**Introduction to Financial Management**

**Learning Outcomes**

After completing this module, students will be able to:

1. Differentiate financial management from investments and portfolio management.
2. Define the role of the chief financial officer in an organization.
3. Describe the major professional designations in the finance discipline.
4. Explain why share price maximization is the primary goal of an organization.
5. Discuss how agency costs prevent organizations from maximizing their share price, and the actions companies and governments can take to prevent this from occurring.
6. Describe the sources of guidelines and regulations relating to corporate governance, executive compensation, and financial reporting available from government agencies and non-profit organizations.
7. Demonstrate the impact that personal and corporate income taxes have on business decision making.

**Introduction**

Financial management deals with how companies ranging from small start-ups to major corporations effectively manage their operating and fixed assets and fund them with an optimal mixture of temporary and permanent debt and equity financing. The goal of an organization’s chief financial officer and its controller and treasury manager is to maximize the market value of the firm’s shares and minimize the agency costs that occur when the managers hired to run the business do not work in the shareholders’ best interests. Improvements in corporate governance, executive compensation, and financial reporting in the last 20 years have significantly reduced agency costs and helped promote economic efficiency.

All business degree students typically take an introductory financial management course in the second or third year of their programs. For students who decide to pursue a finance major, this course is followed by an advanced financial management course as well as specialized courses in international finance, risk management, business valuations and restructuring, and financial statement analysis. After graduation, most finance students pursue an advanced degree in finance or a professional designation such as the Chartered Financial Analyst, Certified Financial Planner, or Chartered Professional Accountant programs to further their careers.

* 1. **| Finance Discipline**

The finance discipline is divided into two main areas: 1) financial management, also called corporate, managerial, or business finance, and 2) investments and portfolio management. As discussed, financial management deals with how companies ranging from small start-ups to major corporations effectively manage their operating and fixed assets and fund them with an optimal mixture of temporary and permanent debt and equity financing. Investments and portfolio managers help companies design and price these debt and equity securities and market them to different individual and institutional investors. They also help investors administer their portfolios on an on-going basis which includes strategic asset allocation, security selection, trade execution, portfolio monitoring, portfolio rebalancing, and performance measurement.

The role of financial management can be best explained by Exhibit 1. A company has two categories of assets. The first category is net working capital (NWC) which is the difference between current assets (A) and current liabilities (C). In a merchandising or manufacturing business, this is the net investment companies make in current assets (primarily inventory and accounts receivable) that are not funded by current liabilities (primarily accounts payable). The second category is long-term assets which include the land, building, equipment, intangibles, and other assets that a company needs to operate. Both these asset categories are essential to a business and require financing.

**Exhibit 1: Financial Management**

|  |  |
| --- | --- |
| **Seasonal Low**  **Seasonal High**  **A** – Current Assets  **B** – Long-term Assets  **C** – Current Liabilities  **D** – Permanent Debt Financing  **E** –Permanent Equity Financing  **A minus C** – Net Working Capital  **F** – Temporary Financing |  |

Sales may vary considerably over the year depending on seasonal buying patterns like Christmas in the retail sector. As they change, so does the company’s need for NWC. During busier periods or seasonal highs, more NWC is needed. During slower periods or seasonal lows, the need for NWC falls. Over the year, long-term assets usually remain constant as land, building, and equipment cannot be adjusted to match seasonal variations in demand. The company maintains enough capacity to meet demand at the busiest time of the year.

NWC (A minus C) varies over the year but never falls below the level at the seasonal low so this amount is referred to as long-term NWC. Since long-term NWC never goes lower, it is financed with permanent financing (D and E) as are the other long-term assets (B) to ensure financing is always in place. During the seasonal buildup, NWC (A minus C) increases for a limited time and temporary financing (F) is used, but this financing is quickly repaid once the seasonal high is over.

**Topics in Financial Management**

Financial management seems simple, but it is quite complex. The main topics in financial management include:

**Goals of the firm.** The primary goal of a firm is to maximize the value of its common shares which equals the present value of the future cash flows the company expects to generate. A company incurs agency costs when its management and ownership are separate, and the managers hired to run the business do not work in the shareholders’ best interest and maximize share price. Improvements in corporate governance and executive compensation, stricter financial reporting standards, and greater shareholder activism are helping to reduce agency costs.

**Corporate governance and executive compensation.** Since the governance problems at Enron in the early 2000s, there has been a crisis of confidence in corporations. Instead of working in shareholders’ long-term best interests and maximizing the company’s share price, senior managers have been more concerned about their stock options plans and other executive perquisites or perks. To address this problem, corporations, governments, and different interest groups have worked to better align the interests of management with shareholders through improved corporate governance, executive compensation, and financial reporting practices.

**Financial statement analysis.** One of the most important skills a manager learns is how to analyze a company’s financial statements. Problems such as rising labour costs, slow-moving products, or excessive borrowing can quickly put a company in jeopardy if they are not addressed properly. Financial statement analysis only helps managers to identify these problems. They must then put their interpersonal skills and knowledge of other business disciplines such as marketing or supply chain management to work developing and implementing effective solutions. Managers use several tools to analyze a firm’s financial statements including traditional and cash flow-based financial ratios, vertical and horizontal analysis, and cash flow statement analysis.

**Financial statement quality.** As demonstrated by the Enron bankruptcy, even audited financial statements cannot always be trusted. Managers are under tremendous pressure to meet their earning targets. Many of them resort to accounting manipulation such as aggressive revenue recognition; excessive cost capitalization; deferring important discretionary costs like research and development, advertising, or employee training; delaying or accelerating gains and losses on asset sales; timing non-recurring items like restructuring charges to meet their goals. Audits often do not uncover these deceptive practices because of poor audit planning, a lack of proper monitoring and staffing, and client conflicts of interest. Some analysts try to address this problem by adjusting the financial statements themselves while others rely on earnings quality measures such as the Beneish Model, Altman’s Z-score, or accruals ratios to assess the quality of earnings. The stock market reacts harshly if companies are suspected of earnings management.

**Maturity matching.** A company matches the maturities of its assets and liabilities when it intentionally finances seasonal increases in net working capital (NWC) with temporary sources of financing such as a line of credit. Similarly, its long-term assets are financed with permanent sources of financing such as a commercial mortgage or term loan. Some managers try to increase their “bottom line” by funding long-term assets with temporary financing because lenders charge lower interest rates for these short-term loans, but these loans have to be renewed frequently over the assets’ lives. What happens if a financial crisis hits the global economy and lending is greatly curtailed due to market uncertainty? Many businesses will be unable to renew or rollover their temporary loans as they mature so they will face the prospect of having to sell new equity at very unattractive prices thus greatly diluting the ownership stake of existing shareholders. Most of the time mismatching maturities does not create a problem, but it only takes one unexpected decline in operating performance or a financial crisis to scare off lenders and place a company’s future in jeopardy. The best practice is to match maturities to ensure needed funding is available.

**Financial planning and growth**. Companies engage in both short-term and long-term financial planning. The master budget is a comprehensive short-term financial plan that is divided into operating and financial budgets. Operating budgets focus on product costing and variance analysis and are primarily of interest to accountants. Financial budgets are more important to finance professionals as they help determine whether a company has enough cash and is complying with its lending conditions, adhering to its financial policies, and achieving its financial goals. Companies also develop long-term financial plans for periods that are greater than a year based on a long-term sales forecast. These plans are less accurate and detailed than short-term financial plans but still provide important information relating to a company’s future growth prospects, the assets required to support this growth, and the necessary financing.

**Capital budgeting.** Capital budgeting is a critical activity for any business. It helps senior management establish a long-term strategic direction for a company by evaluating different growth opportunities such as introducing new products, expanding into new markets, or acquiring competing firms. At the lower levels of the firm, it is invaluable in assessing product improvement ideas, cost-saving plans, or proposed capacity additions. Maintaining a constant flow of new investments is essential to a company’s long-term profitability and survival.

