Critical Perspectives on the Implementation of IFRS in Canada

Michel Blanchette , Université du Québec en Outaouais (Canada),
email : michel.blanchette@uqo.ca
Aurélie Desfleurs, Université de Sherbrooke (Canada),
email : aurelie.desfleurs@usherbrooke.ca

ABSTRACT

This paper gives a critical perspective on the implementation of International Financial Reporting Standards (IFRS) in Canada and discusses the degree of change that it represents. The foundations of accounting standards are analyzed in relation to evidence from countries already using IFRS. The transformation is mainly not substantial except for fair value accounting and consolidation.

KEYWORDS

IFRS, principles-based, fair value, implementation, earnings management, Canada.

1. INTRODUCTION

Accounting standards are on the spot. The rise of *International Financial Reporting Standards*, known as IFRS, is impressive. Since 2001, over 100 countries have required or permitted their use, including the European Union. Canada is committed to switch in 2011 for listed companies. The objective of this paper is to give a critical perspective on the implementation of IFRS in Canada and to look at supporting and dissenting literature on the issue. It discusses pros and cons of IFRS, in relation to *Canadian Generally Accepted Accounting Principles* (GAAP), trying to see whether their implementation is a cosmetic change or a substantial transformation of Canadian accounting practice.

We commence our analysis by reviewing the principal characteristics of standards setting in Canada and why Canadian GAAP needs a change. One of the principal strengths of Canadian GAAP is to be a principles-based accounting system, which tends to avoid numerical guidelines and extensive implementation guidance, preferring to place much more reliance on judgment. Unfortunately, in practice, it opens the door to earnings management and income smoothing. Along with the fact that Canada is very small on the international markets in a context marked by a growing search of harmonization, it has jeopardized the comparability of Canadian-made financial statements in such a way that a change has become necessary.

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We follow our analysis by examining the expected benefits of implementing IFRS. We review the economic rationales offered for convergence towards an internationally accepted set of accounting standards, more precisely three desirable characteristics of IFRS: quality, transparency and, above all, comparability, without forgetting the cost-savings of not duplicating the standard-setting process.

A review of the extant literature on IFRS calls us to question the potential threats that may come along with the implementation of new accounting standards. They are not easy to observe and future research will tell how dramatic they are. But it is important to address them as soon as possible, because it may be extremely difficult and complicated to step back from IFRS once adopted. The threats associated with governance, subjectivity, regional fit, enforcement and alternative sets of standards are discussed.

Alali and Cao (2010) identify several sources of political influences from public authorities and interest groups that may affect the IFRS standard-setting process. We thus question the independence and the funding of the *International Accounting Standard Board* (IASB), the private sector organization (instead of a public organization) in charge of international standard setting. The IASB seems influenced by the big-4 accounting firms, directly or indirectly.

Moreover, IFRSs can be criticized for the subjectivity they imply. They allow choosing between several accounting options, and the application of these choices often requires estimates. It offers the opportunity of managing earnings. Many authors (JeanJean and Stolowy, 2008; Rosen, 2008) seem sceptical as to the capability of IFRS to confine earnings management to a reasonable level.

One expected benefit of IFRSs is to provide better comparability assuming they are known and understood by users of financial statements. A domestic accounting system reflects many distinctive regional habits and cultures. We then question whether comparability is unanimously desirable and whether the loss of regional fit in the name of uniformity represents another threat associated with IFRS implementation. This lack of regional fit may also have negative effects on the uniformity of IFRS application. Some studies (Tsakumis et al., 2009) observe different interpretations from country to country for some selected IFRS rules.

Last but not least, literature states that enforcement is a key factor to ensure uniformity in the application of a set of rules like IFRS (Alali and Cao, 2010, p. 84). The IASB has unfortunately no enforcement mechanism for its standards.

For Canada, is this change of accounting system just cosmetic or does it represent a substantial transformation? To answer that question, we examine the basis of IFRS and Canadian GAAP conceptual frameworks. We reach the conclusion that most differences between Canadian GAAP and IFRS are not a substantial transformation to the fundamental conceptual framework, except for fair value accounting and the entity theory in consolidation. This does not preclude significant differences to happen in the end result of accounting practice, but it will be in the details of application rather than the fundamental underlying concepts. The most important difference is the use of fair value accounting. That represents a real challenge, even if Canadian GAAP was already heading towards more fair value measurements.

The remainder of the paper proceeds in the following manner. In section 2, we look at the characteristics of Canadian GAAP that may call for a change. In sections 3 and 4, we discuss the expected benefits and potential threats coming along with IFRS. The section 5 examines whether the shift to IFRS is a cosmetic change or a substantial transformation, on the grounds of their conceptual characteristics. Section 6 concludes.

2. WHY CANADIAN GAAP NEEDS A CHANGE?

In Canada, financial reporting requirements were laid down in federal and provincial corporations' acts until 1946, when the *Committee on Accounting and Auditing Research* of the *Canadian Institute of Chartered Accountants* (CICA) began to publish bulletins on financial accounting issues in order to guide Canadian accountants. These bulletins were then structured and formalized in the *CICA Handbook* in 1968, which became over time the authoritative statement of Canadian GAAP.

Until recently, Canadian GAAP was strongly influenced by U.S. GAAP (AcSB, 2004, para.14), but it all changed in 2006 when it was decided that IFRS would take over in 2011, at least for "publicly accountable" enterprises (AcSB, 2006). In this section, we look at the character of Canadian GAAP and the reasons why it needs to be changed.

2.1 Character of Canadian GAAP - A history of smoothing methods

Historically, Canadian GAAP has built quite a good reputation with a well-respected standard setting process.[i] An alleged strength of Canadian GAAP is that it is considered *principles-based* as opposed to *rules-based* (Webster and Thornton, 2005; Hines, 2004).

Principles-based systems refer to fundamental understandings and rely on judgment in the application. They keep considerable ambiguity, provide many choices, and are driven by openness and flexibility (Carmona and Trombetta, 2008, p. 457). Rules-based systems are generally more detailed and include specific criteria, 'bright line' thresholds, examples, scope restrictions, exceptions, subsequent precedents and implementation guidance (Nelson, 2003, p. 91). The distinction is not always clear and some argue that many actual sets of rules are a mix of both systems. While Canadian standards rely predominantly on principles, they also contain a certain level of detailed rules (Chlala and Fortin, 2005).

A principles-based approach, as in Canada, may be desirable in theory, because it enables accountants and auditors to refer to principles for guidance, but, in practice, it opens the door to *earnings management* and *income smoothing*. Earnings management "occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (Healy and Wahlen, 1999, p. 368). Income smoothing reduces the volatility of accounting profits after applying accounting practices. It may be a form of earnings management or a consequence of accounting standards.

For years, Canadian GAAP has provided companies with a wide range of accounting standards adapted to the Canadian reality. Special accounting rules have been developed for particular industries such as natural resources and mining, banks and not-for-profit organisations, or for specific types of transactions such as research and development, long-term contracts and foreign currency translation. See Table 1 next page for a selection of these rules.

