

# COMMERCIAL LAW

## INTRODUCTION TO FINANCIAL ACCOUNTING AND FINANCIAL STATEMENTS

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## Chapter 6

# Introduction to Financial Accounting and Financial Statements<sup>1</sup>

### [§6.01] Introduction

Accountancy and law are complex and fascinating disciplines that often overlap. Both the accountant and the lawyer are frequently required to call upon each other to prepare specialized documents that will be used to assist and advise their clients more effectively.

This chapter is intended to provide the general accounting information lawyers require to deal with the elements of financial reports and the accounting processes that are encountered in practice. Three topics are presented. The first topic introduces financial statements - the results of the bookkeeping/preparation process. The users of these statements and reports rely on them for important information, and must therefore be familiar with the principles and assumptions used by the measurement model and system in order to appreciate the limitations, implications, and representation of the data.

The second topic describes the various forms of communication which an accountant or auditor may include with financial statements. Each type of communication implies a different degree of confidence which the preparer makes, relative to the fairness or truthfulness of the representation made by the financial statements. To varying degrees, the financial statements may or may not be "correct". As a result, communication provided by the accountant or auditor indicates the believability or representational faithfulness of the information.

The final topic introduces the general analytical techniques and perspectives used to interpret financial statements. Financial statements are a medium in the information transfer process. The ultimate utility of the reports is dependent upon the user's ability to make informed conclusions from the data.

<sup>1</sup> Revised in 2001 by **Stephen P. Wurz**, C.A. IFA, and in November 2004 by Stephen and **Derek M. Sanders**, both of PricewaterhouseCoopers LLP. This chapter was originally prepared for PLTC by Johan de Rooy of the UBC Faculty of Commerce, October 1988; updated by the author to April 1991; reviewed by Peter G.H. Weldon, C.A., Lindquist Avey Macdonald Baskerville in April 1993 and 1994; reviewed from January 1995 to 2000 by Jeff P. Matthews, C.A.

This chapter is not intended to provide you with sufficient expertise in financial accounting matters. Rather, the aim is to sensitize you to the discipline of accountancy and to make you aware of its potential. For further advice on complex issues or when financial reports are fundamental to the matter under review, you should consult experts in the field.

### [§6.02] Financial Statements - Generally Accepted Accounting Principles and Assumptions

#### 1. Generally Accepted Accounting Principles

In order to understand and interpret financial statements, it is necessary to be familiar with "generally accepted accounting principles" or "GAAP", a term that is central to the compilation of these statements. GAAP refers to the assumptions, rules and guidelines used to prepare financial statements. The following generally accepted accounting principles are discussed in detail below:

##### (a) Generally accepted assumptions:

- going concern assumption (continuity)
- stable unit of measure assumption (unit of measure)
- periodicity assumption (time period)

##### (b) Generally accepted principles:

- (historical) cost principle
- revenue principle
- matching principle
- objectivity principle
- consistency principle
- conservatism principle

#### 2. The Going Concern Assumption

An underlying assumption in accounting is that an accounting entity will continue to operate for a period of time sufficient to carry out its existing commitments. The assumption of continuity, especially in the case of corporations, is in accord with the experience in our economic system. This assumption leads to the concept of the going concern. In general, the going concern assumption justifies ignoring immediate liquidating or market values when presenting assets and liabilities in the balance sheet and legitimizes the use of historical costs, as in the long run such a valuation system will not alter the cash flows of the enterprise. [Note that the terms "enterprise", "business", "firm", "company" and "entity" are used interchangeably in this chapter.]

Although the assumption of a going concern is justified in most normal situations, it should be dropped when it is not in accord with the facts. For example, accountants are sometimes asked to prepare a statement of financial position for an enterprise that is about to liquidate. In this case, the assumption of continuity is no longer valid and the accountant drops the going-concern assumption and reports assets at their current liquidating value and liabilities in the amount required to settle the debts immediately.

### 3. The Stable Unit of Measure Assumption

The use of the stable unit of measure assumes that money is used as the basic measuring unit for financial reporting. Money is the common denominator in which accounting measurements are made and summarized. The dollar, or any other monetary unit, represents a unit of value; that is, it reflects an ability to command goods and services. Implicit in the use of money as a measuring unit is the assumption that the dollar is a stable unit of value, just as the kilometre is a stable unit of distance and the hectare is a stable unit of area.

Having accepted money as a measuring unit, accountants freely combine dollar measures of economic transactions that occur at various times during the life of an accounting entity. They combine, for example, a \$20,000 cost of equipment purchased in 1999 and the \$40,000 cost of similar equipment purchased in 2006 and report the total as a \$60,000 investment in equipment.

However, unlike the kilometre and the hectare, which are stable units of distance and area, the dollar is not a stable unit of value. The prices of goods and services in our economy change over time. When the general price level (a phrase used to describe the average of all prices) increases, the value of money (that is, its ability to command goods and services) decreases.

Despite the steady erosion in the purchasing power of the dollar in Canada during the last 40 years, accountants have continued to prepare financial statements in which the value of the dollar is assumed to be stable. This simplifying assumption is one of the reasons why financial statements are viewed by some critics as misleading.

### 4. The Periodicity Assumption

The accountant assumes an indefinite life for most accounting entities. However, accountants are asked to measure operating progress and changes in economic position at relatively short time intervals during this indefinite life. This is because the users of financial statements need periodic measurements for decision-making purposes.