**Risk and return.** Intuitively, the riskier an investment, the greater the return investors will expect. Risk is defined as the variability of the cash flows that an investment generates over time. Much of the risk can be eliminated by portfolio diversification, but investors must be fairly compensated for the risk that remains. This required rate of return (RRR) is the discount rate used when valuing the debt and equity securities a company issues to its investor. If a company becomes riskier say due to increased international competition or political factors, then the discount rate will rise, and the value of these securities will fall. Measuring risk and the corresponding RRR using models such as the capital asset pricing model (CAPM) is difficult as each company has unique operating characteristics that are constantly changing.

**Cost of capital.** This is the weighted average cost of the permanent debt and equity capital (WACC) used to finance a firm’s long-term assets. No capital project should be undertaken unless it earns at least the firm’s cost of capital which is equal to the shareholders’ RRR. The cost of capital is difficult to measure accurately, and small errors have a major impact on decision making. Reliable market data is usually available for large, publicly traded companies but not for smaller private firms. Due to this uncertainty, many companies do not attempt to calculate their cost of capital alone but instead rely on outside financial information providers to supply expert advice and needed model inputs.

**Working capital management.** The goal is not to minimize NWC but to maximize long-term profits by optimizing the level of current assets and liabilities. It may be more profitable for a firm to carry additional inventory, implement more generous credit policies, or pay creditors sooner even though they all raise the level of NWC. Once the optimal level of NWC is determined, a company must manage these assets effectively, select the most cost-effective sources of temporary financing and invest any cash surpluses wisely.

**Temporary financing.** Companies that match the maturity of their assets and liabilities regularly issue temporary financing with a term of less than a year to fund seasonal increases in NWC. Once the seasonal build-up is over this financing is quickly repaid. Different sources of temporary financing include trade credit, lines of credit, revolving credit agreements, specific assignments, purchasing order financing, factoring, securitization, commercial paper, and letters of credit.

**Permanent financing.**  Companies regularly issue permanent debt and equity financing with a term of greater than one year to finance purchases of long-term NWC and fixed assets such as land, plant, and equipment. For small and medium-sized enterprises (SME), commercial loans and leases are the most important sources of permanent debt financing. For larger businesses, commercial loans and leases are still important, but publicly issued bonds and private loan placements with long-term institutional lenders and high-net-worth individuals are also popular. Many start-up companies naively believe they can borrow all the funds they need to launch their new ventures, but quickly realize they must balance their use of debt with equity to meet their high loan servicing obligations. Because start-ups do not have access to public equity markets, they need to look to other sources of equity such as the owner’s assets; loans and gifts from family and friends; angel investors; venture capitalists; or private equity placements. Once the venture is bigger and more established, it can go public to raise additional capital in the bond or stock markets. Even public companies are hesitant to issue new equity because of the high issuance costs and potential loss of control and instead rely heavily on their retained earnings to finance growth.

**Capital structure.** Financial professionals often talk about the “magic” of financial leverage. How this works is that companies borrow money at low rates from financial institutions or by issuing bonds. These funds are then reinvested in the firm, where they normally earn higher returns. The company pays taxes on the difference and keeps what remains. It sounds simple, but companies must be very careful to use financial leverage in moderation. High leverage means greater borrowing costs, which include interest and principal repayments. When the economy is doing well, companies can generally meet their obligations because cash flows are high. If a major economic slowdown occurs, and they tend to occur when they are least expected, then a company may struggle with its debt servicing. If it cannot meet its obligations, it may have to declare bankruptcy and be forced to either reorganize or liquidate. Regardless, shareholders will likely lose their investment. Managers must be able to determine a company’s optimal capital structure. This is the level of borrowing that balances the benefits of financial leverage with the risk of bankruptcy. The general rule is a company should only borrow what it can pay back in a serious downturn.

**Business valuation.** Accountants and financial analysts must often estimate the fair market value of a business enterprise, its specific assets and liabilities, or damages such as breach of contract or patent infringement. Business valuation is a complex process that is prone to errors because of problems accurately forecasting a company’s future operations. Many public accounting firms offer business valuation services in addition to their traditional services in business advisory, taxation, financial reporting, and insolvency. Investment bankers apply valuation principles when advising clients on public offerings or corporate restructurings. Venture capitalists employ them to price start-up companies.

**Mergers and acquisitions (M&As) and corporate restructuring.** M&As combine firms to increase their value through the creation of synergies. These synergies can take many forms such as higher prices due to reduced competition, increased sales from improved distribution, lower operating costs because of economies of scale, tax savings from loss carryforwards, or improved strategic and financial management. Besides M&As, companies can restructure their operations using divestitures, spin-offs, split-outs, and split-ups to re-focus the business on its core operations, redeploy capital, pay down debt, or outsource production. Corporate restructuring is generally viewed unfavourably by the public because of the plant closures and layoffs that often result. Although these actions are difficult for employees, they are essential if the economy is to remain efficient and managers are to maximize their firm’s share price.

**Bankruptcy, liquidation, reorganization.** Most companies experience financial distress at some point. Falling profit margins, shrinking cash flows, and declining asset turnover ratios are all symptoms of a troubled company. In Canada, bankruptcy is the jurisdiction of the federal government so there is only one set of rules for the entire country. Under the Bankruptcy and Insolvency Act, companies experiencing financial distress can either be liquidated or reorganized. In a liquidation, a creditor representative takes possession of the bankrupt company’s assets, disposes of them, and distributes the proceeds according to a specified priority of claims. In a reorganization, a company’s management and its creditors decide that the business is worth saving and develop a plan to revive it. By saving the company, creditors feel that they can receive a larger payout than in a liquidation, and employees and governments benefit from continued employment and additional tax revenue.

**Dividend policy.** A company can distribute surplus cash to its shareholders by paying them a cash dividend or repurchasing their common shares. The amount paid out is normally the portion of a business’s earnings that are not needed to finance its future growth. Many academics feel that whether a company pays a dividend or not is irrelevant. They claim that if the dividend is too low, shareholders will simply generate additional cash by selling some of their shares. If the dividend is too high, they will use the funds to buy more shares. The dividend decision is relevant though as dividends and capital gains are taxed differently. Transaction costs incurred by shareholders buying and selling shares vary with the size of the dividend as do the issuance costs paid by companies raising new equity. The size of the dividend influences management’s financial flexibility and the agency costs incurred by the company’s shareholders. Finally, the size of a dividend and whether it is increasing or decreasing provides a signal to the financial markets about a firm’s financial performance. Senior management must design a dividend policy that meets their company’s financing needs and stock market expectations.

**Risk management.** Companies are exposed to numerous operational and financial risks that may cause serious financial distress if not managed properly. Losses may occur because of fire, theft, or damage of physical or intellectual property; data breaches; commercial or product liability, patent infringement, environmental violations, personal harassment, and other workplace health and safety infractions; loss of key employees and business interruptions; non-fulfillment or cancellation of international contracts, cancellation of import/export agreements with foreign governments, government expropriation of assets, foreign political strife, limitations on currency conversion or moratoriums on debt repayment; and fluctuating commodity prices, interest rates, or exchange rates. A company can purchase regular casualty insurance from an insurance broker to protect itself against most of these losses or they can self-insure if the premiums are too high. The Government of Canada’s Export Development Corporation (EDC) offers insurance relating to export sales and foreign operations. Derivative securities including forwards, futures, swaps, and options are used to hedge fluctuations in commodity prices, interest rates, and exchange rates. Most large corporations also have strong Enterprise Risk Management (ERM) programs with a designated risk manager to identify, assess, monitor, and mitigate important business risks throughout the organization.

**International financial management.** Companies have more opportunities if they are willing to expand internationally, but this growth brings many additional risks. By broadening their operations, multi-national firms can increase the size of their market; offer more expensive or specialized products that a smaller domestic market cannot support; diversify sales across multiple regions with different economic cycles; realize economies of scale; secure more affordable financing; access technology or natural resources that are not available domestically; or take advantage of a low-cost, highly-skilled workforce that is subject to fewer work rules. Besides different linguistic, cultural, and legal environments and varying business practices, multinational companies must contend with foreign exchange and political risks. Raising financing abroad is subject to different market conventions and translating foreign operations into a firm’s domestic currency when preparing consolidated financial statements is complex.