One common point of many Canadian practices is that they smooth accounting income. For example, when a company capitalizes some development costs, it spreads out the expenses over the period that they are amortized. Many other areas of Canadian GAAPs have also allowed income smoothing in the past with depreciation, amortization or depletion. The straight-line method has been all over the place in Canadian GAAP and applied to fixed assets, intangible assets, goodwill (amortization over a period not exceeding 40 years until 2001), deferred charges, pension plans, capital leases and foreign currency translation.

Another area where the Canadian *principles-based* approach allows income smoothing or earnings management is revenue recognition. When revenues are based on estimates of percentage-of-completion for long-term contracts, there is a lot of uncertainty or margin of error in the accounting figures. Managers can use this margin of error to recognize revenues faster or slower according to their objectives (as long as they stay within acceptable means of the standards). Moreover, two methods (*percentage-of-completion* and *completed-contract*) are accepted by Canadian GAAP.

Table 1: Selected rules of Canadian GAAP adapted to the Canadian reality

Industry or type of transactions	**Special accounting rules (selected references in the *CICA Handbook*)**
Abnormal gains/losses	Separate presentation of *extraordinary* items (Standard 3480 Extraordinary Items)
Banks and lenders	Instructions for recognizing and measuring *write-offs and impairment* of loans (Standard 3025 Impaired Loans)
Entities subject to rate regulation	Recognition of *regulatory assets or liabilities* (Accounting Guideline AcG-19 “disclosures by entities subject to rate regulation”)
Foreign currency translation	*Amortization of exchange gains and losses* when using the temporal method, and optional *hedge accounting* (Former Standard 1650 Foreign Currency Translation, replaced by 1651 in 2005; Standard 3865 Hedges)
Leases	Capitalization possible when some criteria are met (Standard 3065 Leases)
Life insurance companies	*Actuarial liabilities* and *smoothing of gains and losses* on investments (Former Standard 4210 Life Insurance Enterprises – Specific Items, replaced by 4211 in 2005)
Long-lived assets	Straight-line *depreciation* (Former Standard 3060 Capital Assets, replaced by 3061 and 3062 in 2001, and 3064 in 2008; former Standard 3070 Deferred Charges, abolished in 2005)
Long-term contracts	Two methods available: *completed-contract* and *percentage-of-completion* (Standard 3400 Revenue)
Natural resources and mining sector	Two methods available: *full cost accounting* and *successful efforts method* (AcG-5 "full cost accounting in the oil and gas industry"; AcG-16 "oil and gas accounting - full cost")
Not-for-profit organisations	Two methods possible: *deferral method* and *restricted fund method* (Standard 4410 Contributions – Revenue Recognition)
Pension plans	Recognition of *liability* for defined benefit plans (Former Standard 3460 Pension costs and Obligations, replaced by 3461 in 1999; Standard 4100 Pension Plans)
Research and development	Possible *capitalization* of development costs (Former Standard 3450 Research and Development Costs, replaced by 3062 in 2001 and 3064 in 2008)

One critical Canadian-specific practice illustrates well the income-smoothing character of Canadian GAAP: the treatment of foreign exchange gains and losses when using the temporal method. This unique Canadian-made rule on foreign currency translation smoothed income by amortizing foreign exchange gains and losses over the life of the underlying monetary items. Although abolished in 2001, it departed from the international practice which requires to allocate immediately to the income statement all foreign exchange gains and losses (IAS 21). The accounting effect was beloved by Canadian managers as earnings volatility was greatly reduced. And it is well-known that many Canadian companies are highly sensitive to foreign exchange volatility, particularly with the U.S. dollar. But this treatment also required deferred gains and losses to be presented as assets and liabilities, whereas there is no theoretical basis that justifies such items on the balance sheet. Still in the area of foreign currency translation, Canadian GAAP allowed very loose hedging practices until 2006. Since then, the rules have been severely tightened along with international convergence.

One particular Canadian GAAP allows the presentation of extraordinary items in the income statement. The rule is used to measure and reclassify some gains and losses considered abnormal in a special separate category called "extraordinary". This looks pretty fair in theory, but it is a very convenient tool allowing the shift of operating expenses into seemingly abnormal losses in practice, as long as the criteria are deemed to be met. This is the well-known *big-bath*, particularly useful in periods of negative results, such as in a financial crisis. It is an earnings management tool for exaggerating financial losses in one year (cleaning-up the balance sheet) to take advantage of higher accounting profits in subsequent years due to the reduced depreciation expense. And, should we not forget, in a principles-based world, where judgment is highly used to calculate the figures! All good things, it seems, for Canadian managers, but certainly contributing to the Canadian history of smoothing methods.

Another critic can be addressed to standard-setting in Canada. Some ethical issues could be raised because of the perhaps too important influence of the accounting profession on the national standard-setting. The same professional organization (CICA) heads a standard setting body (*Accounting Standards Board* or AcSB) and the discipline-enforcing body. As mentioned by Scott (2009, p. 492), "[t]his creates at least the appearance of a moral hazard problem, since the body responsible for financial accounting standards is associated through the professional organization with the body responsible for enforcement".

2.2 Lack of comparability

Canadian GAAP is adapted to the needs and reality of Canadian companies (CGA-Canada, 1999, p. 8). This has been possible because they are monitored by the CICA. But, on the other hand, the history of smoothing methods, along with the fact that Canada is very small on the international markets (Task Force, 2006, Vol. 1, p. 17), has jeopardized the comparability of Canadian-made financial statements in such a way that a change has become necessary.

As capital markets become more integrated worldwide, Canadian investors are increasingly investing in firms in foreign countries, whose culture, institutions and accounting standards differ. Concurrently, direct foreign investment in Canada has been rapidly growing because no restriction is put on the repatriation of capital or profit by foreign investors. It is very costly for investors to familiarize with more than one set of GAAP. Complying with different reporting requirements increases the cost of capital for firms raising funds outside Canada. A common financial reporting "language" would then be useful.

2.3 In search of harmonization

Prior to IFRS, the focus of harmonization was on U.S. GAAP in Canada (AcSB, 2004). However, with the increasing globalization of securities markets, the need for international accounting standards has expanded. That is why the IASB and the *Financial Accounting Standards Board* (FASB), the American standard setting organization, have agreed, since 2002, to create a global standard-setting partnership to develop a single set of high quality, globally accepted accounting standards. Had Canada continued with a strategy of U.S. GAAP harmonization, it would have continued to import more and more of the rules embedded in U.S. standards. It would then be faced with the possible consequence of having to replace them again with other standards as global convergence continues. That is why, in March 2006, after extensive consultation, the AcSB announced its decision to shift convergence towards IFRS. It was a practical possibility because of the many similarities of approach and specific content between Canadian GAAP and IFRS. As stated by the CICA (CICA, 2009, p. 1), "[n]ot only will the adoption of IFRSs improve the clarity and comparability of financial information globally, it will also prove more efficient and cost effective by eliminating the need for reconciliations of information reported under different national standards".

So let's look now at what IFRS can provide but not Canadian GAAP.

3. WHY REPLACE CANADIAN GAAP BY IFRS?

In this section, we discuss the expected benefits of implementing IFRS. According to IASB and the accounting literature, the most desirable characteristics of IFRSs should be their high quality, transparency and, above all, comparability. Other benefits include their impact on financial markets and the cost-savings of not duplicating the standard-setting process.