The need for frequent measurements creates many of the accountant's most challenging problems. Dividing the life of an enterprise into time segments, such as a year or a quarter of a year, requires numerous estimates and assumptions as to the ultimate outcome of incomplete transactions and events. For example, estimates must be made of the useful lives of depreciable assets and assumptions must be made regarding appropriate depreciation methods. Thus, periodic measurements of net income and financial position are at best only informed estimates. The tentative nature of periodic measurements should be understood by those who rely on periodic accounting information.

### 5. The (Historical) Cost Principle

Both the balance sheet and the income statement are affected by the cost principle. Assets are initially recorded in the accounts at cost, and no adjustment is made to this valuation in later periods, except to allocate a portion of the original cost to expense as the assets expire. At the time an asset is originally acquired, cost represents the "fair market value" of the goods or services exchanged, as evidenced by an arm's length transaction. With the passage of time, however, the fair market value of assets such as land and buildings may change greatly from their historical cost. These later changes in fair market value generally have been ignored in the accounts, and the assets have continued to be valued in the balance sheet at historical cost (less the portion of that cost which has been allocated to expense).

The cost principle is related to the principle of objectivity. Those who support the cost principle argue that it is important for users to have confidence in financial statements, and this confidence can best be maintained if accountants recognize changes in assets and liabilities only on the basis of actual transactions. Objective evidence generally exists to support cost, but evidence supporting market values may be less readily available.

### 6. The Revenue Principle

A generally accepted definition of revenue is "the monetary expression of the aggregate of products or services transferred by an enterprise to its customers during a period of time". The revenue of an enterprise is the value or consideration received from the provision of goods or services by the enterprise to a third party.

This revenue should be measured by the cash value of the product of service exchanged. It is important to note that this does not mean that money must change hands at this point. The revenue principle holds that revenue should be recognized by an

enterprise when it is earned, not necessarily when cash is received.

#### 7. The Matching Principle

This principle holds that expenses or costs directly associated with earning revenues should be recorded in the same period in which the revenue is reported. Expenses are "matched" with the revenue they generate. In other words, when it is determined that revenue has been earned, those expenditures incurred to generate the revenue should be offset or matched against the revenue to derive the income resulting from the transactions.

Together, the matching and revenue principles produce the accrual basis of accounting, the system used by all businesses for preparing external financial statements. The accrual model requires that income be measured in terms of revenues earned (though not necessarily collected) less the expenses incurred (though not necessarily paid) to generate the revenue. In other words, net income is not the same as the change in a business's cash position over a period of time.

#### 8. The Objectivity Principle

The term objective refers to measurements that are unbiased and subject to verification by independent experts. For example, the price established in an arm's-length transaction is an objective measure of exchange or market value at the time of the transaction. Accountants rely on various kinds of evidence to support their financial measurements, but they always seek the most objective evidence available. Invoices, contracts, paid cheques, and physical counts of inventory are examples of objective evidence.

If a measurement is objective, ten competent investigators who make the same measurement will come up with substantially identical results. However, ten competent accountants who set out independently to measure the net income of a given business would not arrive at an identical result. Despite the goal of objectivity, it is not possible to insulate accounting information from opinion and personal judgement.

#### 9. The Consistency Principle

The principle of consistency implies that a particular accounting method, once adopted, will not be changed from period to period. This assumption is important because it assists users of financial statements to interpret changes in financial position and changes in net income.

Consistency increases the comparability of financial statements from period to period. Different companies, even those in the same industry, may follow different accounting methods. For this reason, it is important to determine the accounting methods used by the companies whose financial statements are being compared. This information is typically disclosed in the first note to the financial statements.

#### 10. The Conservatism Principle

The conservatism principle, as applied in accounting, attempts to ensure that, when estimates must be made and uncertainty exists, assets, revenues and gains are not overstated and, conversely, that liabilities, expenses and losses are not understated. At the same time, conservatism does not encompass the deliberate understatement of assets, revenues and gains, or the deliberate overstatement of liabilities, expenses and losses.

Conservatism is a fundamental accounting principle because accountants perceive that their personal risk and legal liability is less if they make conservative statements of net income relative to actual outcomes. Further, as accountants must continually make estimates about the results of incomplete transactions and events, a conservative bias to their reports results in a reduction in the number of unpleasant surprises and subsequent legal difficulties. Finally, accountants by nature and training are risk adverse professionals. Conservatism thus complements this disposition well.

### **[§6.03] Financial Statements**

Properly prepared external financial statements will, by definition, include six components:

- (a) an accountant's or auditor's communication on the financial statements
- (b) a balance sheet (statement of financial position)
- (c) a statement of income (profit or loss) and retained earnings
- (d) a statement of cash flows
- (e) a set of comparative balances for the previous fiscal period
- (f) notes to financial statements.

Each of these components is unique in what it portrays. Together, they convey a complete financial representation of the entity under review. Should any of these items be absent, an explanation is required and the statements should be viewed with scepticism and not worthy of extensive reliance.

A cash flow statement sometimes is not provided for simple statements, where sufficient information is available in the balance sheet, and the income statement is presented in a way such that a reader can "prepare" his/her own cash flow statement; where omitted, a note to the financial statements will usually explain why it is omitted.

The following portion of this chapter reviews these components (with the exception of the accountant's or auditor's communication which will be discussed in detail later) using Acme Limited's financial statements. You are encouraged to refer to these financial statements to ensure the concepts are appreciated and understood.