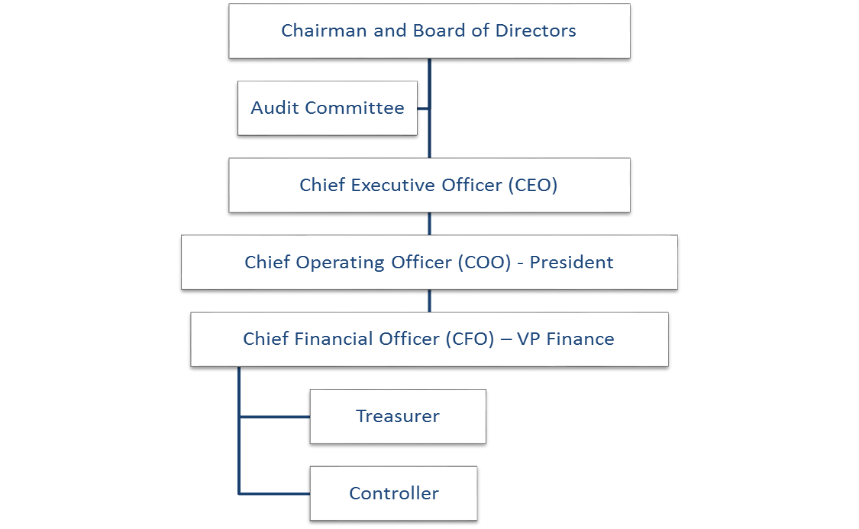
These financial management topics are covered throughout the different modules in this course and subsequent courses.

**1.2 | Finance Function in the Organization**

A public corporation’s shareholders elect a board of directors to oversee the company’s operation on their behalf. The board’s main responsibility is to appoint the chief executive officer (CEO) and other senior executives such as the chief operating officer (COO) and chief financial officer (CFO) and monitor and evaluate their performance. The CEO manages the business on a day-to-day basis, but the board has the right to intervene and overturn their decisions if necessary. Much of the board’s work is done through several sub-committees composed of directors that make recommendations to the full board for approval. The human resources and compensation, corporate governance and nominating, and audit committee are the most common. The audit selects the organization’s external auditors and monitors them and the CFO as they prepare the company’s financial statements and other financial disclosures. They also address any accusations of financial impropriety made by employees or other stakeholders against the company.

Accounting and finance graduates often aspire to become the CFO of a major corporation after graduation. Most students begin their studies in accounting, but as the exhibit below shows, the accounting or controller function is only half of a CFO’s job. The other half is the treasury function which is financial management.

**Exhibit 2: Financial Function in the Organization**



To be successful as CFOs, accountants are encouraged to pursue advanced education and gain valuable experience related to both the controller and treasurer functions. A master’s degree in finance is a possibility, but most choose to earn a second professional designation in corporate finance while they continue to work. The accounting and financial management professions are closely interconnected.

**Professional Designations in Finance**

A professional designation attests to an individual’s knowledge and skills in a specific field such as medicine, nursing, social work, education, law, or accounting and is often a requirement for practicing in that area. These designations are typically awarded by professional associations in partnership with colleges and universities and often require that students pass rigorous accreditation exams and meet lengthy work experience requirements. Professional designations are becoming increasingly important in the finance discipline. New employees may have to enroll in and complete a designation program as a condition of continued employment or to advance at work. Professional designations vary in their rigour, but some are equivalent to master’s degrees in finance and are an inexpensive alternative for students who cannot afford graduate school. The most common finance designations in Canada include:

**Chartered Professional Accountant (CPA).** Engages in public or private accounting supplying financial reporting, auditing, taxation, small business advisory, budgeting, corporate finance, and risk management services to businesses. The Chartered Accountant (CA), Certified Management Accountant (CMA), and Certified General Accountant (CGA) designations have merged in Canada to form the CPA.

**Chartered Financial Analyst (CFA).** Manages the investment portfolios of high net worth individuals and institutions such as pension funds, endowments, insurance companies, and mutual funds. CFAs are experts in the different areas of investing including equities, fixed income, and alternative investments like real estate, venture capital, and other forms of private equity. They are also skilled in risk management including hedging commodity price movements, currency fluctuations, interest rate changes, and credit risk.

**Chartered Business Valuator (CBV).** Focuses on valuing individual assets or whole business enterprises as well as litigation support which includes quantifying business losses for insurance purposes and giving expert testimony at trial if necessary.

**Chartered Insolvency and Restructuring Professional (CIRP).** Work closely with accountants and lawyers managing the corporate bankruptcy process which involves the liquidation or reorganization of troubled companies and personal bankruptcy.

**Certified Financial Planner (CFP).**  Specializes in personal financial planning for lower net worth clients in areas such as retirement and educational savings, taxes, insurance, mortgages, personal loans, wills, trusts, and estates.

**Certified Treasury Professional (CTP).** Oversees a company’s treasury operations such as financial planning, cash management, short-term investments, working capital management, short-term and long-term financing, and risk management.

* 1. **| Goals of the Firm and Agency Costs**

**Goals of the Firm**

The primary goal of a firm is to maximize the value of its common shares which equals the present value of the future cash flows the company expects to generate for its shareholders. Textbooks often say that profit maximization is a firm’s main goal, but accounting profits should not be used for three reasons:

* Profit is an accounting figure that can be more easily manipulated than operating cash flow by choosing different accounting policies, practices, and estimates or through fraudulent financial reporting.
* Profit only measures the current period’s performance while share price equals the present value of all future cash flows. Focusing on profit encourages managers to make more short-term decisions like cutting research and development to raise net income now knowing that the company will not benefit from these expenditures for years.
* Profit does not incorporate varying risk while share price does by adjusting the interest rate used to determine the present value of future cash flows. A firm can raise its profits during good economic times by taking on riskier projects, but investors will not know the effect until the company experiences difficulties in the next downturn.

The goal of share price maximization addresses these problems and forces managers to be more long-term decision-makers.

The value of any asset equals the present value of the future cash flows investors will receive. For a rental property, the cash flows are the rental payments minus any cash expenses. For a bond, they are the regular interest payments plus the return of principal at the end of its life. Determining the value of a business’s shares is no different. A share’s price equals the present value of all future dividends that will likely be paid to the common shareholders. The present value of these cash flows is what someone else is willing to pay now so that with interest they can accumulate the same amount in the future. The interest rate used to determine the present value varies with the riskiness of the investment and is called the investor’s required rate of return (RRR) or the firm’s cost of capital. It is impossible to estimate exactly how long most companies will survive, so analysts adopt the going concern principle and assume the company and its dividends will last indefinitely. A series of payments that go on indefinitely is called a perpetuity. The formula for the present value of a perpetuity is:

Share value =

A company’s share price rises and falls with changes in the two components (i.e. cash flow and cost of capital) of this formula as shown in the exhibit below.

**Exhibit 3: Share Price Maximization**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Company A** | **Company B** | **Company C** |
| **Case 1** |  |  |  |
| Cash flows or dividends per share | CAD 6 | CAD 6 | CAD 6 |
| Cost of capital | 6% | 6% | 6% |
| Share value | CAD 100 | CAD 100 | CAD 100 |
| RRR | 6 ÷ 100 = 6% | 6 ÷ 100 = 6% | 6 ÷ 100 = 6% |
| **Case 2** |  |  |  |
| Revised cash flows or dividends per share | CAD 6 | CAD 5 | CAD 10 |
| Cost of capital | 6% | 6% | 6% |
| Revised share value | CAD 100 | CAD 83 | CAD 167 |
| RRR | 6 ÷100 = 6% | 5 ÷ 83 = 6% | 10 ÷ 167 = 6% |
| **Case 3** |  |  |  |
| Cash flows or dividends per share | CAD 6 | CAD 6 | CAD 6 |
| Revised cost of capital | 6% | 10% | 5% |
| Revised share value | CAD 100 | CAD 60 | CAD 120 |
| Revised RRR | 6 ÷ 100 = 6% | 6 ÷ 60 = 10% | 6 ÷ 120 = 5% |

The three companies in Case 1 generate the same cash flows or dividends per share each year and have the same cost of capital so their share prices are equal. Company investors also earn the same RRR which equals their cost of capital. In Case 2, Company A’s cash flows per share stay the same, but Company B’s cash flows per share fell possibly due to an unsuccessful product launch while Company C’s new product was a success. The cost of capital remained the same for the three companies as their risk was stable, so the share price remained the same for Company A, fell for Company B, and rose for Company C due to the change in cash flows. The cost of capital and RRR must be the same so Company B’s share price fell to raise the RRR for investors to the cost of capital. For Company 3, the share price rose to lower the RRR to the cost of capital. In Case 3, the cost of capital changed, and the share prices adjusted so the cost of capital and RRR for the three companies were the same. Company 2’s share price fell to reflect its higher risk, and Company 3’s share price rose to reflect its lower risk.

