and regulatory statutes recognize the *Handbook* as the benchmark of accounting principles for financial reporting.

Section 1100 of the *Handbook* describes what constitutes generally accepted accounting principles (GAAP):

> "Generally accepted accounting principles (GAAP) encompass broad principles and conventions of general application as well as rules and procedures that determine accepted accounting practices at a particular time" [Paragraph 1100.02(b)]

The International Accounting Standards Board (IASB) has other GAAPs. Canada has adopted international GAAPs as articulated by the IASB and known as IFRS.

Part I of the *Handbook* contains the international financial reporting standards (IFRS) for public enterprises. Since 1 January 2011, public companies must also report using International Financial Reporting Standards.

A public enterprise is an entity, other than a not-for-profit organization, that has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market.

Part II discusses accounting standards for private enterprises (ASPE). Private enterprises have a choice between applying ASPE in Part II or IFRS in Part I.

Both GAAPs and IFRS refer to broad principles and conventions that apply generally in accounting. They also refer to specific rules to determine accounting practices at particular times. However, GAAPs are not universal and identical. The United States has its own set of GAAPs.

Canadian GAAPs refer to both IFRS and ASPE. When the *Handbook* does not cover a matter, accountants refer to other sources of information, such as, for example, International Accounting Standards, Financial Accounting Standards Board (FASB) pronouncements in the U.S., or academic accounting literature. Unfortunately, these sources do not always agree on what constitutes GAAP. The *Handbook* addresses potential differences by saying, "the relative importance of these various sources is a matter of professional judgment in the circumstances."

Accounting bodies develop GAAPs by exercising professional judgment and analyzing the advantages and disadvantages of alternative methods of accounting and reporting. Since accounting cannot produce precise answers to every question, GAAPs provide rules and guidelines that are generally acceptable. Hence, GAAPs may offer choices between allowable alternatives or may be entirely silent on the particular point. However, the basic standard of ASPE is mandatory:

> "An entity *shall* apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the entity." [Paragraph 1100.03 *Handbook*]

Legal contracts often refer to GAAPs in the preparation of financial statements. For example, contracts that contain negative covenants relating to financial status or ratios, such as working capital or debt/equity ratios, frequently state that the relevant financial statements must be prepared in accordance with GAAP. In these circumstances, it is best to specify which GAAP (Canadian, American, or International) should apply to the particular contract.

The Audit Opinion

The auditor's report will refer specifically in its audit opinion to GAAPs. See, for example, the auditor's report for Duggan Inc."

> "In our opinion, the financial statements present fairly, in all material respects, the financial position of Duggan Inc. as at September 30, 20-2 and 20-1, and its financial performance and its cash flows for the years ended September 20-2 and 20-1 in accordance with Canadian generally accepted accounting principles and International Financial Reporting Standards."

Hierarchy of GAAP Sources

There are various sources for GAAP. At the top of the hierarchy, however, are the official statements from organizations that the accounting profession designates as the official body to determine appropriate accounting treatment for financial transactions. In Canada, CPA Canada is the official source of GAAP, which are discussed in its *Handbook*.

Regulatory Agencies

Canada

Regulatory agencies, such as Securities Commissions, require financial statements in compliance with GAAPs to be filed and distributed annually. See, for example, Section 78(1) of the *Ontario Securities Act*

> "Every reporting issuer that is not a mutual fund and every mutual fund in Ontario shall file annually within 140 days from the end of its last financial year comparative financial statements relating separately to,
>
> (a) the period that commenced on the date of incorporation or organization and ended as of the close of the first financial year or, if the reporting issuer or mutual fund has completed a financial year, the last financial year, as the case may be; and
>
> (b) the period covered by the financial year next preceding the last financial year, if any,
>
> made up and certified as required by the regulations and in accordance with generally accepted accounting principles. [R.S.O. 1990, c. S.5, s. 78 (1)]

United States

In the United States, the official body for determining the appropriate accounting treatment of transactions is the Financial Accounting Standards Board (FASB), an independent body created to establish and improve standards for financial accounting and reporting. It is made up of a cross-section of accountants, academics, and users of financial statements. In order to enhance the independence of the board, the seven members of FASB cannot hold private employment during their tenure of service on the board.

In the United States, the Securities and Exchange Commission (SEC) regulates the sale of securities and securities markets. Therefore, publicly listed companies must file regular financial statements according to specified criteria with the SEC.

The SEC does not routinely develop accounting principles and, generally, leaves the development of such principles to the independent accounting bodies, such as FASB. Nevertheless, the SEC will, on some occasions, promulgate accounting principles if it is of the opinion that the accounting profession or bodies are not acting fast enough on their own.