3.1 High quality standards

It is not clear what "high quality standards" means, because it depends on financial statements' users. Indications of high quality for one user may be considered low quality for another one. The notion of high quality is often discussed in terms of relevance and reliability, but according to Ball (2006, p. 9), these concepts are not very useful, because they are often not well defined. Instead, Ball interprets the notion of financial reporting quality in the following terms: "high quality requires an accurate depiction of economic reality [...], low capacity for managerial manipulation, timeliness [...], and asymmetric timeliness" which is a form of conservatism (timelier incorporation of bad news, relative to good news, in the financial statements). IFRS may help in satisfying such conditions, but empirical research has not yet provided clear evidence of their higher quality over other standards.

IFRS gives indeed priority to "substance over form" and favours the use of fair value accounting instead of historical cost accounting. To depict economic reality in a timeliness manner, it is necessary to rely on managerial judgment and methods based on the principle of "substance over form". This principle does enable an accountant or an auditor to look at the substance of a transaction to record it, even if it does not meet any one of the guideline criteria (Beechy, 2005, p.197). This happens when estimating fair value but also in many situations, such as when applying capital lease accounting, hedge accounting, consolidation techniques, and revenue recognition criteria. Under the rules-based U.S. standards for example, it would not be permitted: if any one of the criteria given by a U.S. rule is satisfied, the transaction must be recorded such as prescribed by the standard, in spite of the substance of the transaction. As for fair value accounting, it would have several advantages: more relevant value for investors (Cormier, 2009, p. 5); little recognition lag since changes in economic value are recognized as they occur (Scott, 2009, p. 42); less reliance on arbitrary depreciation estimates as there is no depreciation of long-lived assets when they are measured at fair value (Lefebvre et al., 2009, p. 18). The opportunity to capitalize R&D under IFRS could also result in more value relevant earnings (Van der Meulen et al., 2007).

It is not easy to evaluate accounting quality, but one thing is sure, it requires a strong and efficient standard-setting process. In that regard, the IASB seems to have good objectives and due process in theory, but what about in practice? The issues of governance and subjectivity in the application of IFRS will be discussed in the further section on potential threats coming with IFRS. But for now, let's discuss two of the main alleged qualities of IFRS: transparency and comparability.

3.2 Transparency

Transparency, as pursued by IASB, means that all the information about the financial condition, performance and risk-factors of an entity should be recorded or at least disclosed in the notes (Chiapello, 2005). In that regard, IFRS requires a large amount of information describing transactions and financial positions, explaining accounting policies/methods and providing extensive details on particular situations affecting the entity. Full disclosure and decision usefulness are implications of securities market efficiency: if market is efficient, investors should use all available information in financial statements and notes as they strive to improve their predictions of future return.

IFRS generally requires more disclosure than Canadian GAAP (Deloitte, 2009). For example, IFRS 7 requires extensive disclosures (quantitative and qualitative) on financial risks, including those emanating from liquidity, credit, foreign exchange and interest rate movements. Moreover, a lot of elements that are usually found in the *Management's Discussion and Analysis* of annual reports are disclosed in the financial statements under IFRS.

This is not simple for users of financial statements in practice. It is now common that financial statements under IFRS comprise 50 pages and more (Forgeas, 2010). One consequence is that financial reports get overload with large amounts of complex financial information and in numerous presentation formats. The issue here is to find the right balance between full disclosure and reasonableness of reporting.

3.3 Comparability

Financial statements based on a single set of standards should allow better comparisons as long as the standards are understandable, do not permit too many choices and uncertain estimates, and are applied uniformly. If IFRS reporting is applied uniformly, it is less costly for investors to compare firms across markets and countries (JeanJean and Stolowy, 2008). Regulators, such as stock exchanges, may also reduce their monitoring costs if information is more uniform and comparable (Ampofo and Sellani, 2005).

The use of IFRSs as the primary accounting standards by domestic companies is now widely spread. Since 2001, over 100 countries have required or permitted the use of IFRSs (IASB and IASCF, 2009). As the number of IFRS' users increases, the comparability of their financial statements should be enhanced. But what is the real status of IFRS utilization around the world? And to what degree is it applied in practice (fully applied as issued by IASB vs. applied with amendments)?

Number of IFRS' users

According to Deloitte Touche Tohmatsu (2010) in a survey available from the Web, 91 jurisdictions require the use of IFRS by all listed companies and 25 by all unlisted. The numbers increase to 123 and 95 respectively when the jurisdictions considered as using IFRS include those requiring them from only some entities (not all) and those permitting (as opposed to requiring) them. The numbers seem high, but how do we know if the IFRS' users apply the "full" IFRS (as issued by the IASB) or some amended version?

The survey also gives a classification of the types of audit reports provided by the listed companies using IFRSs: from the total of 123 jurisdictions where listed companies use IFRSs, there are 89 for which the audit reports refer to conformity with IFRSs, 30 to conformity with IFRSs as adopted by the European Union, and 4 to conformity with local GAAP or other IFRS-related GAAP. There is a need to investigate further the degree of utilization of IFRS or the like.

Degree of utilisation of IFRS

A survey by Nobes and Zeff (2008) identifies where IFRS, as issued by IASB, is required, or where some local or amended version of IFRS is required. The authors find that direct application of IFRS as issued by IASB is required in only one major capital market: South Africa. Elsewhere, IFRS is incorporated in national GAAP (involving delays and time lags), is in a process of convergence (e.g. China), or is accompanied by amendments (e.g. European Union).

Nobes and Zeff (2008) also investigate the auditors' affirmations of compliance with IFRS in the five largest stock markets where required in 2005-2006: Australia, France, Germany, Spain and the United Kingdom. They find that the audit reports of all 255 listed companies of their sample refer to a version of IFRS or to local GAAP. In 22 cases (8.6% of the sample), there is dual reporting, which means that a second auditor's affirmation is provided, stating that full IFRS (as issued by IASB) is followed.

Overall, IFRS is widely used and the trend is accelerating. IFRS is currently the most likely set of rules to use in order to gain comparability internationally. But the full application of IFRS *as issued by*

IASB is small at the moment. For now, many countries have adopted a *version* of IFRS, so that it is not the current full IFRS as issued by IASB. Moreover, Kvaal and Nobes (2010) observe significant evidence that pre-IFRS national practice continues where allowed within IFRS and document formally that there are different national versions of IFRS practice.

The next section looks at the potential benefits of IFRS from a market perspective.

3.4 Capital market effects

Financial statements are one of the most important pieces of information in the decision-making process of many stakeholders, including investors and lenders. Since financial statements are prepared in accordance with accounting standards, better standards should lead to a better allocation of economic resources, and therefore reduce the cost of capital of firms and increase liquidity on the market, where markets are efficient.

One way of assessing the value-added of IFRS is to look at the impact of IFRS adoption on financial markets. If markets are efficient, they should adjust continually to new information about IFRS adoption. Daske et al. (2008) test the effect of IFRS adoption on stock prices and market liquidity. Their sample contains more than 3 000 firms from 26 countries (Europe, Asia, Africa, and Australia) between 2001 and 2005 that were mandated to adopt IFRS. They observe that market liquidity increases on average by about 3% to 6% in comparison to the levels prior to IFRS adoption. They also note a decrease in firms' cost of capital and an increase in equity valuations, but only when accounting for the possibility that the effects occur prior to the official adoption date. Markets seem anticipating positively the economic consequences of IFRS adoption, which is consistent with Armstrong et al. (2010) who find that events increasing the likelihood of IFRS adoption are accompanied by stock price increases (and vice versa).