The value of a stock market index like the TSX/S&P 300 or S&P 500 is equal to the weighted average price of all shares in that index. These indexes are the primary performance measures for the economy which is why the media focuses so closely on them in their financial reporting. If markets rise, the economy is prospering because future cash flows are rising or risk levels are falling, but the opposite is true if the markets fall.

**Agency Costs**

A company incurs agency costs when its management and ownership are separate, and the managers hired to run the business do not work in the shareholders’ best interest and maximize the share price. These costs are incurred because:

* Managers are more worried about their job security than pursuing risker, potentially more profitable projects especially if they are close to retirement
* Managers are focused on their pay and perquisites instead of their performance
* Executive pay is linked to a company’s size, growth, and media profile not its profitability
* Boards of directors are not independent of the CEO and have conflicts of interest
* Boards of directors lack the time and ability to perform their duties
* Auditors are not independent of management
* Shareholders of widely-held companies do not act to reduce agency costs
* Take-over defenses prevent poor managers from being removed

Agency costs affect other stakeholders besides shareholders like employees or creditors. High-profile corporate bankruptcies in the U.S. (i.e. Enron in 2001) and Canada (i.e. Nortel in 2013) have motivated governments, corporations, non-profit organizations, and investors to reduce them. Their actions include:

* Improved corporate governance policies and practices
* Greater emphasis on “pay for performance” which links executive pay to achieving specific corporate goals and increasing the firm’s share price
* Enhanced financial reporting and better auditor training and independence
* Rising activism by large institutional investors or dissident shareholder groups to address agency problems
* More corporate take-overs by competitors and private equity firms to remove poor-performing managers
* Severance and change-of-control entitlements, also called “golden parachutes,” encourage poor-performing executives to leave and not resist take-overs
  1. **| Corporate Governance**

In Canada, most large companies incorporate federally under the Canada Business Corporations Act (CBCA) so they can conduct business in every province. CBCA stipulates the powers and responsibilities of a firm’s board of directors and the rights of its shareholders although many of these regulations can be modified in the company’s articles of incorporation and bylaws if supported by shareholders. Also, businesses listed on the Toronto Stock Exchange (TSX) or the Toronto Stock Exchange Venture (TSXV), Canada’s large and small-cap exchanges, must follow other regulations in the Ontario Securities Act and the TSX Company Manual.

Until recently, securities regulation in Canada was a provincial jurisdiction where each province had its legislation. Most countries, including the U.S. through its Securities Exchange Commission (SEC), have recognized that national securities regulation is more effective given that public companies typically raise funds in several jurisdictions at once. Despite this, provincial governments were unwilling to give up their authority, although they did agree to form the Canadian Securities Administrators (CSA). This is a national body composed of federal, provincial, and territorial governments that prepares national or multilateral policies or instruments relating to securities regulation. National instruments are adopted and implemented by each province’s securities commission while multilateral instruments are only effective in some provinces. National or multilateral policies are guidelines only. In a November 2018 decision, the Supreme Court of Canada finally gave the federal government the power to establish a national securities regulator that is responsible for security regulation in Canada but there has been limited progress to-date. The Supreme Court also indicated the federal and provincial governments should continue to work together cooperatively.

**Role of the Board of Directors**

A public corporation’s shareholders elect a board of directors to oversee the company’s operations on their behalf and work in their long-term best interests. The board is the ultimate decision-making authority although most major decisions such as mergers and acquisitions are still voted on by the shareholders. The board’s main responsibilities are to appoint the CEO and senior executives, monitor and evaluate their performance, determine their compensation, and sometimes terminate them. It also sets the company’s strategic direction; monitors opportunities and risks; approves the budget including any major decisions such as capital expenditures, raising new capital, organizational restructurings, or new product launches; and approves the audit financial statements detailing the company’s financial performance before they are distributed to shareholders. The CEO and other executives manage the business on a day-to-day, but the board has the right to intervene and overturn them if necessary. Directors must be familiar with the company’s operation to know if it is being managed effectively. The degree of board involvement varies, but the trend is for directors to be more actively involved.

The board elects a chairperson to oversee its activities and enhance its effectiveness. The chair’s responsibilities are to set the agenda for board meetings, ensure directors receive all needed information, preside over director and shareholder meetings, and be a liaison between the board and management. All directors are elected by shareholders at the annual general meeting and can be removed at their discretion. Directors are primarily experts from business, politics, academia, and the legal professions but they also include union or employee representatives and those with specific skills in areas such as sustainable development or ethics. Having a diverse board with more varied backgrounds and personal characteristics including gender, age, ethnicity, and geographical location is important, but it is also critical to have directors with extensive industry experience. Boards of larger established companies typically meet eight times a year for a day-long meeting either face-to-face or by conference call. In-person meetings are more common because of the engaging debate and direct personal contact. The boards of smaller companies meet more often due to their dynamic nature which requires more careful oversight. Special meetings are called to discuss pressing issues between regular board meetings. Strategic planning retreats lasting a couple of days are also held to map out the firm’s direction.

Directors are given notice of the meeting and receive an agenda and other meeting materials well in advance, so they have adequate time to examine the package and contemplate any questions or concerns. The meetings are conducted formally with quorum requirements, official motions, and minutes that are later circulated to directors for approval. Regular attendance at meetings is critical to making informed decisions and directors are evaluated on their attendance. No proxies are allowed, and directors are potentially liable for any decisions made in their absence, so they are usually there to vote. Most issues are decided by a majority vote, but the firm’s articles of incorporation or bylaws may stipulate that certain motions need to be supported by more than 50% of directors or even be unanimous.

Much of the board’s work is done through several smaller permanent standing committees composed of directors that make recommendations to the full board for approval. Possible standing committees are the executive, strategic planning, nominating, compensation, audit, finance, risk management, governance, legal, pensions, health and safety, community relations, and ethics and sustainability committees. The executive, audit, finance, nominating, and compensation committees are the most common and the audit committee is mandatory. The executive committee acts between board meetings when it is impractical to call another meeting and may help the board chair consult with management. This committee is either elected by the board members or consists of the board chair and the chairs of each of the standing committees. The audit committee oversees the annual audit of the financial statements, while the finance committee supervises the preparation of the yearly budget and raises needed capital. The compensation committee designs director and executive pay systems and evaluates their performance. The nominating committee recruits new directors and recommends them to the board and the shareholders for approval.

In addition to standing committees, boards form special committees or task forces for a limited period to address critical matters or achieve specific goals quickly before being disbanded. Advisory councils consisting of outside experts that counsel the board on emerging issues or the general strategic direction of the business, but these experts are not directors and have no authority.