## 1. The Balance Sheet

The balance sheet is a statement that records those items that the enterprise owns (assets) and how these items are financed (liabilities and equity). The statement reports these values as at a specific point in time; in the case of Acme, this time is December 31, 2007 and 2006.

The balance sheet organizes the accounts under three categories: assets, liabilities, and equity. Assets represent items which the enterprise owns or has control over the use of (e.g., leasehold improvements). Stated another way, assets represent one or more of the following: cash or cash equivalents; future cash inflows (e.g., accounts receivable); future benefits (e.g., inventories, property, plant and equipment); or unexpired costs (e.g., goodwill and prepaid expenses). These assets are used by the entity to earn income or revenue in subsequent fiscal periods.

Liabilities and equity represent different methods whereby the assets are financed or paid for. Liabilities are monies or credit extended by non-owners to the enterprise to acquire assets. Equity reports the funds provided by owners (for example, capital stock) or the enterprise from the earnings process (for example, retained earnings), and is also the residual interest shareholders have in the enterprise as measured in historical cost values. Equity does not, however, represent the market value or worth of the entity, as this is a function of the business' ability to earn income in the future. The fair market value of an enterprise's equity is beyond the scope of financial accounting, as it is dependent upon subjective estimates made within the marketplace.

A logical interaction exists between assets and liabilities/equity. Anything that an entity owns must have been paid for or financed from some source of funds such as creditors' money (liabilities), the owners' money (capital stock) or the entity itself (retained earnings). Consequently, a fundamental relationship between these accounts is expressed by

the following balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

A review of Acme's balance sheet reveals that at December 31, 2006 and 2007 this equality was:

December 31, 2006

$$\$3,452,830 = \$1,754,899 + \$1,697,931$$

December 31, 2007

$$\$3,964,360 = \$1,798,776 + \$2,165,584$$

In addition to the distinction on the balance sheet between assets, liabilities, and equity, the statement also segregates accounts between those that are current and those that are other than current.

The current/non-current dichotomy identifies those accounts on the balance sheet that will be either:

- (a) re-cycled (paid or collected) through cash during the upcoming year (for example, accounts receivable and all current liabilities except bank indebtedness);
- (b) converted into cash or accounts receivable during the upcoming year (for example, deposits);
- (c) consumed or expired during the upcoming year (for example, prepaid expenses); or
- (d) amounts that are cash, cash equivalent, or indebtedness which are readily liquid.

The purpose of this classification is to combine the accounts which are part of the daily operation of the business in order to distinguish them from balances which are not part of the daily operating cycle (non-current or long term accounts). The isolation of the current accounts also indicates the liquidity of the business. Current assets, to varying degrees, all represent cash or cash inflows to be realized in the upcoming year and current liabilities represent the reverse, that is, cash to be paid out. If current assets exceed current liabilities this, to some extent, suggests that the entity is liquid and thus will be able to pay off liabilities as they come due. The reverse relationship indicates that cash outflows might exceed cash inflows, resulting in possible financial difficulties for the business.

Non-current balances represent the productive ability of a business (for example, the property, plant and equipment which are used to produce goods for resale or facilitate the business's operations) and the source of long term financing used to acquire these assets. Further, by definition, liabilities other than current liabilities are amounts which are not due and payable (principal at least) within one year (except by default), and, as such, portray cash outflows which are not expected until

one or more years hence.

Equity, the residual interest of the owners in the business, is a non-current item because the primary way to convert these amounts into a cash outflow is to liquidate the business, which contradicts the going concern assumption.

## 2. The Statement of Income and Retained Earnings

This statement contains two subsets: statement of income and a statement of retained earnings (note that they are frequently presented as two separate statements). Each component warrants special and separate consideration.

The income statement presents the accumulation of income producing transactions for a particular period of time, usually one year. The statement details the sum of all sales (revenues) less the expenses associated with or incurred to earn these revenues. The difference between the revenues and expenses is net income (or loss) for the period during which these amounts were accumulated.

The income statement typically subdivides revenues and expenses into categories that portray the major activities of the business. An inquisitive reader can therefore determine how the business is managing its affairs and begin to analyse performance.

Essential to a better understanding of the income statement is an awareness of the implications and ramifications of the revenue and matching principles. Together, these principles derive net income (which is not the same as cash flow) during the fiscal period. The accrual basis of accounting is used to prepare this (and all other) statement(s) whereby revenues are recorded when earned (not when collected) and expenses are recorded when incurred (not when paid) and then matched with revenues. As the leads and lags between cash (in and out) flows are ignored in the income statement, a less than perfect correlation exists between income and cash flows. Causation, however, can reasonably be assumed.

This statement continues with a reconciliation of retained earnings at the beginning of the year to the balance at the end of the year. This articulation of net income and retained earnings is another fundamental relationship in all financial statements. Retained earnings refers to the income which the enterprise has generated and retained since inception, less the amount which has been distributed to owners as dividends. Retained earnings are a component of the owners' residual interest (equity) in the enterprise and are adjusted during the year by the net income earned, less amounts distributed. The reconciliation of retained earnings through the incorporation of the

consequences of net income and dividends is a logical proof of the interrelationship of the income statement and balance sheet. This complementary union is expressed by the following retained earnings equation:

Opening Retained Earnings for the period + Net Income - Dividends = Closing Retained Earnings for the period

In the case of Acme, this relationship for 2006 and 2007 is:

2006:

$$\$1,170,523 + \$220,908 - \$3,500 = \$1,387,931$$

2007:

$$\$1,387,931 + \$378,653 - \$11,000 = \$1,755,584$$

## 3. The Statement of Cash Flows (*formerly known as the Statement of Changes in Financial Position*)

For fiscal years beginning on or after August 1, 1998, the statement of changes in financial position are referred to as the statement of cash flows. There are two ways to prepare the statement of cash flows; using the direct or indirect method. Previously, the indirect method was used to prepare the statement of cash flows; however, the direct method is now encouraged. In practice, it is still more common to see the indirect method used by most reporting entities. ACME Ltd.'s cash flow statement has been prepared using the direct method.

