

General Standards of Financial Statement Presentation — Background Information and Basis for Conclusions

Section 1400

Foreword

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

Background Information and Basis for Conclusions documents are primary sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. These documents are intended to help readers understand how the Accounting Standards Board reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Handbook Section or Accounting Guideline.

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INTRODUCTION

- 1 This document summarizes considerations that were deemed significant by the members of the Accounting Standards Board (AcSB) in reaching the conclusions in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400, and related amendments to other CICA Handbook – Accounting material. This document sets out the reasons the AcSB undertook the project to develop this material, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual AcSB members gave greater weight to some factors.
- 2 Nothing in this document is to be taken as overriding the requirements of Accounting Handbook Sections. However, the discussion may assist readers in understanding how the AcSB reached its conclusions in developing Section 1400 and the AcSB's intent with respect to its interpretation and application.

BACKGROUND

- 3 Some financial statement users have requested clarification of the meaning of "fair presentation in accordance with generally accepted accounting principles (GAAP)." To address this request, the AcSB issued a new Section 1400, GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, that revises and replaces GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1500.
- 4 Also, the AcSB took the opportunity to delete GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06, and FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, to remove the ability for an entity to depart from a Handbook Recommendation when following that Recommendation would result in misleading financial statements.

- 5 Input to the deliberations of the AcSB, comprised comments received to proposals issued in July 2001, 1 modified proposals issued in September 2002 2 and results of a roundtable discussion conducted in February 2003.
- 6 Some respondents questioned how the overall fairness of presentation of financial statements would be assessed. Some respondents also expressed the view that it is important to "step back" and consider whether the financial statements as a whole present fairly in accordance with GAAP the financial position and results of operations of an entity. Respondents generally supported the proposal to remove the ability for an entity to depart from a Handbook Recommendation when following that Recommendation would result in misleading financial statements. The AcSB re-deliberated these issues and decided to make modifications as indicated in this document.
- 7 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, is closely linked to Section 1400 and the AcSB advises readers to review the separate Background Information and Basis for Conclusions document.

DEPARTURE FROM GAAP

- 8 In accordance with former FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, an entity would depart from a Handbook Recommendation "in those rare circumstances where following a Handbook Recommendation would result in misleading financial statements." Former paragraph 1000.61 required that, "when assessing whether a departure from a Handbook Recommendation is appropriate, consideration would be given to:
- (a) the objective of the Handbook Recommendation and why that objective is not achieved or is not relevant in the particular circumstances;
 - (b) how the entity's circumstances differ from those of other entities which follow the Handbook Recommendation; and
 - (c) the underlying principles of accounting alternatives by referring to other sources."
- Former paragraph 1000.61 stressed that "there is a strong presumption that adherence to Handbook Recommendations results in appropriate presentation and that a departure from such Recommendations represents a departure from generally accepted accounting principles." Furthermore, former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06, required that "*Where the accounting treatment or statement presentation does not follow the recommendations in this Handbook, the practice used should be explained in notes to the financial statements with an indication of the reason why the recommendation concerned was not followed.*" The Handbook did not, however, require that the effects of the departure be quantified and disclosed.
- 9 The AcSB removed FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, and GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06, from the CICA Handbook – Accounting. The AcSB believes that GAAP is sufficiently well developed that it should not result in misleading financial statements. Furthermore, if application of a primary source of GAAP could result in misleading financial statements, the proper course of action is to amend the source, rather than to require a departure from it.
- 10 A departure from a primary source of GAAP was intended to be rare, and experience over many years has resulted in few, if any, such departures. This reinforces the view that GAAP is sufficiently well developed that it should not result in misleading financial statements. Furthermore, the circumstances in which a departure from a primary source of GAAP would be appropriate are difficult to clearly define. Consequently, one entity's view of what results in misleading financial statements in a particular circumstance might differ from that of another entity and therefore, prevent comparability. A similar problem would exist for accountants who report on those financial statements. The AcSB believes that consideration of the need to amend GAAP through appropriate due process, with the result that it would be applicable to all entities, is preferable to requiring an entity to unilaterally determine that a departure from a primary source of GAAP is necessary. In this regard, the AcSB has established standard-setting mechanisms to consider such circumstances and to deal with them on a timely basis. It is incumbent upon entities and their advisers to identify potential issues in sufficient time for their resolution through established processes. The Emerging Issues Committee provides a forum for timely review of emerging accounting issues that are likely to receive divergent or unsatisfactory treatment in practice. Alternatively, the AcSB may consider the need to amend, or issue new, pronouncements.
- 11 A majority of respondents agreed with the proposal to remove FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, and GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06. A minority of respondents disagreed, for reasons discussed in the following paragraphs.
- 12 Several respondents expressed concern that the proposal would, in theory, require the issue of misleading financial statements when GAAP results in misleading financial statements. Some respondents noted that rules of professional conduct, criminal codes and other similar requirements prohibit association with misleading financial statements. The AcSB agrees that it is not appropriate to issue or be associated with misleading financial statements and, based on many years of practical experience, is satisfied that compliance with GAAP achieves a fair presentation. Furthermore, no respondent identified a valid example of an instance where most accountants, exercising professional judgment, would agree that a departure from a primary source of GAAP would be necessary to avoid a misleading presentation. If significant issues do arise then they should be considered via the established standard-setting process. (See paragraph 10 of this document for details.)
- 13 Some respondents suggested that the ability to depart from a Handbook Recommendation has been used in certain circumstances to justify the use of certain established accounting practices in preference to specific Handbook