3.5 Cost-benefit

Setting accounting standards requires high technical skills and a solid organization to sustain and support the work. Transactions in the new economy have become increasingly complex and hard to follow (derivatives, variable interest entities, stock-based compensation plans, etc.). Intuitively, it makes sense to believe that it should be much cheaper to maintain one full standard-setting process as opposed to duplicating it several times. But the challenge is to consider all the benefits and all the costs, not only the direct savings on the cost of maintaining a standard setting process. In the next section, we look at some of these indirect costs by discussing potential threats that come with IFRS.

4. POTENTIAL THREATS COMING WITH IFRS

A number of threats come along with IFRS. They are not easy to observe and future research will tell how dramatic they are. But it is important to address them as soon as possible, because it may be extremely difficult and complicated to step back from IFRS once adopted. The threats associated with governance, subjectivity, regional fit, enforcement and alternative sets of standards are discussed.

4.1 Governance of the IFRS standard setting process

Just a change of influence?

Before the ascendancy of IFRS in recent years, U.S. standards dominated international accounting and particularly the Canadian standards development. The decision of Canada, in 2006, to redirect its accounting development towards IFRS instead of U.S. standards has revealed the drop in influence of the U.S. on the international scene.

Some view the worldwide convergence towards IFRS positively as it prevents international accounting from the single influence of one major standard-setter: the FASB (Chiapello, 2005). On the other hand, IFRS may just be a shift of political influences. IFRS is developed by the IASB, in theory an independent standard-setting body, not-for-profit oriented, and accountable to the public interest. But in practice, there is a lot of politics involved and many questions can be raised about governance and funding of the IFRS standard setting process.

What about IASB's independence?

The IASB is responsible for the development of IFRS. Alali and Cao (2010) identify several sources of political influences from public authorities and interest groups that may have affected the IASB's rule setting: influence from the European Union, the U.S., the U.K. and China, but also from market authorities such as the *International Organization of Securities Commissions* (IOSCO) or the *U.S. Securities and Exchange Commission* (SEC). Moreover, the big-4 accounting firms are very influent, directly or indirectly. Chua and Taylor (2008) suggest that "[t]he desire by the Anglo-American accounting and audit industry to retain control over the international accounting standard-setting process might explain how a private sector organization (i.e. the IASB) came to own this process", instead of a public organization.

The funding of IFRS is also a concern (AICPA, 2009). The *IASC Foundation*[ii] mentions that "[t]he funding burden should be shared by the major economies of the world on a proportionate basis, using GDP as the key determining factor of measurement" (IASCF, 2009). Alali and Cao (2010) underline that 19 different countries are funding the IASB and countries with large GDP and large contributions may use their contributions to influence the IASB.

Is there enough outside influences acting on the process?

As the utilization of IFRS increases, there are less and less alternative accounting models available. According to Ball (2006, p. 22), it could reduce competition among alternative financial reporting systems, and hence reduce innovation, with a risk that the IASB becomes a politicised, polarised, bureaucratic, UN-style body. The IASB and its constituents are becoming a larger group. For Haswell (2006), the IASB is subject to bureaucratic pressures and these can only increase as the IASB increases in size, power and prestige. The issue of governance is far from being resolved and it is a critical one for the IFRS to evolve independently and neutrally.

4.2 Subjectivity in the application of IFRS

Accounting involves subjectivity in two main situations. One is when several accounting methods are eligible for one type of transaction, because a subjective choice could be made by firm's management between the methods. The other one is when the application of a rule requires (subjective) estimates (e.g. provision for bad debts, duration of fixed assets, provision for guarantees). IFRS is subject to these two situations that open the door to earnings management. Many authors are sceptical as to the capability of IFRS to confine earnings management to a reasonable level.

Choices of accounting methods in practice

IFRS enables several accounting methods in numerous cases (e.g. straight-line or accelerated depreciation for fixed assets; valuation methods for inventory with first-in-first-out, weighted average or other; historical cost or fair value for selected assets and liabilities; optional use of hedge accounting for eligible hedging transactions, etc.). A survey by KPMG and Keitz (2006) provides statistics on choices made in practice by firms from 16 countries (Europe, South Africa and Hong Kong) in areas where IFRS allows choosing between several options. They find that choices vary a lot between firms for some subjects, such as the accounting for jointly controlled entities, but it is not always the case for fair value accounting. In particular, while the fair value option is often used for investment properties and financial instruments (30% of the time or more), it is rarely used for property, plant and equipment (only 2% of the sample) and never for intangibles.

The fair value option is available for recording many assets and liabilities in balance sheets. This is a departure from the traditional historical cost which is viewed as more objective, neutral and verifiable. Fair value can be objective, neutral and verifiable to a certain extent as well, when it is based on asset price observed on an active market. But it relies heavily on (subjective) management estimates when there is no market or when the market is considered inactive. Market value may not be appropriate if market is not efficient (Biondi and Suzuki, 2007). In these cases, fair value is a *subjective* concept, difficult to measure adequately.

Evidence of earnings management

Earnings management occurs when managers apply discretion in preparing accounting information. This is done by choosing accounting methods or making estimates. For Rosen (2008), "[u]nder IFRS, management will be expected to make a flurry of accounting assumptions within broad acceptable ranges that will directly impact their own bonus".

Barth et al. (2008) look at accounting figures to find evidence of earnings management. They compare the volatility of profit (net income), cash flows and accruals for firms from 21 countries that voluntarily adopted IFRS between 1994 and 2003 vs. other firms applying domestic standards (non-U.S.). The intuition is that earnings management should be reduced for companies applying IFRS if IFRS is better. Their results show less earnings management for firms applying IFRS.
Christensen et al. (2008) also look at earnings management based on volatility of earnings, cash flows and accruals. They compare the degree of earnings management by German firms that voluntarily adopted IFRS before 2005 (firms that perceive net benefits of doing so) and by firms that were forced to comply in 2005 (firms that perceive no net benefits of doing so). They find that earnings management has decreased after IFRS adoption for voluntary adopters but not for forced adopters in 2005. This result casts doubts as to the origin of earnings management. Is it the set of standards or the incentives of voluntary adopters that drives earnings quality?

JeanJean and Stolowy (2008) analyze the distribution of earnings to see whether companies from Australia, France and the U.K. manage earnings to avoid losses any less after the implementation of IFRS. They find that the degree of earnings management remains stable in Australia and the U.K. after the adoption of IFRS in 2005, while it increases in France. It is worth noting here that France is a code-law country while Australia and the U.K. are common-law. Ball (2006) notes that financial reporting practices in common-law countries are considerably more sensitive to earnings and timelier loss recognition than in code-law countries and East Asia. He questions the capability of a set of rules based on a common-law view (i.e. IFRS) to change the financial reporting practice in countries with different political and economic environments.