The statement of cash flows is the most complex and insightful of the statements prepared by accountants. This statement builds upon the information recorded in the other statements and consolidates the data into a single report. The statement of cash flows requires a thoughtful appreciation of what the other statements individually and in aggregate indicate.

The balance sheet reports the financial position of an entity at a particular point in time. Just as a camera takes your snapshot and records for posterity how you look today, a balance sheet records a company's asset, liability, and equity accounts as they are at the date the balance sheet was prepared.

The income statement reports the results of a business operation over a particular time period, for example, one year. This statement can be compared to a movie camera, which records what takes place over a period of time. The income statement provides details of the revenues (the inflow of assets or reduction in liabilities) and expenses (the outflow of assets or incurrence of liabilities) incurred to earn these revenues. Those activities of the company that result in a net income or net loss

are reported in the income statement.

The statement of retained earnings reports the cause of a change in retained earnings during the time period covered by the income statement. It is not only a net inflow of assets from net income or a net outflow from net loss that changes these retained earnings; there are also other causes of change, such as dividends or retroactive restatements of prior period earnings. Such other causes do not belong to the current operations of a company and therefore are not shown on the income statement in the current period. The statement of retained earnings and the income statement show the change in the balance sheet account retained earnings. The statement of retained earnings reconciles the beginning and the ending balances of the retained earnings account.

The balance sheet shows the financial results of a company's activities at a particular point in time. Some of these activities, such as operations and dividends, are reported in the income statement and statement of retained earnings. There are other activities, however, that remain unreported. These unreported activities are the financing and investing activities of a business, which are important to financial statement readers who wish to evaluate the financial position and the results of operations of a particular company. The final financial statement is the statement of cash flows and provides information concerning these otherwise unreported activities. In the same way that the income statement and the statement of retained earnings show the changes that occurred in the balance sheet's retained earnings account, the statement of cash flows reports the changes that occurred to the other accounts of the balance sheet over the period in which the net income is reported. These changes encompass all asset, liability, and equity accounts.

A statement of cash flows classifies cash receipts and payments into three major categories: operating activities, investing activities, and financing activities. Grouping cash flows into these categories identifies the effects on cash of each of the major activities of a firm.

#### (a) Operating Activities

A statement of cash flows reflects the transaction and events that constitute its operating activities. Generally, the cash effects of these transactions and events determine the net cash flow that results from operating activities.

The primary operating cash inflows are cash receipts from customers, as a result of either sales made or services rendered. Typical operating cash outflows include cash payments for merchandise purchases, cash payments to employees, cash payments to outside suppliers for various services and supplies, and cash payments for taxes.

Acme's statement of cash flows indicates that while net income before extraordinary items was \$263,253 for fiscal year 2007 (as per the income statement and measured using the accrual basis of accounting), the net income provided only a \$41,340 increase in cash from operating activities. The difference between these two amounts primarily reflects the fact that Acme had to reinvest much of its income in non-cash current accounts and therefore could not increase its cash position by the full extent of its income.

#### (b) Investing Activities

A firm's transactions involving the acquisition and disposal of plant assets and intangible assets, and the lending and subsequent collection of money constitute the basic components of its investing activities. The related cash receipts and payments appear in the investing activities section of the statement of cash flows. Cash inflows come from such events as cash sales of plant assets and intangible assets; cash sales of investments in shares and bonds; and loan repayments from borrowers. Typical cash outflows related to investing activities are derived from cash payments to purchase shares and bonds and cash loaned to borrowers.

A review of Acme's statement of cash flows reveals that the company purchased or invested in fixed assets costing \$148,023 and \$414,485 during 2007 and 2006 respectively. During 2007 the entity divested or sold fixed assets and received consideration of \$220,600.

#### (c) Financing Activities

A firm engages in financing activities when it obtains resources from owners, returns resources to owners, borrows resources from creditors, and repays amounts borrowed. Cash flows related to these events are reported in the financing activities section of the statement of cash flows. Cash transactions involving owners include cash received from issuing preferred stock and common shares, and cash paid dividends. Cash transactions with creditors include cash received by issuing bonds and mortgage notes, and cash paid to

settle these debts. It is important to remember that paying cash to settle such obligations as accounts payable, wages payable, and income tax payable are operating activities, not financing activities.

Acme raised various forms of long term debt or equity during 2007 and 2006, repaid outstanding debt, and made dividend distributions. These transactions generated \$37,872 and \$209,427 in cash for the two years presented.

One objective of financial reporting is to help external users assess the amount, timing, and uncertainty of future cash flows to the enterprise. These assessments will help users evaluate their own prospective cash receipts from their investment in, or loan to, the firm. Although statements of cash flows report past cash flows, these statements should be useful for assessing future cash flows.