- requirements. This was not the AcSB's intent and, in any case, if a departure had been adopted in these circumstances, such entities do not appear to have made the appropriate disclosures to support the use of such an override in financial statements, in accordance with former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06. Furthermore, the intent of former FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, was for a departure only when following a Handbook Recommendation would render the financial statements misleading, and not when an alternative treatment might be considered "better" or "more relevant".
- 14 Some respondents, mainly financial statement preparers, expressed concern that the proposal to remove the ability to depart from a Handbook Recommendation reduces the flexibility necessary for professional judgment. The AcSB developed GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, and GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400, using a principles-based approach that emphasizes the role of professional judgment, while keeping in mind the need for comparability and consistency in financial statement reporting.
 - 15 Some respondents simply stated that they did not understand the reason for removing the paragraphs. This Background Information and Basis for Conclusions document presents those reasons.
 - 16 Some suggested that rather than adjusting its financial statements for the effect of a departure, an entity should provide note disclosures explaining why management believes financial statements prepared in accordance with GAAP are misleading, together with a description of the accounting treatment they believe is appropriate and what the effects would be on the financial statements. This approach could raise questions as to which is the "real" financial position or result of operations, and some may question why the alternative that management believes to be misleading is the one reported in the primary financial statements, while the other alternative is disclosed only in the notes. On the other hand, some suggest that if it is desired to maintain comparability of the GAAP-basis financial statements, but there are concerns that there might be extremely rare circumstances in which an alternative needs to be presented, then it might be preferable to explain the concerns in the notes to the financial statements, rather than impairing comparability by modifying the primary financial statements.
 - 17 Equivalent provisions in the United States are contained in Rule 203 of the Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA). 3 This requires compliance with officially established accounting principles and states, "there is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading." When a departure from an accounting principle is made under Rule 203, the auditor must demonstrate that application of the principle would have resulted in misleading financial statements and describe "the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement." However, under the US approach, the notion of fair presentation exists only by reference to US GAAP and is achieved by adhering to US accounting standards and practices. As a result, any departure is presumed not to result in fair presentation. The circumstances in which departures from US GAAP have occurred under Rule 203 have been rare, almost to the point of non-existence. While the AcSB's decision to eliminate the ability to depart from a Handbook Recommendation may appear to differ slightly from that in the United States, the AcSB believes that the practical effect is the same.
 - 18 The US Financial Accounting Standards Board's (FASB) Simplification and Codification project arose as a result of its October 2002 proposal, "Principles-Based Approach to US Standard Setting," on which it invited comments. This proposal discusses a principles-based approach to standard setting to improve the quality and transparency of financial accounting and reporting in the US. Part of this proposal considered the need for an overall reporting framework similar to that in International Accounting Standards Board's (IASB) IAS 1 (Revised), "Presentation of Financial Statements." This proposal pointed out that such a framework could include a true and fair view override to deal with the extremely rare circumstances in which management concludes that compliance with a requirement in an accounting standard could be so misleading that it would conflict with the objectives of financial reporting.
 - 19 Respondents to this FASB proposal were largely split regarding the true and fair view override issue. Many respondents said that US GAAP should include a true and fair view override, but only in "rare" situations and if adequately disclosed. In general, these respondents indicated that a true and fair view override is critical as a basis for ensuring that financial reporting reflects the economic substance of transactions or events, allowing for unforeseen circumstances where strict compliance with the standards could be misleading and distort the financial statements. Other respondents disagreed. Among other things, they said that well-developed principles should render unnecessary the need for a true and fair view override in US GAAP, also referring to the similar override that is contained in US Generally Accepted Auditing Standards (Rule 203). The FASB decided not to undertake efforts to develop a reporting framework as in IAS 1 or to otherwise consider a true and fair view override for US GAAP purposes.
 - 20 The IASB's IAS 1, "Presentation of Financial Statements," contains a "true and fair override" that is similar to former FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61. The IASB reconsidered it in its project to improve certain International Accounting Standards (IASs). The environmental considerations are somewhat different in the IASB context because the true and fair override notion is not only contained in IASs, but also directly in European legislation. The IASB was, therefore, limited as to what it was able to achieve in the context of an "improvements" project. The approach proposed by the IASB 4 is as follows:

- (a) Financial statements would be required to present fairly the financial position, financial performance and cash flows of an entity (that is, represent faithfully the effects of transactions and other events in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the "Framework for the Preparation and Presentation of Financial Statements"). The application of International Financial Reporting Standards (IFRS) and Interpretations of those Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.
 - (b) In order to override an IFRS or Interpretation, it is necessary that management conclude that complying with the pronouncement would be so misleading that it would conflict with the objective of financial statements set out in the IASB Framework.
 - (c) In those jurisdictions where the "relevant regulatory framework" requires or does not prohibit a departure from the pronouncement, an entity would adjust the financial statements and explain in the notes what it did, including the financial impact. In those jurisdictions where regulation does not permit a departure from the standard, an entity would not adjust the financial statements, but would disclose in the notes the adjustments to each item in the financial statements that management has concluded would be necessary if a departure had been made.
- 21 The AcSB does not favour a disclosure approach, because it conflicts with the longstanding, fundamental principle that inappropriate accounting treatments are not rectified either by disclosure of the accounting policies used or by information in the notes or supporting schedules. GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1400.11, explicitly states this principle. The vast majority of respondents supported this proposal.
- 22 Having taken into account the views of respondents, considered other international positions and re-deliberated the issues, the AcSB deleted FINANCIAL STATEMENT CONCEPTS, paragraph 1000.61, and GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.06, to remove the ability for an entity to depart from a Handbook Recommendation.