Overall, there are mixed results in the literature as to the impact of IFRS on earnings management. Earnings management associated to IFRS adoption may be due to other factors or incentives than the quality of the standards themselves. One of these factors is the level of enforcement in place. Further research is required to conclude on the impact of IFRS on earnings management practice.

4.3 Lack of regional fit

One expected benefit of IFRSs is to provide better comparability assuming they are known and understood by users of financial statements. But is comparability unanimously desirable? Could it be desirable that accounting conveys regional and cultural differences? For some authors, there is one "true and fair" economic reality and there should be only one accounting to reflect it (Rodrigues and Craig, 2007). But it is not clear that the role of accounting is so much straight forward. Nations live and work differently; they use financial information in various perspectives. Common-law countries are more market-oriented while code-law respond primarily to government needs (Ball et al., 2000).
There are many factors that reflect regional habits and cultures. Local economic and political forces determine how managers, auditors, analysts, rating agencies and other parties influence the implementation of accounting standards (Ball, 2006). A single set of standards cannot reflect them all.

So choices have to be made and it looks like the market-oriented approach (common-law) is presently pursued in IFRS. So one threat coming with IFRS is the loss of regional fit in the name of uniformity, and it may affect more code-law countries, such as France (Chiapello, 2005). Moreover, this lack of regional fit may have negative effects on the uniformity of IFRS application. For Tsakumis et al. (2009), "wherever professional judgment is required, national culture plays a significant role in how accountants interpret and apply IFRS. Culture is a pervasive environmental factor that can lead to inconsistent interpretation and application of converged financial reporting standards. This is troublesome because different judgments could lead to significant differences in financial statements. These differences could severely impact the comparability of financial statements across countries."

Furthermore, since IFRS is primarily developed in English, the interpretation by non-English speaking people may be a problem (Larson and Street, 2004). Some studies (Tsakumis et al., 2009 for example) have investigated this issue and found different interpretations for some selected IFRS rules. Non-English speaking nations may be at a disadvantage in interpreting and using IFRS.

4.4 Uneven application because of uneven enforcement

Literature states that enforcement is a key factor to ensure uniformity in the application of a set of rules like IFRS (Alali and Cao, 2010, p. 84). Under its constitution, the IASB is only a standard-setter without enforcement mechanism for its standards. It cannot require the enforcement of IFRSs in practice. Uneven enforcement may be an opportunity, for some organisations, to use the "brand name" of IFRS. This may affect the reputation of IFRS and its image of high-quality, after the misuse of companies enjoying a weak enforcement environment.

4.5 Necessity of alternative sets of standards

Supposing that IFRS could provide a universal common language for financial reporting of listed companies, the reality is that alternative sets of standards may still need to coexist for other companies. Several sets of standards are actually used in countries applying IFRS. There are separate sets of rules for unlisted companies in general (such as the one adopted by the IASB itself (IASB, 2009) and the one in Canada (AcSB, 2009)), for unconsolidated financial statements (like in France and China), for companies choosing not to apply IFRS when it is permitted, for companies located in countries applying amended versions of IFRS or applying national GAAP based on IFRS but with time lags.

The convergence towards IFRS is definitely on the go, but we still observe a lot of diversity and alternative sets of standards. Who knows if that situation is going to change? At least, we can expect several sets of accounting standards to keep on for many years to come.

> The next section addresses a fundamental question about the implementation of IFRS in Canada: is it just a cosmetic change or does it represent a substantial transformation?

5. IS THIS A COSMETIC CHANGE OR A SUBSTANTIAL TRANSFORMATION OF CANADIAN ACCOUNTING STANDARDS?

In this section, we try to get a sense of the impact of the transition towards IFRS that takes place in Canada on the grounds of underlying logic and concepts.

5.1 Conceptual framework: principles-based vs. rules-based

IFRS and Canadian GAAP include a conceptual framework relying on the same approach. Both sets of standards are considered "principles-based", although there is some debate about it, and this is one of the reasons why Canada has chosen to converge to IFRS. The main accounting principles (historical cost, substance over form, revenue recognition, matching, conservatism, going concern, consistency) are generally similar in IFRS and Canadian GAAP (CICA, 2009, p. 3; AcSB, 2008, p. 1), notwithstanding the fair value discussed below.

In spite of similarities, some difference can be observed between the IASB and the CICA conceptual frameworks, especially about the users of financial statements.

5.2 Conceptual framework: users of financial statements

Major accounting standard-setting bodies have adopted the decision usefulness approach in their conceptual framework. Under this approach, accounting is a communication tool designed to help in the decision-making of users. In order to serve the users, financial statements need to have some desirable characteristics, such as reliability, relevance and timeliness. There are many users of financial statements, including managers, shareholders, investors, lenders, governments, employees, suppliers, customers and the public, but they don't have the same needs. For example, investors need timely information about market values in order to evaluate the return on their investments while governments prefer historical data on expenditures and revenues for fiscal reasons. That is why standard-setting bodies must clearly identify for which users financial statements are primarily prepared for.

In Canadian GAAP, the priority is on investors and creditors (*CICA Handbook*, Standard 1000, para. 11), but in IFRS, the priority is focused on investors (IASB, 2001, para. 10). Chua and Taylor (2008, p. 471) underline that "IFRS are clearly grounded in a strong emphasis on investor protection". Capital markets and investors are privileged in the development of IFRS, and one significant consequence is that fair value is much more used than in Canadian GAAP.

5.3 Fair value accounting

In IFRS, many items can be re-valued at fair value, up or down, notably for property, plant and equipment, financial instruments, investment property, intangibles and biological assets. Although many revaluations are optional, this is a major shift from historical cost. The fair-value measurement is also applied in several situations and transactions, such as non-monetary government grants, share-based payments, provisions and minority interest at initial recognition.

The main advantage of fair value accounting is that it should better reflect economic reality on the market, which is presumably good for investors but not necessarily for other users. But is this consistent with the boundaries of accounting recognition?

Impact of fair value accounting on the boundaries of accounting recognition

Traditionally, changes in assets/liabilities are recognized when transactions are completed. The fair value measurement in IFRS allows recognizing changes in assets/liabilities when there is a commitment, before the transaction is completed. Walton (2006, p. 339) states that "[t]he contention set out here is that the recognition of a transaction earlier in its cycle, by simulating a realisation, enlarges the scope of what is recognised in financial statements, and thereby expands the boundaries of the statements from that previously accepted".

Reliability vs. Relevance

Two major conflicting qualities of accounting information are reliability and relevance. Reliability refers to objective, neutral and verifiable information. This is best served by historical cost accounting, because the cost of an asset or liability for a firm is usually a clearly identifiable, measurable and verifiable number. Relevance refers to the usefulness of information for decision-making, so it depends on the type of decisions being made. When investors are considered the most important users, such as in IFRS, financial statement information is relevant when it gives information about the firm's future economic prospect. Relevance is then best served by a current value measurement such as fair value.

Fair value accounting in IFRS has transformed the fundamental source of accounting data from verifiable facts to quality of estimates (Chiapello, 2005). It is argued that fair value can be reasonably estimated when market is efficient and liquid, but it is not as clear when there is no market or when it is not considered active. In such cases, estimating fair value depends on a number of suppositions including cash flow forecasts, discounting rates, and other parameters. So the boundary of accounting measurement is extended when applying fair value accounting.