A statement of cash flows shows the periodic cash effects of a firm's operating, investing, and financing activities. Distinguishing among these different categories of cash flows helps users to compare, evaluate, and predict cash flows. Analysis of cash flow information enables creditors and shareholders to assess a firm's ability to discharge its liabilities and pay its dividends. A firm's need for outside financing may also be better evaluated. Over time, the statement of cash flows permits users to observe and analyse management's investing and financing policies.

A statement of cash flows also provides information useful in evaluating a firm's financial flexibility. Financial flexibility is a firm's ability to generate sufficient amounts of cash to respond to unanticipated needs and opportunities. Information about past cash flows, particularly cash flows from operations, helps to assess this flexibility. An evaluation of an entity's ability to survive, for example, an unexpected drop in demand, may include a review of its past cash flows from operations. The larger these cash flows, the greater will be the business' ability to withstand adverse changes in economic conditions.

Without comparable information, users would be severely limited in assessing the achievements of the enterprise.

Comparative figures allow users of the financial statements to:

- (a) identify changes in relative and absolute amounts. These differences allow users to speculate about what the changes indicate about the efficiency and effectiveness of the management team during the period(s) under review;
- (b) predict future performance and cash flow. Financial statements generally present the results of past transactions and events. While financial history is not necessarily indicative of future performance, past results are a useful starting point for making informed, future oriented estimates. A simple postulate in geometry states that at least two points are needed to determine a line. In the same way, comparative information provides a basis for making such linear and trend extrapolates. While users are warned against automatically making simplified and naive forecasts based on comparative information, such information does provide a useful point of departure. The incorporation of changes in the business environment and circumstance of the entity into the projection will enhance their utility;
- (c) isolate relationships and consider their reasonableness and implications. Financial accounting, by virtue of its self-balancing and reconciling nature (for examples, the balance sheet and retained earnings equations), implies that the various statements are interwoven and connected. For example, Acme's sales increased by about 6% from 2006 to 2007. As accounts receivable represents the portion of sales that are uncollected as at the balance sheet date, a relatively equivalent increase in this account could be intuitively expected. The actual increase is about 4%, which indicates reasonable harmony between sales and accounts receivable. Inventories, the items that are sold, should presumably increase in tandem with sales. However, the inventories increased by 34% during the year! Something appears amiss and further investigation is warranted. If this rate of increase continues, Acme will soon face a liquidity problem as it continues to invest in a non-cash asset. Without comparative information, such an analysis would not be possible.

Comparative balances are essential to using financial statements in an informed and insightful way.

#### 4. Comparative Balances

Generally accepted accounting principles require that external financial statements provide comparative information for the complementary preceding fiscal period. Comparative balances encourage users of the financial information to evaluate the current performance and financial position relative to another period or point in time.

## 5. Notes to Financial Statements

The various financial statements introduced in these notes are only part of the information included in a complete financial statement package. The statements make numerous representations of the financial position and results of operations of the entity. What is still required is qualitative information to explain, describe, and provide background data supporting these balances and results.

The notes to financial statements complete the reporting process. An inquisitive reader should expect this information to:

- (a) explain how these balances were derived (for example, note 1 to Acme's financial statements);
- (b) disaggregate highly consolidated amounts (for example, notes 2 and 3);
- (c) describe the circumstances and details of events and conditions critical to deriving these amounts (for example notes 4 and 5);
- (d) draw attention to contingencies and events subsequent to the balance sheet data that have significant continued effect on the entity (for example, notes 6, 7 and 8).

Numbers cannot capture to the full extent an entity's character. Readers are warned to review these notes and consider how they clarify the information reported in the other statements. The body of most external financial statements will make explicit reference to these notes. For example, Acme's balance sheet, statement of income and retained earnings and statement of cash flows explicitly state, "The accompanying notes are an integral part of these financial statements". Further, many of the accounts on the balance sheet make reference to the notes. Without these notes, the user is severely handicapped in making full use of the financial statements or understanding what the statements imply about the enterprise.

### **[§6.04] Accountants' and Auditors' Communications<sup>2</sup>**

External financial statements produced by a professional accountant are covered by a "report" which tells the reader the nature of the accountant's involvement with the financial statements. Each report explains the type of work that went into the engagement and the degree of

assurance or credibility that the accountant is adding to the financial statements.

There are three types of reports used by professional accountants when financial statements are issued to the public. These are:

- (a) an Auditors' Report;
- (b) a Review Engagement Report; and
- (c) a Notice to Reader Report.

Each type of report indicates the level of assurance the user can assume concerning the financial information attached. The highest level of assurance is provided by an "Auditors' Report", in which the accountant states an opinion on the fairness or truthfulness of the information presented in the financial statements.

A "Review Engagement Report" is significantly different from an Auditors' Report and may be prepared when the shareholders have waived their right to an audit. In a Review Engagement Report, the accountant does not render an audit opinion on the financial statements, but provides only negative assurance that "nothing has come to our attention" to suggest the statements are materially incorrect.

Finally, a "Notice to Reader Report" is a caution that the accountant has only compiled the statements, and that the assembly of information is arithmetically correct.

Most limited companies are required by law to present annual financial statements to their shareholders. Unless the shareholders waive their right, these statements must be audited by an independent accountant, generally a Chartered Accountant. The auditor is responsible to the shareholders and reports to them. In addition, an audit may be a requirement of a lending agreement, legislation or contractual obligation.

The objective of an audit is to obtain reasonable assurance that the financial statements taken as a whole are not materially misstated. The Auditors' Report clearly indicates that, although the auditor exercises due care and diligence in auditing the information, the ultimate responsibility for the "correctness" of the information resides with management.