FAIR PRESENTATION

- 23 "Fair presentation" is difficult to define unless expressed in terms of compliance with standards. Accordingly, the AcSB decided to amend GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1500, to clarify that "fair presentation" is not a separate consideration from whether financial statements are in accordance with generally accepted accounting principles.
- 24 A first step in this clarification was taken initially by proposing to reword former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.05 (now GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1400.09), to clarify its original intent when it was first introduced into the CICA Handbook – Accounting. That intent ensures that all information required to be disclosed by GAAP is included in the financial statements (including notes to such statements and cross-referenced supporting schedules), rather than other documents. Some had misinterpreted the former wording to require a separate consideration of fairness.
- 25 After the initial proposals, some questioned how the overall fairness of presentation of financial statements would be assessed. Also, some additional comment letters expressed the view that it is important to "step back" and consider whether the financial statements as a whole present fairly in accordance with GAAP the financial position and results of operations of an entity. They proposed that merely complying with the various presentation and disclosure requirements specifically identified in the CICA Handbook – Accounting might not be sufficient. They believed that the spirit of GAAP also needed to be taken into account.
- 26 The AcSB concurs that it is always necessary, but in some cases not sufficient, to follow the minimum requirements of GAAP and that an entity should "step back" and consider whether its financial statements are presented in a manner that provides clear and understandable information to users of financial statements. In particular, this applies to the manner in which notes to the financial statements are presented — so as to be informative and useful, rather than merely providing "boilerplate" information. However, the AcSB believes that this should be restricted to an assessment of whether "fair presentation in accordance with GAAP" has been achieved, rather than whether fundamental recognition or measurement requirements should be compromised.
- 27 The AcSB proposed to clarify this matter by introducing a new paragraph .04, which explained that a fair presentation in accordance with generally accepted accounting principles requires not only applying accounting policies that are in accordance with GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, but also assessing whether there are transactions, circumstances or events of such size, nature or incidence that their disclosure is necessary to understand the entity's financial position, results of operations and cash flows. The AcSB also proposed that an entity consider whether information is presented in a manner that is clear and understandable. In this context, the AcSB considered the notion of "understandability" in the same manner as is explained in FINANCIAL STATEMENT CONCEPTS, paragraph 1000.19. This notion of "understandability" would include the presentation of information in a manner that uses plain English, avoids excessive detail, and identifies the key relationships between items disclosed or presented in different parts of the financial statements.
- 28 Respondents questioned how to apply the proposal to assess the adequacy of disclosure. Respondents also wondered where to draw the line between disclosures in Management Discussion & Analysis and financial statement disclosures

and some were concerned about the possible additional difficulty in fully meeting the proposed requirement. The AcSB agreed to retain the proposal subject to the following modifications:

- narrow the focus to those transactions and events whose effect is reflected in the financial statements;
- refer to size, nature, **and** incidence (rather than size, nature, **or** incidence) to further narrow the focus;
- specify that professional judgment should be exercised in determining whether additional information is required;
- clarify that an entity is not required to assess or disclose the possible effects of future events on future fiscal periods; and
- refer to exceptional circumstances.

29 In conjunction with these changes, and at the suggestion of a respondent, the AcSB modified paragraph 1400.01 to clarify that it is not only the extent of disclosures, but also their clarity, that contributes to communication of information.

30 Paul Cherry, Chair of the AcSB, in his Message from the Chair in the May 2003 edition of the FYI Newsletter discusses the importance of GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400, which revises and replaces GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1500:

The fact that many amounts reported in financial statements are "soft numbers", such as impairment write-downs of long-lived intangibles and many fair value estimates, is still not well understood by investors and other users of financial statements. In 1995, the AcSB introduced disclosure requirements concerning "measurement uncertainty" when it is reasonably possible that the recognized amount could change by a material amount in the near term. Although that disclosure objective is even more important today, the quality of those disclosures has often been poor — largely boilerplate and ineffective. The situation has been compounded by similar deficiencies in the MD&A. Hopefully, the revised Handbook section on general standards of financial statement presentation and the new MD&A Guidelines and related interpretation issued by the Canadian Performance Reporting Board will help.

31 The AcSB added paragraph 1400.08 to address a concern raised in the February 2003 roundtable discussion, regarding whether it is necessary to evaluate whether appropriate disclosures have been provided when DIFFERENTIAL REPORTING, Section 1300, may allow a qualifying enterprise to omit some disclosures.

OTHER MATTERS

32 The AcSB amended paragraph 1400.02 to clarify that governing provisions set out in statute are not the only ones that need to be considered in making decisions about disclosure in specific situations; governing provisions of other regulations relevant to the entity should also be considered. Respondents supported this amendment. In addition, in response to a respondent's suggestion, the AcSB revised the wording to clarify that disclosure decisions are made in the context of GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, rather than "the minimum standards established by the profession."