**Shareholder Rights**

A corporation is owned by its common shareholders, but their rights are not absolute. The board of directors must hold an annual general meeting of its shareholders. Before the meeting, the board circulates a management information circular which describes the issues to be either voted on or just discussed including the election of directors; appointment of external auditors; annual financial statements; management discussion and analysis; director and executive compensation; and other management or shareholder proposals. The board determines the agenda, but regulators require that the circular be detailed enough so shareholders can make informed decisions. Shareholders may require that the board include shareholder proposals in the circular as well even if the board does not support them. Proposals can also be introduced at the meeting, but the chair is normally able to rule them out of order claiming insufficient time was given to examine them before the meeting. If the chair does allow these proposals to be discussed and voted on, the results are usually only advisory which means they are not binding on management. The board may call a special meeting of shareholders at any time to seek shareholder approval of a proposal. Shareholders who own 5% or more of the shares can also call special meetings.

At the meeting, shareholders elect the directors nominated by the board for a one-year term. Shareholders can nominate directors if advanced notice is given and relevant information about the candidates is included in the circular. Each director must be approved by a majority of the shareholders and those who are unsuccessful must withdraw. Shareholders can also call a special meeting to remove the directors. During the rest of the meeting management reviews the information in the circular, answers shareholders’ questions, and votes on any proposals. Under the CBCA, certain important actions such as business acquisitions, sales of assets, new share-based compensation plans involving the issuance of new shares, and changes to the articles of incorporation and bylaws must be approved by shareholders. In some cases, if shareholders disagree with a transaction but the majority of shareholders vote in favour, they have the right to have their shares bought out at fair market value. Shareholders can also bring legal action against the board to force them to comply with the company’s articles of incorporation, by-laws, or provincial securities legislation or to stop treating shareholders in an unfair or prejudicial manner.

Shareholders have considerable rights, but most do not attend the annual meeting because of the time and expense. The board asks for their votes in a proxy solicitation which allows the board to exercise their votes at the annual general meeting in support of their agenda. Other shareholder groups who oppose management may try to compete for these votes by issuing a shareholder information circular and proxy solicitation, but management is usually successful because of their skill soliciting proxies and greater financial resources. The exception is large institutional investors who often meet directly with management to discuss their concerns. If they are not addressed, the institutional investors may speak at the general meeting or make a public statement. Activist investors and private equity firms may also press the company for change and even initiate a proxy fight or take-over bid to replace current management.

**History of Corporate Governance in Canada**

The movement to improve corporate governance in Canada began in 1994 with a report sponsored by the TSX entitled “Where Were the Directors? – Guidelines for Improved Corporate Governance in Canada.” The report also called the Dey Report after its committee chair, made 14 recommendations which the TSX adopted as best practice guidelines. Companies listed on the exchange were required to disclose their governance policies and practices in their annual report and provide an explanation of where they varied from these guidelines. The Dey Report was followed by another TSX sponsored report entitled “Five Years to the Dey” in 1999 that found although companies were making progress in approving their governance practices that there were still several shortfalls. This was followed by another TSX sponsored report in 2001, the “Saucier Report on Corporate Governance,” that recommended changes to the guidelines adopted by the TSX. This report was quickly followed by the Enron bankruptcy in 2001 which exemplified the poor state of corporate governance and financial reporting in the U.S. and other countries. In July 2002, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) which enacted several measures to restore investors’ faith in the financial markets. Given the need to maintain Canadian investor confidence and access to the U.S. capital markets, the CSA passed several similar national policies and instruments relating to corporate governance and financial reporting. Those relating to corporate governance include:

NP 58-201 Corporate Governance Guidelines

NI 58-101 Disclosure of Corporate Governance Practises

**Corporate Governance Guidelines**

NP 58-201 Corporate Governance Guidelines apply to all publicly traded companies in Canada. Companies do not have to adhere to them, but under NI 58-101 Disclosure of Corporate Governance Practices, they are required to disclose their governance policies and practices and explain any variations with these guidelines to shareholders. These guidelines are influenced by several unique Canadian factors including the smaller size of the Canadian financial market and the proportionately higher number of small-cap companies. Canada has more concentrated business ownership with a single shareholder, typically the founding family, controlling a higher percentage of companies compared to the U.S. These factors favour a simpler, more flexible corporate governance system than in the U.S., but Canadian guidelines must be stronger so its large domestic companies can access U.S. capital markets. The Multi-Jurisdictional Disclosure System (MJDS) allows firms to issue shares concurrently in both Canada and the U.S. using the same documentation. Many Canadian firms cross-list their shares in the two countries to access lower-cost capital, reduce issuance costs, and make their shares more marketable for investors.

A summary of NP 51-201 Corporate Governance Guidelines includes:

**Board composition.** A majority of a board’s directors should be independent to provide greater objectivity when dealing with management. An independent director should serve as board chair or be appointed as the lead director if that is not possible. The independent chair or lead director should act as the effective leader of the board and ensure the board carries out its duties. The option to have a lead director relates to the practice of having the company’s CEO serve as the board chair. Although common in the past, most companies have discontinued this practice with improvements to corporate governance.

An independent director has no direct or indirect material relationship with the company. A material relationship is one that can “be reasonable expected to interfere with the exercise of a member’s independent judgment.” This includes current and former employees or auditors, their family members, individuals who accept consulting or advisory fees from the company, or persons employed by another firm that provides legal, financial, or consulting services. Independent and non-independent directors are also called outside and inside directors. When company executives serve on the board, they are called executive directors.

**Meetings of independent directors.** Independent directors should meet regularly without the non-independent directors or the company’s management.

**Board mandate.** A written mandate should acknowledge the board’s overall responsibility for the stewardship of the company. This includes:

* Ensuring the integrity of the CEO and other executives and that they create a culture of integrity in the organization
* Establishing a strategic planning process and approving a new plan annually
* Identifying the opportunities and risks of the business and implementing an appropriate risk management program
* Succession planning including appointing, training, and monitoring senior management
* Adopting a communication policy that gives all stakeholders equal access to corporate performance information
* Constructing internal control and management information systems
* Developing corporate governance policies and practices including measures allowing stakeholders to provide feedback directly to independent directors

**Position descriptions.** Written job descriptions should be established for the board chair, the chairs of all board committees, and the CEO. This includes establishing with the CEO the goals and objectives that the firm is expected to achieve.

**Orientation and continuing education.**  All directors should receive a thorough orientation where they examine the role of the board of directors and its different committees, the nature of the business’s operations, the time commitment required, and the skills they are expected to bring to the board. The board should also provide each director with ongoing professional development opportunities to enhance their skills and knowledge of the business’s operations.

**Code of business conduct and ethics.** The board should adopt a written code of business conduct and ethics to promote integrity and discourage wrongdoing. It should apply to all directors, executives, and employees and specifically address:

* Conflicts of interest including transactions and agreements where a director or executive officer is determined to have a material interest
* Protection and proper use of corporate assets and business opportunities
* Confidentiality of corporate information
* Fair dealing with the issuer’s security holders, customers, suppliers, competitors, and employees
* Compliance with laws, rules, and regulations
* Reporting of any illegal or unethical behaviour

The board must monitor compliance with the code, approve all exceptions, and report any departures to shareholders.

**Nomination of directors.** A nominating committee should be appointed that consists of independent directors only. It must have a written charter that describes its purpose, responsibilities, member qualifications, member appointment and removal, structure and operations, and system for reporting to the board. The committee should have the right to engage and compensate outside advisors as required.

Before nominating new directors, the committee should consider the optimal size of the board and establish qualifications for new positions to fill any identified gaps in the board’s skill set. Nominees are selected based on these competencies as well as their personality and other characteristics necessary to build a strong group dynamic on the board. The committee should also consider whether nominees can devote enough time and resources to their position as a director. The nominating committee makes recommendations to the board. Once approved by the board, the nominees are voted on by shareholders at the annual general meeting.

**Compensation committee.** A compensation committee consisting of only independent directors should be appointed. It must have a written charter that describes its purpose, responsibilities, member qualifications, member appointment and removal, structure and operations, and system for reporting to the board. The committee should have the right to engage and compensate outside advisors as required.

The committee sets the relevant goals for the CEO’s compensation, evaluates their performance against these goals, determines compensation based on performance, and makes a recommendation to the board. It makes similar recommendations for the other executives and directors. Finally, it advises the board on what incentive and equity-based pay plans to adopt and reviews all compensation disclosures made to shareholders.