Revenue recognition and matching principle

Fair value accounting is also changing the boundary of revenue recognition (Chiapello, 2005). Under historical cost accounting, the logic of revenue recognition is based on an income statement approach: revenues are generally recognized when goods or services are actually delivered and at the amount being billed. Net income is the result of matching in the right year realized revenues with the costs of earning those revenues.

With fair value, IFRS adopts a balance-sheet approach. Revenue is recognized when a change in value (gain or loss) occurs. It implies an early revenue recognition, depending on the difference between values at two balance sheet dates, as opposed to matching items in the right year.

Going concern assumption

Another impact of fair value accounting on the boundaries of accounting principles is regarding the going concern assumption. When fair value is used, it is closer to a liquidating assumption than a going concern one, because all assets and liabilities are evaluated at the market price, as if the firm were being liquidated (Biondi and Suzuki, 2007).

Understandability

An important desired quality of IFRS is understandability, or its potential "to be readily understandable by users" (IASB, 2001). This is challenged and hardly compromised by fair value accounting. In fact, fair value accounting requires the recognition of unrealized gains and losses. But recognizing such unrealized items in the income statement involves volatility of profit. That is why accounting standard-setters have allowed some unrealised gains/losses to bypass the income statement by allocating them directly to equity. The equity section has been enlarged by including a new category of information called "other comprehensive income" (OCI).

A new statement has been created to show the global performance of organisations and it includes profit from the income statement plus the annual variation of OCI. It is named "statement of comprehensive income".[iii] It should be noted that unrealised gains and losses are transferred from OCI to income statement upon realisation of underlying items. So the reconciliation of equity is now much more complex to follow by users and accounting figures on profitability are presented at two places: in the income statement and in the statement of comprehensive income. It will take time before the financial community digests this information.[iv]

Conservatism

Under Canadian GAAP, most assets in the balance sheet are written-down when their fair value goes down. It is the case for inventory, fixed assets, intangibles, financial instruments and even accounts receivable through the provision for bad debts. In IFRS, assets can also be written-down, but the method for calculating the loss is not the same and IFRS allows write-ups to the extent that they reverse prior write-downs. These differences do not change the fundamental principle that accounting figures should be based on conservative figures. Canadian GAAP is just somehow less conservative in identifying and measuring write-downs while, at the same time, more conservative in not allowing write-ups. In the financial statements, losses-in-value will look the same to the readers/users. The possibility of write-ups in IFRS means that more judgment and estimates are involved, allowing more possibilities for earnings management.

Volatility

There are pros and cons that come with IFRS about volatility implied by fair value accounting. On the pros' side, fair value is relevant to evaluate return on investment. From an investor's perspective, the predictive ability of financial statements is increased when changes in value of assets and liabilities (fair value accounting) are reported. If volatility is not reported, then investment decisions are impaired and it can result in inefficient allocation of capital. So it is argued that volatility in accounting figures is good (CFA, 2005, p. 12).

On the opposite side, unrealised gains and losses recognized under fair value accounting may just introduce noise and mask the real outcome in some situations. The volatility reflecting true economic variations may be useful to users of financial statements, but the noise may worsen the quality of information and mislead users (Ball, 2006, p.13-14).

The recent financial crisis has also raised questions on the relevance of fair value accounting (Magnan, 2009). It is argued that fair value accounting may have amplified the crisis by inducing a procyclical pressure in asset prices (Lefebvre et al., 2009). In booms, fair value can induce an overstatement of profits and write-ups in assets, allowing financial institutions to increase their borrowing. In busts, fair value accounting leads to a decreasing value of banks' assets in already weak markets which results in further declines in market prices.

Does fair value accounting fit into the role of accounting?

There are many different roles that accounting can play. It can help investors to make investing decisions by trying to report economic reality. But the positive accounting theory (Watts and Zimmerman, 1986) underlines other important roles of accounting in debt contracting, monitoring, rewarding of management, rewarding of shareholders and taxation.

If financial statements serve contractual purposes, then a set of rules based on objective, neutral and verifiable information may be more appropriate than fair value, even if this is deviating from economic reality. On the other hand, if financial statements aim at reflecting economic reality, then a set of rules based on fair value accounting may be considered more appropriate, but with limitations. One limitation is that fair value accounting may reduce the precision of accounting measurement and therefore worsen its usefulness in contracting, because it allows a number of choices/estimates that rely on subjective judgment by managers. Another limitation is the fact that financial statements are fundamentally a summary of past transactions while stock prices depend highly on new and off-balance sheet information (Chua and Taylor, 2008).

Fair value accounting is a major characteristic of IFRS, and several accounting principles are challenged by it (Magnan, 2009). This may provide better information for investors and other users but it also introduces more subjectivity in accounting numbers and complexity in financial reporting. This brings us to another important issue associated with IFRS: the degree of judgment that it involves.

5.4 Degree of judgment involved in IFRS

One of the criteria for high quality of financial statements is the low capacity for managerial manipulation (Ball, 2006, p.9). Managers can apply judgment in two situations: when they choose accounting methods and when they make accounting estimates. In doing so, they can pursue several goals such as earnings management and income smoothing, overvaluing profit or undervaluing it.

Canadian GAAP is similar to IFRS in many areas and both sets of rules are principles-based. Consequently, they both allow earnings management practices because of the subjectivity involved in the application. But the degree of judgment differs in some areas. On one hand, less judgment is allowed where IFRS is more restrictive than Canadian GAAP, reducing the number of discretionary choices and estimates. On the other hand, IFRS provides new areas of earnings management in comparison to Canadian GAAP when it opens up on judgment such as in fair value accounting.

As discussed in the section "Potential threats coming with IFRS", there are mixed results as to the evidence of earnings management when IFRS is used. The fair value orientation of IFRS is certainly a major area where it can allow more judgment in the application than Canadian GAAP. Meanwhile, Canadian GAAP offers a few areas involving more judgment than IFRS, particularly in deferring or capitalizing deferred charges or costs and in presenting items such as extraordinary gains/losses and deferred tax. See Table 2 next page for a more detailed list.

Overall, the two sets of rules have several areas involving judgment. But the new area of fair value accounting in IFRS, combined with the history of income smoothing of Canadian accounting, runs the risk of generating higher levels of earnings management in Canada when IFRS is implemented, unless enforcement is strengthened.