Role of Management in Selecting GAAPs

Management has a key role in determining the nature, format, and underlying principles of its financial statements. Indeed, the Representation Letter that corporate management must submit to its auditors will usually state in the first paragraph:

> We are responsible for the fair presentation in the financial statements of financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles.

To discharge its responsibility, management must select accounting principles; determine asset life; and decide reporting policy if there is no existing principle.

The interaction between management and the corporation's auditors is delicate and, sometimes, tense. Accounting firms are first and foremost businesses that value client retention. They realize, however, that corporations can "opinion shop" if the audit firm is being difficult in respect of particular items on the financial statements.

Thus, at the very least, a lawyer who uses financial statements should have a general understanding of GAAPs and IFRS that the audit opinion addresses. The Notes to the financial statements will set out the corporation's selection of GAAPs and IFRS and their impact on the financial statements.

Are GAAPs Good for You?

GAAPs and IFRS are rules of content that deal with compiling and disclosing information in the financial statements. The first item in the Notes to the financial statements will describe the principles that the particular enterprise applies in the preparation of its financial statements. GAAPs and IFRS provide considered and properly researched principles that accountants can adhere to and readers can use with reasonable confidence in understanding financial statements. They also make financial statements more comparable if the underlying GAAPs are the same for all statements.

There are, however, some limiting aspects of GAAPs. We have seen, for example, that conservatism is one of the basic underlying concepts of accounting, which generally tends to understate income and understate assets. Although this may be a desirable aspect of stewardship and fiduciary accounting, conservatism can lead to lowered valuations, which can mislead investors.

Given the variety of GAAPs that one may apply to measure or report upon the same situation, we can have many net income figures, each of which is equally valid and according to GAAPs. This is an important consideration in drafting legal agreements. In a sense, consistent application is just as important as the particular GAAP that one applies in a contract. Thus, in many situations, cash flow is a much more reliable figure because it eliminates the need to select between alternative accounting principles. Ultimately, cash is king!

Accounting Standards

The two key accounting standards–setting bodies in the world are the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) of the United States. The two bodies do not have identical standards. Indeed, they differ quite significantly in some areas such as “fair value” accounting.

Broadly speaking, fair value accounting standards value a firm’s assets and liabilities based upon market value rather than historical cost. The difference is particularly important in the valuation of financial instruments, property, plant, and equipment on the balance sheet.

Canada adopted International Financial Reporting Standards (IFRS) for public companies in 2011 even though our economy is more closely linked to the United States, which primarily uses FASB pronouncements.

Framework of IFRS

IFRS refers to the body of authoritative literature of the International Accounting Standards Board (IASB) designed principally for use by profit-oriented entities. The IFRS Foundation oversees the IASB. The IASB developed a *Conceptual Framework* for the development of IFRS and for guidance to accountants in preparing public enterprise financial statements.

The objective of the IASB is to narrow the differences among accounting standards, procedures, and regulations that apply in the preparation of financial statements in different countries. Harmonization facilitates economic decision making and international comparisons of companies. Reporting entities must comply with all of the standards and interpretations (including disclosure requirements) and make a positive statement of explicit and unreserved compliance in the audit opinion.

The framework recognizes that the overall objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. General purpose financial reports are not designed to show the value of a reporting entity. However, they provide useful information to help existing and potential investors, lenders, financial analysts, and other creditors to estimate the value of the reporting entity.

Financial statements prepared according to IFRS will involve:

Accounting policy choices;
Professional judgment in making estimates;
Fair value measures in the financial statements; and
Disclosures in the Notes.

The overall objective of IFRS is fair presentation in the financial statements. In this aspect, there is no underlying difference in principle between IFRS and Canadian GAAPs. However, absent specific prohibition, IFRS admits deviation and provides for a “true and fair” override if complying with IFRS would produce misleading information. In contrast, there is no such concept of a true and fair view override in Canadian GAAPs.

Financial reports are based on estimates, judgments, and models rather than exact depictions. The Conceptual Framework of IFRS establishes the concepts that underline those estimates, judgments, and models. The fundamental qualitative characteristics of useful financial information are relevance and faithful representation.

Financial statements, *per se*, are not predictions or forecasts. However, relevant and faithful representation of material financial information are the foundation for making predictions and forecasts by investors, management, and financial analysts. Thus, accounting is a stepping stone to financial valuation.

Faithful representation does not imply perfect accuracy in all respects, but the information should be relevant and faithfully represented. Financial information in reports should be material. Materiality means that omission or misstatement of the information could influence decisions that users make based on the information about a specific reporting entity.

Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of its financial report. The IASB does not specify a uniform quantitative threshold for materiality. Whether an item is material or not is a matter of professional judgment in the circumstances of the entity's financial information.