33 Paragraph 1400.09 (former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.05) continues to require that financial statements are cross-referenced to any notes and supporting schedules. It has been noted that US GAAP does not require such cross-referencing. However, the AcSB believes that this results in better presentation and has retained this requirement.

34 The AcSB deleted GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.07, that commented on the structure of the remaining CICA Handbook – Accounting requirements — General Matters versus Specific Items — since this paragraph is now out of date. No respondent objected to this deletion.

35 The last sentence of former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.08, read: "To eliminate unnecessary detail it is desirable to express all amounts shown in the financial statements to the nearest dollar or, depending upon the magnitude of the amounts involved, to the nearest thousand dollars." Many entities appropriately express amounts in monetary units greater than thousands of dollars. Therefore, the AcSB deleted this outdated sentence. No respondent objected to this proposal. In addition, the AcSB moved the first two sentences of this paragraph to paragraph 1400.07, without modification.

36 The AcSB clarified the circumstances in which financial statements are prepared on a comparative basis. Former GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.09, stated that comparative information should be shown "when it is meaningful." Paragraphs 1400.12-.13 add the ability to omit comparative information when GAAP specifically allows.

37 No respondent objected to the additional reference to not presenting comparative information when GAAP specifically allows. It was suggested that additional examples be provided when comparative information is not meaningful and that it be made clear that the exception should only arise in rare circumstances. The examples provided are not intended to be an exhaustive list. However, the AcSB agrees that the circumstances are likely to be rare and modified the wording accordingly. The wording of paragraph 1400.12 has also been modified to acknowledge the possibility that a source other than a primary source of GAAP might permit comparative information to be omitted. In such circumstances, however, such permission would only apply to the information presented in accordance with that other source. It would not be used to override a requirement to provide other comparative information in accordance with a primary source of GAAP.

- 38 The AcSB deleted GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1500.11, which required that the basis of valuation for assets should be explicitly stated where not self-evident. Other Accounting Handbook Sections now require this information. No respondent objected to this deletion.
- 39 A few respondents suggested that paragraph 1400.14 that deals with pledged assets, be moved to another Accounting Handbook Section. However, the AcSB could not identify a more-appropriate location for this paragraph in an existing Section and has therefore chosen to retain it in Section 1400 on the grounds that CICA Handbook – Accounting users are familiar with its existing location.

CONSEQUENTIAL AMENDMENTS

- 40 As a consequence of the proposed changes, amendments were made to certain other parts of the CICA Handbook – Accounting. Accounting Handbook Revisions Release No. 24 dated July 2003 provides these consequential amendments, including related explanations.
- 41 The AcSB only considered the necessary changes to the Introduction to Accounting Recommendations and to the Introduction to Accounting Guidelines that result directly from the issuance of GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, and GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, Section 1400. The AcSB will perform a more fundamental review of these Introductions as part of its Accounting Standards Improvements project.

CONSISTENCY WITH US AND INTERNATIONAL REQUIREMENTS

- 42 In developing this Section, the AcSB has taken into account the hierarchy of US GAAP, as set out in the AICPA's Statement on Auditing Standards No. 69 (SAS 69), as well as the IASB's International Financial Reporting Standards. The AcSB believes that this Section is not in conflict with the requirements of SAS 69 or the International Financial Reporting Standards.

Footnotes

1. Generally Accepted Accounting Principles, Exposure Draft, Accounting Standards Board, July 2001.
2. Generally Accepted Accounting Principles, Re-exposure Draft, Accounting Standards Board, September 2002.
3. Auditing guidance is not part of the hierarchy of US accounting standards and guidance. However, because the hierarchy of US accounting standards is established as part of the auditing guidance, and the Securities and Exchange Commission (SEC) and AICPA ethics codes both require auditors to follow that guidance, the effect is essentially the same as if it were part of US GAAP.
4. See IASB Exposure Draft, "Proposed Improvements to International Accounting Standards," May 2002. In November 2002, the IASB tentatively agreed to retain this approach.

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