Table 2: Areas where IFRS and Canadian GAAP involve different levels of judgment by managers *Note: This table is mainly based on a comparison of Canadian standards to the related IFRSs (as at July 31, 2008), prepared by the staff of the AcSB (CICA, 2009). Differences on revenue recognition other than construction contracts are not included; the IASB is undertaking (in collaboration with FASB) a project on revenue recognition likely to result in a significantly different accounting model (CICA, 2009, p. 57).*
Panel A - Areas where IFRS involves more judgment than Canadian GAAP
Fair value accounting (CICA 3061, 3800, 3855, 3870; IAS 16, 20, 39, 40, 41, IFRS 2) Financial instruments can be measured at fair value in Canadian GAAP and IFRS, and stock-based compensation is generally measured at fair value in both sets as well. But many more items can be measured at fair value in IFRS: property plant and equipment, investment property, intangibles, biological assets, non-monetary government grants and minority interest at initial recognition. Consequently, IFRS involves far more judgment than Canadian GAAP regarding fair value accounting. However, it can be noted that IFRS is more restrictive than Canadian GAAP regarding the circumstances in which the option to measure a financial instrument "at fair value through profit or loss" is available; and Canadian GAAP allows more particular choices than IFRS in some area of stock-based compensation, although generally within the same concept of fair-value accounting.
Impairment and loss-in-value of financial instruments, investments and long-lived assets (CICA 3051, 3063, 3064; IAS 28, 36, 39) The identification and measurement of impairment losses differ in IFRS compare to Canadian GAAP and IFRS requires write-ups.
Depreciation of property, plant and equipment (CICA 3061; IAS 16) IFRS requires the application of a component approach in depreciating property, plant and equipment (each component/part shall be depreciated separately). This approach involves more judgment in breaking down the total cost into separate components.
Asset retirement obligations (CICA 3110, EIC-159; IAS 37) IFRS may require more judgment on initial measurement of asset retirement obligations than Canadian GAAP because it is based on management's best estimate of the enterprise's cash outflows (compare to fair value in Canadian GAAP).
Hedge accounting (CICA 3865; IAS 39) Canadian GAAP and IFRS are converged regarding hedge accounting, except for fair value hedge accounting for a portfolio hedge of interest rate risk which is only permitted by IFRS.

Non monetary transactions (CICA 3831; IAS 16, 38, 40) Canadian GAAP is more comprehensive than IFRS as it applies to a broader range of non-monetary transactions.
Related party transactions (CICA 3840; IAS 24) Canadian GAAP is more comprehensive as IFRS do not contain requirements on measuring related party transactions and on guidance for the resulting gains and losses.
Foreign currency translation in a highly inflationary environment (CICA 1652; IAS 29) IFRS requires the application of several procedures and judgments for restating financial statements when the functional currency is the currency of a hyperinflationary economy.
Employee future benefits (CICA 3461; IAS 19) Several differences in the measurement of employee future benefits between IFRS and Canadian GAAP: one important difference is the choice allowed in IFRS to bypass the income statement by allocating directly to equity some actuarial gains and losses.
Interests in joint ventures (CICA 3055; IAS 31) IFRS permits the use of either the proportionate consolidation method or the equity method to account for joint ventures (although the IASB is currently considering removing the proportionate consolidation option for jointly controlled entities) while Canadian GAAP requires the proportionate consolidation method.
Contingencies (CICA 3290; IAS 37) IFRS involves judgment in recognizing and measuring liabilities that are “probable” (vs “likely” in Canadian GAAP) and assets for which the realisation of income is virtually certain (contingent assets are not recognized in Canadian GAAP).
Panel B - Areas where Canadian GAAP involves more judgment than IFRS
Capitalized charges or costs (CICA 1581, 3850, 3855; IAS 23, 39, IFRS 3) Canadian GAAP allows more judgment in the decision to capitalize or not many charges or costs. Acquisition-related costs, such as finders’ fees and legal fees can be capitalized in Canadian GAAP while they are expensed in IFRS. Interests during acquisition, production or construction can be expensed or capitalized under Canadian GAAP while they are capitalized in IFRS. The transaction costs on financial instruments other than “fair value through profit or loss” can be expensed or capitalized in Canadian GAAP while they must be capitalized in IFRS.
Deferred income taxes (CICA 3465; IAS 12, IAS 1, SIC-25) Canadian GAAP and IFRS are converged on the principle of recognizing and measuring taxes except for some particular situations. One difference involving judgment is the classification of deferred income tax in current and long-term items in the balance sheet under Canadian GAAP (according to the expected reversal date of the temporary differences). There is no such classification in IFRS.
Compound financial instruments (CICA 3863; IAS 32) IFRS is more restrictive than Canadian GAAP in the initial measurement of compound financial instruments as it does not allow the use of the relative-fair-value method.
Discontinued operations (CICA 3475; IFRS 5) IFRS contains a more restrictive definition of a discontinued operation than Canadian GAAP.
Extraordinary items (CICA 3480; IAS 1) Extraordinary items can be presented separately in the income statement under Canadian GAAP. They are prohibited in IFRS.
Construction contracts (CICA 3400; IAS 11) Two methods are possible in Canadian GAAP while the percentage-of-completion method must normally be used in IFRS.
Impaired loans (CICA 3025; IAS 39) IFRS is more stringent than Canadian GAAP regarding general loan loss allowances.
Mineral resources and full cost accounting (CICA 3061, EIC-126, 174, AcG-16; IAS 16, IFRS 6) IFRS provides limited guidance on the financial reporting for mineral resources and allows some form of full cost accounting only during the exploration and evaluation phases. Full cost can be extended to development and production phases in Canadian GAAP.

5.5 Presentation of financial statements and consolidation

Presentation of financial statements

In this section, we discuss the traditional financial statements under Canadian GAAP, before the introduction of the concept of comprehensive income in 2005.

IFRS and Canadian GAAP, both being principles-based, allow a lot of discretion in the presentation of financial statements. The names and titles may vary not only between the two sets of rules, but also between companies applying the same set. It is difficult to predict the reality of accounting presentation that will take place in Canada in 2011 when IFRS is implemented. For now, we know that the name of financial statements may change and the terminology used for some items as well.

The content of financial statements under IFRS may change considerably in some areas in comparison with Canadian GAAP[v]. The *balance sheet* is named *statement of financial position* in IFRS and the ranking of assets is often in a reverse-liquidity order, presenting non-current before current (same logic possible on the liability/equity side). In Canada, the common practice is to rank assets in liquidity order. The basic performance statement under IFRS is now the *statement of comprehensive income*. This statement must be presented separately; it cannot be included within the *statement of changes in equity* as it could be done in the past. This is a change of focus as the *income statement* was traditionally considered as the basic performance statement. The *income statement* can still exist as a separate statement under IFRS but it is considered as a sub-part of the *statement of comprehensive income*.

Other differences relate to the reclassification of items such as extraordinary gains/losses, deferred tax and minority interest. Gains and losses meeting specific criteria can be classified as extraordinary in the *income statement* under Canadian GAAP; this is prohibited under IFRS. Deferred income tax is presented entirely as non-current (long-term) in the *statement of financial position* under IFRS while it is broken down into short-term and long-term under Canadian GAAP.

Under IFRS, the notes attached to financial statements are considered as an integral part of a full set of financial statements (IAS 1.10). As mentioned earlier, IFRS requires generally more information to disclose in the notes than Canadian GAAP do. This is consistent with the transparency objective pursued in IFRS.