The auditor will thoroughly examine the company's financial records and operations to verify that the information reported in the financial statements is reasonable. The procedures used by the auditor normally include physical inspection; confirmation from external third parties of the existence and accuracy of balances due to or from the company; examination of supporting documentation to assure authenticity; and evaluations of the company's internal control procedures to ensure that systems and controls are in force to safeguard the company's assets and accounting records.

<sup>2</sup> Part of the material in this section was provided by the Institute of Chartered Accountants of British Columbia. The author acknowledges and appreciates the permission of the Institute to use their material.

If the auditor disagrees with the company on the accuracy or fairness of the financial information presented, the report will be qualified with specific reference to the disagreement in the report. Should that be the case, the auditor must state the nature of such disagreement, quantify the amount, if possible, and explain the impact of the disagreement on the financial statements. Such disagreements might involve the valuation of assets or the method of recording revenue.

The objective of a review is to discover if the financial statements are plausible within an appropriate disclosed basis of accounting which, except in special circumstances, would be generally accepted accounting principles.

A "Review Engagement Report" may be adequate for the needs of financial statement users where there is limited exposure or where the shareholders are involved in the day-to-day operations of the business.

A review involves inquiry, analytical procedures and discussion related to information supplied by the company. In conducting the engagements, the accountant must exercise due care in undertaking the review of the financial statements. If anything comes to light that indicates the statements do not adhere to generally accepted accounting principles or which make the financial statements misleading in any way, the accountant must disclose this fact in the "Review Engagement Report". Accountants may not be associated with financial statements which they know, or have reason to believe, are misleading or incorrect, and they must disassociate themselves from the statements if the company is adverse to changing them.

Review engagements require that the accountant be objective and, consequently, independent of relationships with clients.

Frequently, professional accountants are asked to compile financial statements for a variety of business purposes when there is not a need for the assurance provided by an "Auditors' Report" or a "Review Engagement Report". Examples would include internal reports for management and information required for income tax purposes.

The accountant's involvement is to receive information from a client and to arrange it into the form of a financial statement.

The accountant is not required to perform procedures to verify, corroborate or review information supplied by the client. The accountant's concern is that the assembly of information is correct. No assurance is given; however, there is also no reason to believe that the financial statements are false or misleading.

The "Notice to Reader" is intended as a clear warning of the limited usefulness of these statements. For decision-making purposes, readers of statements prefaced by a

"Notice to Reader" who do not have access to other information should consider seeking the assurance provided by an audit or a review.

Over many decades, audited financial statements have developed an excellent track record of reliability. Note, however, that the auditors do not guarantee the accuracy of financial statements; rather, they render their professional opinion as to the overall fairness of the statements. "Fairness", in this context, means that the financial statements are not misleading. However, just as a physician may make an error in the diagnosis of a particular patient, there is always a possibility that an auditors' opinion may be in error. The primary responsibility for the reliability of financial statements rests with the management of the issuing company, not with the independent auditors.

## **AUDITORS' REPORT**

To the Shareholders of XYZ Ltd.

We have audited the balance sheet of XYZ Ltd. as at December 31, XXXX and the statements of income, retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the company as at December 31, XXXX and the results of its operations and the changes in its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

(signed)  
Chartered Accountants

City  
Date

## REVIEW ENGAGEMENT REPORT

To (person engaging the professional accountant).

We have reviewed the balance sheet of XYZ Ltd. as at December 31, XXXX and the statements of income, retained earnings and cash flows for the year then ended. Our review was made in accordance with Canadian generally accepted standards for review engagements and accordingly consisted primarily of inquiry, analytical procedures and discussion related to information supplied to us by the company.

A review does not constitute an audit and consequently we do not express an audit opinion on these financial statements.

Based on our review, nothing has come to our attention that causes us to believe that these financial statements are not, in all material respects, in accordance with Canadian generally accepted accounting principles.

(signed)

Chartered Accountants

City

Date

## NOTICE TO READER

We have compiled the balance sheet of XYZ Ltd. as at December 31, XXXX and the statements of income, retained earnings and cash flows for the year then ended from information provided by management (the proprietor). We have not audited, reviewed or otherwise attempted to verify the accuracy or completeness of such information. Readers are cautioned that these statements may not be appropriate for their purposes.

(signature)

Chartered Accountants

City

Date

### [§6.05] Financial Statement Analysis

Various techniques are used in the analysis of financial data to emphasize the comparative and relative importance of the data presented and to evaluate the position of the firm. These techniques include ratio analysis, common size analysis, examination of relative size among firms, comparison of results with other types of data, study of differences between the components of financial statements among industries, and review of descriptive material. The information derived from these types of analyses should be blended to determine the overall financial position. No one type of analysis is best or sufficient to support overall findings or to serve all types of users. These notes are confined to an introduction to ratio analysis, the most common and powerful technique. You may wish to pursue the other approaches on your own.

Financial statement analysis is a judgmental process. One of the primary objectives of this process is to identify major changes or turning points in trends, amounts, and relationships and to investigate the reasons underlying those changes. Often a turning point may signal an early warning of significant shift in the future success or failure of the business. The judgment process can be improved by experience and the use of analytical tools.