**Board assessment.** The board, its committees, and directors should be regularly evaluated on their effectiveness. Boards and committees are evaluated against their mandate and charters, while directors are evaluated against their job descriptions and the competencies they were expected to bring to the board.

**1.5 | Executive and Director Compensation**

An effective executive and director compensation system is critical to aligning the interests of management and shareholders to minimize agency costs and maximize shareholder value. The price of a company’s shares equals the present value of their future cash flows, so executive compensation needs to be highly correlated with long-term performance. Pay systems that reward short-term profits at the expense of long-term success are detrimental. These systems must also be competitive with other firms in the industry, so the company can attract, motivate, and retain high-quality managers in a competitive global market for executive talent.

There have been major improvements to corporate governance in Canada since the Dey Report was published in 1994 and the realization by directors that they can be held accountable for a lack of proper oversight. Boards of directors now play a much more active role in a company’s management setting its strategic direction, selecting the right CEO, counseling management as they work to achieve the firm’s goals, and evaluating executive performance. With more active involvement comes the need for higher director compensation, but like executives, director pay systems must maximize shareholder value by rewarding long-term performance. This is difficult as directors are tasked with building their own compensation plans leading to potential conflicts of interest.

The Canadian Coalition for Good Governance (CCGG) recognizes how important effective executive and director compensation are to good corporate governance. Improved monitoring of executive performance by boards and shareholders and strong penalties for those who attempt to mislead investors are essential, but nothing is more important than giving executives and directors the proper financial incentives to maximize shareholder value. CCGG has published two reports on how to design effective executive and director compensation systems.

Executive Compensation Principles (2013)

Director Compensation Policy (2017)

**CCGG Executive Compensation Principles**

**Principle 1** **– A significant component of executive compensation should be “at-risk” and based on performance.** This means their pay is variable and dependent on attaining specific performance goals established by the board of directors. These include quantitative and qualitative goals, company-wide and individual goals that must be achieved over the short, medium, and long term. The motto is “pay for performance.”

**Principle 2 – Performance should be based on key business metrics that are aligned with corporate strategy and the period during which risks are assumed.** Metrics are expressed in absolute terms or relative to the performance of their industry peers and should be intricately linked to achieving the firm’s goals as set out in its strategic plan. Companies should disclose to shareholders the linkages between their different performance and strategic goals. There must be a balance between both short-term and long-term performance.

**Principle 3 – Executives should build equity in the company to align their interests with those of shareholders.** New executives should meet a minimum shareholding requirement that accounts for a significant portion of their net worth within a reasonable period, usually five years, after joining the company. This ownership stake should be maintained over their employment and for a period after leaving the firm to discourage short-term decision making at the end of their tenure.

**Principle 4 – A company may choose to offer pensions, benefits, and severance and change-of-control entitlements. When such perquisites are offered, the company should ensure that the benefit entitlements are not excessive.**  To attract and retain high-paid executives, companies may provide additional perquisites or perks in addition to regular health and welfare benefits such as a driver, a personal chef, a company jet, stays at 5-star hotels or company-owned apartments when traveling, charitable donations made on their behalf, club memberships, private boxes at sporting events, theatre tickets, free parking, use of a vacation home, tuition assistance for their children or loans to purchase company stock. Executives may also be awarded Supplemental Executive Retirement Plans (SERPs) to top off their registered pension plans as their benefits are capped by the government. Those terminated without cause or when the company is taken over by another firm may also receive generous severance pay.

**Principle 5 – Compensation structure should be simple and easily understood by management, the board, and shareholders.** CCGG recommends that compensation committees simplify pay plans so they are easily understood by the board and executives and can be explained to shareholders who must ultimately judge their effectiveness. NI 51-102F6 Statement of Executive Compensation further stipulates that companies must disclose to shareholders any direct and indirect compensation paid to their directors, CEO, CFO, and next three highest-paid executives. This must include a detailed description in simple language of the director and executive compensation plans and the rationale for their design.

**Principle 6 – Boards and shareholders should actively engage with each other and consider each other’s perspective on executive compensation matters.** CCGG recommends that boards hold a “say on pay” vote on director and executive compensation at each annual general meeting so shareholders can express their satisfaction with the company’s approach. These are advisory votes that are not binding on management, but boards should use them as an opportunity to gather valuable feedback.

**CCGG Director Compensation Policy**

**Principle 1 – Independence and Alignment with Shareholders.** Director compensation systems, like those of executives, should be aligned with the interests of shareholders to minimize agency costs and maximize shareholder value. Pay must be high enough to attract qualified directors, but not so high as to comprise their independence and objectivity. Directors must be willing to oppose actions that are not in the shareholders’ best interests and resign from the board if necessary.

**Principle 2 – Reflect Expertise and Time Commitment.** A director’s compensation should reflect their knowledge, skills, experience, level of responsibility, and time commitment as well as the size and complexity of the company. Executive directors should not receive any extra compensation for serving on the board.

**Principle 3 – Compensation May Vary for Different Directors.** Director compensation should vary depending on the responsibilities and time commitment of each director. There should be no difference in pay for directors in similar roles to promote group cohesion. Serving as a board chair, lead director, or committee chair warrants higher compensation as does serving on a busier committee such as the audit committee or a special committee.

**Principle 4 – Shareholding by Directors.** Directors should purchase an equity stake in the company upon joining the board and add to that investment over time. A minimum shareholding requirement should be set equal to some multiple of each director’s annual pay and they should have to hold that investment for a minimum of one year after resignation or retirement from the board.

**Principle 5 – Minimize Complexity and Ensure Transparency.** Director compensation plans should be simple, so they are easily understood by directors and shareholders. The rationale for the plan, the process used to develop it, and the reason for any changes should be disclosed to shareholders in the management information circular circulated before the annual general meeting.

**1.6 | Financial Reporting**

A corporation’s audited financial statements are the most important source of information about its operating and financial performance. Until the Enron bankruptcy in 2001, most investors naively assumed that all audited financial statements were accurate. What Enron exposed was that companies regularly engaged in accounting manipulation to hide problems and exaggerate their financial performance and that these actions went undetected or were ignored by their auditors.

A company’s managers are under tremendous financial pressure for different reasons. Large public corporations are monitored by a group of outside equity analysts who research their performance on behalf of different investment firms. Businesses must meet or beat these analysts’ quarterly earnings estimates (i.e. “beat the street”) or there will likely be serious stock market repercussions. Portfolio managers are evaluated based on their short-term and not their long-term performance, so missing earnings estimates usually causes an immediate decline in a company’s share price as portfolio managers sell shares in response to the bad news. CEOs and other executives receive a large portion of their pay from bonuses and stock options that are contingent on a rising share price. Companies also need “in-the-money” stock options to attract and retain good managers. Bank loan conditions are often based on profitability, so companies often inflate their earnings to keep their financing. CEOs are under constant scrutiny from the board of directors and are always fearful of losing their job if they do not meet market earnings expectations.

These pressures force executives to spend a lot of valuable time playing the “earnings game.” They exaggerate the company’s earnings to meet growth targets or “smooth” profits over time to regularly meet analysts’ expectations and avoid concerns by the board of directors and the stock market. Analysts skillfully guide analysts to an earnings per share figure every quarter and usually err on the low side, so the company ends up exceeding the forecast. If it is going to miss expectations, the firm does so by a lot and saves the earnings for the future through various “financial shenanigans.” Companies can inflate or smooth their profits through aggressive revenue recognition; excessive cost capitalization; deferring discretionary costs like research and development, advertising, or employee training; delaying or accelerating gains and losses on asset sales; or timing non-recurring items like restructuring charges.

Accounting manipulation went undetected at Enron and other companies because the public accounting firms performing their audits did not properly plan the engagements and did not effectively manage junior associates who often lacked adequate training. They also did additional consulting work for their clients that were usually more profitable than the audit. The partners were fearful of losing this work if they opposed the client’s attempts to manipulate earnings. Finally, many auditors went to work for their audit clients after they left their accounting firms, so they often overlooked questionable practices to gain favour with future employers.