Consolidation

Consolidation involves a number of adjustments including the recognition of minority interest figures (also called non-controlling interest) in some situations. Minority interest is part of equity under IFRS as the entity theory is being followed. This is a major change compare to the common practice under Canadian GAAP which requires minority interest to be presented outside equity.[vi] Consequently, there is no expense relating to minority interest in the income statement under IFRS, contrary to the Canadian practice. This is a substantial difference. Under Canadian GAAP, minority shareholders are not considered as owners participating in the residual interest of the consolidated entity. This is why their share of profit in subsidiaries is considered as an expense in the income statement, similarly to the interest expense associated to interest-bearing liabilities. In the entity theory used in IFRS, minority shareholders are considered as partial owners of the consolidated entity. They are consequently presented in equity and, like for the parent's shareholders, get their share of profit directly accumulated in it. More precisely, the share of profit attributable to the parent's shareholders accumulates in retained earnings, and the share of profit attributable to the minority shareholders accumulates in a separate equity account called "minority interest" or "non-controlling interest".

The entity theory used in IFRS has also other implications on measurement in the consolidation of financial statements. The identifiable assets acquired and liabilities assumed are measured at their full fair value on the date of acquisition in a business combination under IFRS. Consequently, the measurement of minority interest incorporates these full fair value adjustments[vii]. The Canadian practice is to recognize only the portion acquired/assumed of the fair value adjustments and, as a result, to measure the minority interest figure at its historical book value. The cumulative effect of these measurement differences also changes the goodwill because goodwill is a residual value.

The entity theory in consolidation, along with fair value accounting as discussed earlier, represent the two areas of substantial transformation of Canadian practice that result from the implementation of IFRS.

6. CONCLUDING REMARKS

This paper highlights characteristics of Canadian GAAP that call for a change and discusses the relevance of IFRS to take over. No single set of standards is perfect and the usefulness of accounting information depends on the objectives it seeks to fulfil. IFRS puts more importance on investors' needs and this reflects on the conceptual framework and principles. Accounting concepts such as the historical cost principle are challenged and replaced by fair value and market-oriented measures.

Overall, the objectives of IFRS fit pretty well with some of the Canadian needs in terms of financial reporting. The convergence towards IFRS is a normal evolution of Canadian accounting standards. The cost of sustaining a separate set of rules is not justified considering the size of the Canadian market and the importance of international activities by Canadian companies. IFRS should compensate for the main weaknesses of Canadian GAAP and provide international acceptance for a better comparability of Canadian-made financial statements. If accounting standards used in Canada are more comparable internationally, then Canadian companies should benefit from it (e.g. lower cost of capital).

But IFRS comes up with a number of threats. First, IFRS allows a lot of accounting choices and estimates: it opens the door to earnings management. There are mixed results in the literature about the accounting quality inherent to IFRS. Second, IFRS involves a certain complexity which, coupled with the fact that there is an incredibly large amount of information in the disclosure notes, makes it very hard to follow and understand. Fair value accounting is not too difficult to interpret when it is applied to assets and liabilities, but the accounting counterpart is very complex with adjustments and transfers in and out of a new category of information called "other comprehensive income" or OCI. It should be noted that this problem does not apply as much to unlisted companies because a separate set of standards has been adopted in Canada for them (*Generally Accepted Accounting Principles for Private Enterprises*, AcSB, 2009). This should allow private companies to apply simplified accounting rules in the short-term, but there will be less comparability with listed companies, with unlisted ones that decide to opt for IFRS, and with unlisted entities in other countries. So the accounting practice for unlisted companies could well evolve towards an international harmonization in a longer-term because many of these companies operate internationally and involve foreign stakeholders. Something to follow...

The convergence towards IFRS reconfirms the principles-based approach that characterizes Canadian GAAP. Most differences between Canadian GAAP and IFRS are not a substantial transformation to the fundamental conceptual framework, except for fair value accounting and the entity theory in consolidation. This does not preclude significant differences to happen in the end result of accounting practice, but it will be in the details of application rather than the fundamental underlying concepts.

Besides, the fair value orientation of IFRS is major, but many fair value adjustments are optional. Even before the decision to move to IFRS, Canadian GAAP was heading towards more fair value measurements, in line with the U.S. GAAP. The shift to IFRS has certainly accelerated this movement that was already undergone. Overall, IFRS is certainly an important step in the evolution of Canadian accounting, but it does not represent a substantial transformation.

Limitations and future research

Assessing the degree of change that IFRS brings on Canadian GAAP is not a black-or-white task. One limitation of this paper comes from the arbitrary nature of the authors' interpretation on it. The transition period began in 2006 and the changes in Canadian standards since that time are generally part of the convergence process. It is difficult to know if these changes would have been made in domestic Canadian GAAP whether the decision to adopt IFRS for listed companies had not been taken.

Another limitation is the need for more empirical data on the implementation of IFRS around the world. But at the same time that IFRS is adopted, many other things are changing: enforcement, auditing, globalisation... So it is difficult to isolate the IFRS factor in observing financial reports.

One area of future research is to look at the cost-benefit for a nation to implement IFRS. Canada is coming late into IFRS and can learn from the experience of other countries. It is believed that some difficulties encountered by countries having implemented IFRS have been to switch too quickly, with inadequate consultations of interested parties, and adopting IFRS with amendments. Canada seems well positioned in that regard as the transition period is 5-year long, with a process involving numerous consultations and a full adoption of IFRS, with no amendments (CICA, 2009).

An indirect cost for a nation adopting IFRS is the loss of autonomy on the standard-setting process. It will now be difficult for countries using IFRS like Canada to have specific rules adapted to local characteristics, at least for listed companies. Is the improved comparability provided by IFRS more important than the loss of regional fit in financial reporting? Future research on the impact of implementing IFRS in different regions may provide answers to this question.

One consequence of the worldwide convergence towards IFRS is that all the participating nations will *apparently* speak the same financial language. This may be good for investors but not necessarily for other users of accounting information such as governments. There is a danger that the apparent uniformity of IFRS hides regional differences in the application.

Of course, one area of future research is to look at and compare the relevance of different sets of rules existing around the world: full IFRS (as issued by the IASB), amended IFRS, IFRS for small and medium-sized entities, domestic rules, rules for not-for-profit organisations, and so on. Other areas for future research include the following: the impact of enforcement on accounting practice; the evidence of earnings management and market reaction in IFRS application; the usefulness of IFRS in contracting. It is hoped that the understanding of IFRS and its effects will evolve quick enough so that accounting can play a positive and constructive role in society. But right now, it looks like the utilization of IFRS has quite a lead over its understanding in practice!

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[i] According to the CICA, this reputation enables Canada playing a prominent role in the development of IFRS with many representations on key IASB and IASC Foundation committees (CICA, 2009, p. 12).

[ii] The *IASC Foundation* is renamed the *IFRS Foundation* effective March 1, 2010 (IASCF, 2010, section 1 of the Constitution).

[iii] The statement of comprehensive income was named “statement of recognised income and expenses” in IFRS prior to 2009.

[iv] It should be noted that the issue of understandability of IFRS is not limited to fair-value.

[v] It should be noted that the presentation of financial statements is presently in the process of being significantly revised in IFRS (IASB, 2008).

[vi] Canadian standards for consolidation and non-controlling interests have changed in December 2008, but to be applied in 2011 only (*CICA Handbook*, Standards 1582, 1601 and 1602, December 2008).

[vii] Although IFRS has adopted the concept of fair value for the measurement of minority interest initially, there is still an issue outstanding in the calculation, allowing alternative treatments. It is about the inclusion (or not) of a control premium or discount in the initial value of minority interest (IFRS 3.19, 20, B44 and B45).