#### 1. Ratio Analysis

Financial ratios are usually expressed in percent or times. The following is a list of the several types of financial ratios:

- (a) Liquidity ratios are measures of a firm's ability to meet its current obligations (cash outflows) as they come due. These ratios may include ratios that measure the efficiency of the use of current assets.
- (b) Solvency (leverage) ratios measure the degree of protection of long-term suppliers of funds to insure against bankruptcy or the probability thereof.
- (c) Profitability ratios measure the earnings ability of a firm.

A ratio can be computed from any pair of numbers. Given the large quantity of variables included in financial statements, a very long list of meaningful ratios can be derived. There is no standard list of ratios or standard computation of such and each author and source on financial statement analysis uses a different list. The ratios discussed below are among those most frequently used.

#### 2. Liquidity Analysis

The ability of an entity to maintain its short-term debt-paying ability is important to all users of financial statements. If the entity cannot maintain a short-term debt-paying ability, it will not be able to maintain a long-term debt-paying ability, nor will it be able to satisfy its shareholders. Even an entity on a very profitable course will find itself bankrupt if it fails to meet its obligations to short-term creditors.

In these notes, procedures are suggested for analysing short-term assets and the short-term debt-paying ability of an entity. The procedures require an understanding of current assets and current liabilities.

Current assets and current liabilities imply potential or real cash (in or out) flows. As liquidity analysis focuses on an enterprise's ability to satisfy liabilities as they mature, most ratios in this classification use current balance sheet items in their calculation. Within this grouping, two types of ratios emerge:

those focusing on balance sheet relationships and the company's relative liquidity at a point in time; and those combining current assets accounts with their component income statement accounts to assess the firm's efficiency in managing its current assets to generate cash.

The ratios most commonly used to measure liquidity are the current ratio and the quick (or acid-test) ratio. The ratio is usually stated in dollars and indicates how many dollars of current assets the company has for each dollar of current liabilities. For example, as shown at Appendix 11, Acme had a current ratio of 1.92 to 1 in 2007. This means that Acme had \$1.92 invested in current assets for every dollar in current liabilities.

In essence, the current ratio is another way to evaluate the company's working capital management. Working capital is determined by subtracting current liabilities from current assets. A positive difference indicates that the company has more current assets than current liabilities; it does not, however, indicate the relative margin of difference. The current ratio corrects this deficiency by providing the margin of safety on a relative basis (that is, a percentage basis) rather than on a dollar basis.

The closer a company's current ratio is to 1, the more likely the company will have difficulty in meeting its short-term obligations. In general, a current ratio of at least 2 to 1 is considered desirable. However, the acceptability of a particular current ratio depends on the trend in the ratio over time and how it compares with those of similar companies. It is also important to note that too high a current ratio can be undesirable, as it can indicate that the company has too much money invested in current assets, which are normally non income-producing, rather than in fixed assets, which are income producing.

Current assets normally consist of cash, accounts receivable, marketable securities, inventory, and prepaid expenses. Of these five items, inventory and prepaid expenses are considered the least liquid assets because they are the furthest from being converted into cash, owing to the fact that inventory items must be sold and the sales collected, and prepaid expenses cannot be readily sold for cash. As a result, analysts often calculate an additional liquidity ratio (the quick ratio) to provide further insight than the current ratio by removing inventory and prepaid expenses from current assets. From a creditor's perspective, the quick ratio provides a more meaningful evaluation of the company's liquidity and ability to meet payments when due. Acme's 2007 quick ratio of .68 would normally be considered poor, because it is less than 1 and

indicates that the company has insufficient cash and cash equivalents to meet its short-term obligations.

Turnover or activity ratios indicate how efficiently management uses its assets. The acquisition and use of assets are costly. Unless the assets generate sufficient sales, overall profitability will suffer. Two commonly used activity ratios are accounts receivable turnover, and inventory turnover.

Accounts receivable turnover indicates how many times a year a company collects its receivables. Once calculated, the accounts receivable turnover ratio can be used to estimate the average number of days required to collect a receivable. The number of days determined is commonly referred to as the collection period.

At Acme, an account receivable remained outstanding for an average of 53 days in 2007. The acceptability of this number depends on the company's policy for granting credit.

Another activity ratio of interest to an analyst is inventory turnover; that is, the number of times a year the company sells its inventory. Acme turned over its inventory approximately 2.59 times a year, or every 141 days in 2007. Obviously, a firm could maximize its inventory turnover and minimize inventory costs by keeping inventory amounts small. However, this policy could lead to lost sales and a decline in customer goodwill. As a result, management attempts to maximize inventory turnover while ensuring that enough inventory is available to meet customer needs.

### 3. Solvency Analysis

Debt of a business carries two obligations: to repay the principal and to pay interest during the period of time that the principal is owed. When analysing a firm's debt-paying ability, it is necessary to determine the firm's ability to pay the principal and interest on debt in the long run. As debt is primarily outstanding for an extended period of time (usually several years), solvency analysis focuses on the long run liquidity of the entity. Long run liquidity is therefore often described as solvency - the ability to repay non-current obligations as they mature.

There are two approaches to viewing a firm's long-term debt-paying ability. One approach views the firm's ability to carry the debt as indicated by the income statement and the other approach views the firm's ability to carry debt as indicated by the balance sheet.

In the long run, there is usually a relationship between the reported income resulting from accrual accounting and the ability of the firm to meet its long run obligations. Although the reported income does not agree with the cash available in the short

run, the revenue and expense items eventually do result in cash movements. Because of the close relationship between the reported income and the ability of the firm to meet its long-run obligations, a major emphasis is placed on the entity's profitability when determining long-term debt-paying ability.