In response to Enron and the SOX legislation in the U.S., Canada adopted new international accounting and auditing standards, and the CSA passed additional national instruments relating to financial reporting and auditing.

**Accounting and Auditing Standards**

The Accounting Standards Oversight Council oversees the development of accounting standards for public and private companies, not-for-profit organizations, pension plans, and the public sector in Canada. The Auditing and Assurance Standards Oversight Council oversees the development of auditing standards.

**Exhibit 4: Accounting Standards Bodies in Canada**

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| --- |
| **Accounting Standards Oversight Council**  Accounting Standards Board (AcSB)  CPA Canada Handbook - Accounting  Part I – International Financial Reporting Standards (IFRS)  Part II – Accounting Standards for Private Enterprises  Part III – Accounting for Not-for-Profit Organizations  Part IV – Accounting for Pension Plans  Public Sector Accounting Board (PSAB)  CPA Canada Handbook - Public Sector Accounting  **Auditing and Assurance Standards Oversight Council**  Auditing and Assurance Standards Board (AASB)  CPA Canada Handbook – Assurance |

Effective January 1, 2011, Canada adopted IFRS for all Publicly Accountable Enterprises (PAE). PAEs are organizations that (1) issue debt or equity that trades in public markets, or (2) hold assets in a fiduciary capacity for a broad group of outsiders. IFRS are developed by the International Accounting Standards Committee (IASB) of which CPA Canada is a founding member. Private Enterprises are not obligated to use IFRS and have the option to follow a simplified Canadian GAAP free of the detailed reporting standards established for large public companies. The U.S. along with China and Japan are the major countries that still have not adopted IFRS. U.S.’s Financial Accounting Standards Board (FASB) is working to harmonize their standards with IFRS and many international firms report using both IFRS and U.S. GAAP.

Canada is a member of the International Auditing and Assurance Standards Board (IAASB) and adopts International Standards Auditing (ISA) as they are introduced. CPA Canada funds the AcSB, PSAB, and AASB but these bodies operate independently to remain objective.

**Financial Reporting Disclosures**

NI 51-102 Continuous Disclosure Obligations outlines the financial information public corporations must supply to their shareholders and market regulators. Audited annual financial statements and the accompanying notes are approved by the board of directors and filed with regulators within 90 days of financial year-end. This includes a statement of comprehensive income (i.e. income statement), statement of changes in equity, statement of cash flows, and a statement of financial position (i.e. balance sheet). Comparative financial data for the previous financial year is included.

Interim financial statements and notes must be approved by the board of directors or the audit committee and filed with regulators within 45 days of each quarter-end. These reports cover each of the first three quarters and are followed by the annual financial statements at the end of quarter four. Interim reports do not have to be audited because of the time constraints and added expense but firms must indicate this to shareholders. If the interim reports are audited, an auditor’s opinion must be provided. Comparative financial data for the corresponding quarter in the previous financial year is included.

A Management, Discussion, & Analysis (MD&A) must accompany the annual financial statements and each interim report. It is a verbal description, from management’s perspective, of the company’s current financial performance, opportunities and risks, successes and failures, and financial position. This is a balanced account of the company’s performance that expands on the largely numerical information in its financial statements and notes. MD&A may also include a financial outlook containing forward-looking information about a business’ financial prospects. The firm must identify this outlook as a projection, describe the assumptions that the projection is based on, and caution users of any risks that may cause the actual results to vary from estimates. The outlook needs to have a reasonable basis and be updated regularly. The annual MD&A must be approved by the board of directors, and the MD&A for each of the interim reports can be approved by the board of directors or audit committee.

MD&A may also include adjusted accounting figures from the company’s audited financial statements. Firms feel these “non-GAAP” disclosures better measure their financial performance, but unethical companies do use them to manipulate earnings. For example, companies may exclude unusual or non-recurring transactions such as restructuring charges or one-time gains and losses from asset sales from net income as they will not likely recur soon.

Historically, companies issued an annual report which included the audited financial statements, notes, and MD&A along with a chairperson’s or CEO’s message, the auditor’s report, and a management statement on internal control. Some companies continue this practice, but most now issue this information separately.

Other required NI 51-102 filings include:

**Annual information form.** Provides a detailed description of the company’s history; products and services; operating units and subsidiaries; competitive market conditions; seasonal or cyclical nature; access to specialized knowledge and skills; new product developments; intangible property such as brand names, customer lists, copyrights, franchises, licences, patents, software, and trademarks; access to critical raw materials and key components; output and reserves at natural resource properties; exploration or research and development efforts; major contracts; economic dependence on specific customers, geographical regions, foreign operations, suppliers, or technologies; expansion plans and other business developments; business risks; workforce size and composition; corporate social responsibility policies; capital structure and credit ratings; sources of debt and equity financing; dividend distributions; bankruptcies and corporate reorganizations; executives and directors; conflicts of interests and non-arm’s length transactions; and legal proceedings and regulatory actions. An annual information form duplicates some of the information in the MD&A, but it is meant to be a more comprehensive description of the company while the MD&A relates to developments in a specific accounting period.

**Management information circular.** Provides information about the issues to be voted on by shareholders at the company’s next annual general meeting such as director elections, the appointment of external auditors, the approval of executive compensation plans, and other management and shareholder proposals. The circular is approved by market regulators and gives extensive information on the firm’s financial performance, governance, and executive compensation.

**Notices of shareholder meetings and voting results.** Shareholders must be given advanced notice of all shareholder meetings, minutes of discussions at the meetings, and the percent of shareholders who were for or against each motion or abstained from the vote.

**Proxy solicitation.** Since most shareholders do not attend the annual general meeting, management asks for their votes in a proxy solicitation so they can exercise them at the general meeting in support of their agenda. Other shareholder groups who oppose management may try to compete for these votes by issuing their information circulars and proxy solicitations.

**Prospectus.** Required by market regulators to issue debt or equity securities to the public. A preliminary prospectus gives general information about the business and the type of security it is issuing while the final prospectus includes the number of shares to be sold and their unit price once investor demand is determined.

**Business acquisition report.** A report must be filed describing all significant acquisitions within 90 days of the purchase.

**Take-over bid circular.** Shareholders must be notified when an offeror tries to buy 20% or more of the company’s shares. Sizeable share price premiums are usually paid in business take-overs, so shareholders need to be kept informed so they can participate in these offers.

**Changes in ownership.** Share purchases by investors that exceed 5% of a firm’s shares over 12 months must be disclosed. When an investor’s ownership stake exceeds 10%, it must be disclosed along with each subsequent 2% increment in ownership. This information helps identify potential business take-overs, so shareholders can buy additional shares before prices begin to rise.

**Material change report.** Companies must disclose the nature and substance of any change such as the divestiture or spin-off of a business unit that is expected to have a material impact on its share price. No disclosure is required if the company feels it would be detrimental to its business interests.

**Change of auditor.** Companies must disclose the appointment of a new auditor and indicate whether the previous auditor resigned, was removed, or was not reappointed. The filing must discuss any disagreements between the company and its previous auditor that may have led to the change.

**Change of corporate structure.**  Changes to the company’s legal name or year-end date must be disclosed along with a decision to de-list the company and take it private or to go public through a reverse take-over. A reverse take-over is when an existing private corporation is bought by a shell company that is already public to avoid having to go through an initial public offering and issue a prospectus.

**Issuer bid circulars.** Must be sent to all shareholders when a company tries to buy back its shares at a specified price so all shareholders can take part in the offer. Companies use share repurchases as a substitute for paying cash dividends. Normal course issuer bids allow them to buy back up to 5% of its shares over 12 months at the current market price without going through this formal process, but shareholders must still be informed beforehand of the amount and timing of these repurchases.

**Insider trading reports.** Insider trading involves unfairly trading in the shares of a public company when in possession of material, non-public information about the company, or sharing that information with others. To help prevent insider trading and support the integrity of the financial markets, regulators require directors and senior managers of public corporations to disclose their trading activity in insider trading reports.