Both IFRS and Canadian GAAPs rely on a conceptual framework of accounting standards, which preparers of financial statements can refer to in the absence of specific guidance. IFRS states that it does not apply to items that are "immaterial." Although Canadian GAAP does not contain a similar explicit statement, that, in practice, is how accountants apply GAAP.

Who Is Affected by IFRS?

The underlining objective of the IFRSs is to produce global accounting standards that are transparent and provide comparable information on financial statements. By having a single set of global standards, public corporations can eliminate multiple GAAP reconciliations between countries.

Both IFRS and Canadian GAAPs are comprehensive sets of principles-based standards that have a similar form and structure and share similar basic concepts of income recognition and measurement principles. However, IFRS requires more professional judgment and a greater volume of disclosures.

Canadian GAAPs are simpler to apply and, therefore, less costly. They also have fewer disclosure requirements than IFRS. However, Canada adopted IFRS for "publicly accountable enterprises" (PAE), which include "profit-oriented" enterprises with publicly issued securities and enterprises that hold assets in a fiduciary capacity for a broad group of outsiders. PAE also includes government business enterprises, such as the Ontario Securities Commission.

Not-for-profits are not required to adopt IFRS.

Part I of the *Handbook* deals with IFRS. Entities that prepare their financial statements in accordance with the part must state in their audit opinion that they have been prepared in accordance with IFRS. Such entities may also state that its financial statements are in accordance with Canadian GAAPs.

IFRS and Canadian GAAPs require that management account for financial transactions based upon their substance, rather than their legal form. Thus, accountants should recognize transactions with shareholders in their capacity as shareholders directly in the equity portion of the financial statements rather than through the income statement.

However, there are differences between IFRS and Canadian GAAP. Generally, there are fewer bright lines and rules in IFRS. Hence, there are more accounting policy choices and fewer interpretative matters. In particular, there are substantial differences in valuation and disclosure of impaired assets and securitizations.

IFRS and US GAAP

In Canada, IFRS affects large multinational public companies and small private corporations differently. The big four Canadian accounting firms and their multinational corporate clients like IFRS because it simplifies transnational accounting and makes it easier for them to raise corporate capital in international markets. On the other hand, IFRS is more complex and expensive to administer and, therefore, not particularly attractive to smaller companies that operate only in Canada.

The United States Securities and Exchange Commission continues to study the implications for US companies. It appears, however, that the United States will not adopt a full-blown changeover to IFRS because of the cost and burden of any such change. Instead, the United States may, like Canada, adopt a compromised "endorsement" model that would gradually incorporate IFRS into the US system of rules, while maintaining the United States' authority to modify or reject any international rules if it saw fit.

Fair Value Measurement

Most items are disclosed in the financial statements based on their historical costs. In some circumstances (such as, inventories), historical cost may be reduced to reflect a loss if fair market value is less than cost ([International Accounting Standard (IAS) 2]. In other cases, such as property, plant, and equipment, an entity may reduce or increase amounts to reflect their fair value (IAS 16).

IFRS 13 defines fair value and has a framework for measuring and disclosing it in the financials.
Fair value is the price that an entity would receive if it sold an asset or paid to transfer a liability in an orderly transaction between market participants as at the measurement date. Thus, fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use to price the asset or liability under current market conditions. As such, the entity's intention to hold the asset is not relevant when measuring fair value. The measure is what the buyer will pay for the benefit that it expects to generate from the use (or sale) of the assets, regardless of the entity's actual intentions.

An entity measuring fair value must determine:

- The particular asset or liability that is to be measured;
- For a non-financial asset, the highest and best use of the asset and whether it will be used in combination with other assets or on a stand-alone basis;
- The market in which the orderly transaction would take place for the asset or liability; and
- The appropriate valuation technique to use.

To increase consistency and comparability in the fair value measurements, IFRS 13 establishes a fair value hierarchy that categorizes the inputs used in valuation techniques.

- Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the mea-surement date.
- Level 2 inputs are inputs (other than quoted prices included within Level 1) that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are non-observable inputs for the asset or liability. Such inputs must reflect the assumption that market participants will use when pricing the asset or liability, including assumptions about risk.

In order to measure fair value, management must identify the characteristics of an asset or liability that market participants will take into account when pricing that asset or liability. They must also determine whether a principal market for an asset or liability exists and whether the entity has access to that market. In the absence of a principal market, it will be necessary to identify the most advantageous market for the asset or liability, which is likely to be that which maximizes the amount that would be received to sell the asset or minimize the amount that would be paid to transfer the liability.

For non-financial assets, management must determine the highest and best use of the asset from the perspective of market participants. This is so even if the entity intends to use the asset for a different purpose. Management must exercise judgment in determining the appropriate valuation technique to measure fair value.

The rationale of the input disclosures is to provide users with information so they may assess the valuation techniques and inputs used to develop fair value measurements, their effect on profit or loss or on other comprehensive income for the period.