Leverage refers to the amount of debt a company uses to finance its assets. The more debt, the more highly leveraged the company. The use of leverage has advantages and disadvantages. Its chief advantage is that by using someone else's money, owners can maximize their returns. The primary disadvantage of leverage is that it increases the riskiness of a firm. Increased leverage brings with it increased interest payments (a fixed expense) and the possibility that the company will not have the cash available to meet this expense or future principal payments. As long as a company earns more on its investments than it has to pay in interest, no problems occur. However, if this is not the case, the company can find itself defaulting on its debts and going into bankruptcy.

Leverage ratios measure the extent to which a company uses debt and the impact of leverage on the company's ability to meet its interest payments. The most basic measure of leverage is the debt ratio. The resulting number represents the percentage of assets financed by debt. In 2007, Acme financed 45% of its total assets with debt and the rest, 55%, with equity. Acme's 2007 debt ratio (51%) shows that the company's debt ratio has decreased. This is largely due to the fact that the increase in assets in 2007 was financed through the company's own retained earnings as opposed to external debt.

Another leverage ratio commonly used with the debt ratio is the times interest earned ratio. Creditors often want to know how secure their interest payments are. One way of measuring this is to determine how much earnings, before interest and taxes, exceed interest payments. This figure shows how much earnings could decline before the payment of interest is jeopardized.

Acme's earnings available to meet interest payments in 2007 were 5.48 times the amount of these payments - a good margin of safety. If the ratio were less than 1, it would indicate that the earnings before interest expense are less than the interest expense, resulting in a net loss. Repeated times interest earned ratios of less than 1 suggest that the financial demise of the entity is inevitable. An extremely high ratio suggests that the enterprise is not properly using the advantage of debt financing.

Profitability is the ability of the firm to generate positive income. Analysis of profit is of vital concern to shareholders as they derive revenue, in the form of dividends, which are paid from profit. Further, increased profits can cause a rise in market price, leading to capital gains. Profits are also important to creditors, as they are one source of funds for debt coverage. Management is also vitally interested in profit, as it is often used as a performance measure.

Profitability ratios measure the overall effectiveness of management in operating the business and are therefore probably the most important ratios to financial statement users. Several of the profitability ratios described in the following paragraphs serve as aggregate measures of performance; that is, they represent the firm's bottom line.

The bottom line normally refers to a company's net income. However, this measure is often misleading in a performance evaluation because it is an absolute number when, in fact, profits should be evaluated in the context of the company's size and competitive position. As a result, analysts typically construct profitability ratios to compare some measure of earnings with total assets, sales, or shareholders' equity.

The return on sales (also known as the profit margin) measures how much the company earns on every dollar of sales.

In 2006, Acme earned approximately \$.048 on every dollar of sales, while in 2007 the amount increased to \$.054. Most retailers, such as grocery store and department store owners, have very small profit margins; their turnover of products, however, is high. Without this turnover, profits would be low. In contrast, manufacturers of heavy-duty equipment, such as tractors and computers, have low asset turnover but high profit margins. Thus, each sale generates a significant profit for the company.

The profitability ratio most important to management is return on assets, because this ratio measures how well the company is doing relative to its level of investment in assets. For example, two companies had net earnings of \$10,000 in YR1: however, Company A had total assets of \$100,000 while Company B had total assets of \$80,000. What can we conclude from this data? All other things being equal, Company B earned a greater return on its investment than did Company A. A had a return on assets of 10% ( $\$10,000/\$100,000$ ), while B realized a return of 12.5% ( $\$10,000/\$80,000$ ). Without relating net income to some measure of investment - in this case, total assets - a misleading picture of performance could result.

#### 4. Profitability Analysis

Despite the usefulness of return on assets, shareholders are often more interested in determining the return of their own investment than in the return to creditors and shareholders as measured by return on assets. From the shareholder's vantage point, a company's return on equity is of particular importance.

It is interesting to note that although Acme's 2007 return on assets was 6.6%, its return on equity was 12.2%. Why is this the case?

Take for instance a company with no debt or liabilities. In such a case, its total assets would equal its total equity, and return on assets and equity would be equal. To the extent that a firm uses debt, the return on equity will differ from the return on assets. For example, if a company realizes a return on borrowed capital greater than the amount of interest paid, return on equity will be higher than return on assets, because any excess returns accrue to the shareholders without their having to increase their investment.

In reality, return on equity is a function of return on assets and leverage. In a firm with a relatively simple capital structure (that is, one with only common stock) return on equity is equal to return on assets divided by the equity ratio (Equity/debt + Equity). This relationship indicates that return on equity can be increased by increasing leverage or return on assets. Of course, there is a delicate balance between return on assets and a firm's leverage position, and a change in one will probably affect the other. However, under most circumstances, increased leverage will positively affect return on equity.

## **[\$6.06] Conclusion**

The accounting process and financial statements are, naturally, much more intricate than this chapter might suggest. Accountants generally have a standard reaction when facing situations requiring legal interpretation: seeking legal counsel. When you receive financial information that is not straightforward, or you intend to rely on the information extensively, you should seek professional accounting counsel.

In particular, you may want to consider using an accountant who specializes in forensic accounting, which is the discipline that deals with the relation and application of financial facts to legal problems. The forensic accountant presents the financial facts in an understandable fashion by way of a report (written or verbal), or as an expert witness presenting their findings at trial. The expert report and testimony at trial may contribute significantly to the success of your case.