**Restricted security disclosure.** Companies must disclose the issuance of multiple classes of shares with different voting rights. These can consist of non-voting shares; restricted voting shares that limit the number of shares in a class that can be voted; or subordinate voting shares that receive only one vote per share while multiple voting shares receive more than one vote per share. There may also be other restrictions such as the ability to share in profits or participate in a take-over offer.

**News releases.** Any news release containing financial information about the company must be filed with regulators.

All regulatory filings are posted electronically on CSA’s SEDAR (System for Electronic Data Analysis and Retrieval) and SEDI (System for Electronic Disclosures by Insiders) to provide users with easy access to this information.

**Certification of Disclosures**

NI 52-109 Certification of Disclosure in Issuers’ Annual and Interim Filings requires a company’s CEO and CFO to certify the accuracy of the disclosures in the annual and interim financial statements, MD&A, and other corporate disclosures. This encourages senior management to take a strong interest in the accuracy of these reports and it establishes their liability if problems are later discovered. Management must also file a statement NI 52-111 Reporting on Internal Control Over Financial Reporting. This statement describes the processes taken to ensure the reliability of financial reporting and that all revenues, expenditures, and asset purchases and sales are properly authorized.

**Audit Process**

Audited financial statements of public corporations must include an auditor’s report which gives an opinion as to the quality of the financial reporting. Auditing standards permit four types of opinions.

Unqualified: No significant reservations

Qualified: Reservations about one account only

Adverse: Financial statements are materially misstated

Disclaimer: Unable to obtain the appropriate audit evidence

An audit report is an in-depth investigation that gives a high level of assurance. Private companies may instead request a simpler review engagement that only gives a moderate level of assurance.

**Audit committees**. NI 52-110 Audit Committees requires that companies have an audit committee of at least three independent directors who are financially literate. The committee should have a charter outlining its responsibilities which are to:

* Recommend an external auditor to the board
* Determine auditor compensation
* Directly oversee the auditor’s work as they prepare the annual audit report and any other audit work
* Resolve any disagreements between the company and its external auditors
* Approve the annual financial statements, interim reports, and MD&A
* Approve any other public financial disclosures
* Approve all non-audit work to be performed by the audit firm to reduce any potential conflicts of interest
* Approve company hiring policies relating to the current and former partners and employees of the audit firm to reduce potential conflicts of interest
* Establish procedures to deal with external complaints received by the company about accounting, internal control, or auditing matters
* Establish procedures to allow employees to make confidential, anonymous submission concerning questionable accounting or audit matters

The audit committee has the authority to hire outside advisers to assist in the audit review process.

**Canadian Public Accountability Board.** NI 51-108 Auditor Oversight established the Canadian Public Accountability Board (CPAB) whose role is to promote high-quality audits in Canada. All public accounting firms must be admitted as a participating audit firm by the CPAB to undertake audit engagements. CPAB regularly completes compliance audits of each participating audit firm that evaluates the quality of an actual audit. A compliance audit covers factors such as management oversight, auditor training, auditor independence, evaluation of auditors, assessment of audit engagements, and procedures for the acceptance and renewal of clients. After each compliance audit, CPAB publishes an inspection report that gives recommendations for improvement that must be implemented along with any remedial actions. Remedial actions may include termination of an audit engagement; requiring that the audit firm engage an independent monitor that reports to the CPAB about the audit firm’s compliance with professional standards; requiring that the audit firm engage an independent supervisor that oversees the work of the audit firm; or limiting the number and types of audits a firm can accept. Problem cases are referred to market regulators and CPA Canada for possible disciplinary action. CPAB also comments on general trends in audit quality in Canada and new accounting, auditing, and governance standards proposed by the AcSB, AASB, and CSA.

**1.7 | Personal and Corporate Taxation**

The personal and corporate income taxation systems in Canada can significantly affect financial decision making. These taxes are levied separately by the federal and provincial governments on an individual’s employment, royalty, investment, and other forms of personal income and a corporation’s profits. If a person owns a sole proprietorship or partnership, any profits are taxed as an individual since the business is not a separate legal entity like a corporation.

At the federal level, the Canada Revenue Agency (CRA) has developed a set of rules in the Income Tax Act (ITA) to calculate an individual’s or corporation’s taxable income. CRA administers the personal and corporate tax systems on the provinces’ behalf so taxpayers only need to prepare one joint federal and provincial return for each tax. Two provinces have chosen to collect their taxes themselves which is permissible under the Constitution. Quebec manages its personal and corporate taxes and Ontario administers its corporate tax. The rules in Quebec and Ontario are similar to those at the federal level so having to file two separate tax returns for each tax is less burdensome for taxpayers. Provincial governments can only levy taxes on the taxable income earned in their jurisdiction.

**Personal Income Taxes**

Each level of government determines its tax brackets, rates, and credits to calculate the taxes owed. Progressive income taxation means taxpayers pay a higher tax rate on each successive dollar of income earned. Most countries support this principle on fairness grounds and have established designated income ranges or tax brackets with rising tax rates subject to a maximum rate. Tax credits are subtracted from the taxes owed while deductions and exemptions reduce taxable income. Governments use these adjustments to target underserved groups in society, encourage desirable personal or business behaviours such as increased capital investment, or produce a fairer income tax system.

**Exhibit 5: 2020 Federal and Provincial/Territorial Personal Tax Rates and Brackets**

|  |  |  |
| --- | --- | --- |
|  | **Tax Rates** | **Tax Brackets (CAD)** |
| **Federal government** | 15.00% | Up to 48,535 |
| 20.50% | 48,536 to 97,069 |
| 26.00% | 97,070 to 150,473 |
| 29.00% | 150,474 to 214,368 |
| 33.00% | 214,369 and over |
| **British Columbia** | 5.06% | Up to 41,725 |
| 7.70% | 41,726 to 83,451 |
| 10.50% | 83,452 to 95,812 |
| 12.29% | 95,813 to 116,344 |
| 14.70% | 116,345 to 157,748 |
| 16.80% | 157,749 and over |
| **Alberta** | 10.00% | Up to 131,220 |
| 12.00% | 131,221 to 157,464 |
| 13.00% | 157,465 to 209,952 |
| 14.00% | 209,953 to 314,928 |
| 15.00% | 314,929 and over |
| **Saskatchewan** | 10.50% | Up to 45,225 |
| 12.50% | 45,226 to 129,214 |
| 14.50% | 129,215 and over |
| **Manitoba** | 10.80% | Up to 33,389 |
| 12.75% | 33,390 to 72,164 |
| 17.40% | 72,165 and over |
| **Ontario** | 5.05% | Up to 44,740 |
| 9.15% | 44,741 to 89,482 |
| 11.16% | 89,483 to 150,000 |
| 12.16% | 150,001 to 220,000 |
| 13.16% | 220,001 and over |
| **Quebec** | 15.00% | Up to 44,545 |
| 20.00% | 44,546 to 89,080 |
| 24.00% | 89,081 to 108,390 |
| 25.75% | 108,391 and over |
| **New Brunswick** | 9.68% | Up to 43,401 |
| 14.82% | 43,402 to 86,803 |
| 16.52% | 86,804 to 141,122 |
| 17.84% | 141,123 to 160,776 |
| 20.30% | 160,777 and over |
| **Nova Scotia** | 8.79% | Up to 29,590 |
| 14.95% | 29,591 to 59,180 |
| 16.67% | 59,181 to 93,000 |
| 17.50% | 93,001 to 150,000 |
| 21.00% | 150,001 and over |
| **Prince Edward Island** | 9.80% | Up to 31,984 |
| 13.80% | 31,985 to 63,969 |
| 16.70% | 63,970 and over |
| **Newfoundland and Labrador** | 8.70% | Up to 37,929 |
| 14.50% | 37,930 to 75,858 |
| 15.80% | 75,859 to 135,432 |
| 17.30% | 135,433 to 189,604 |
| 18.30% | 189,605 and over |
| **Yukon** | 6.40% | Up to 48,535 |
| 9.00% | 48,536 to 97,069 |
| 10.90% | 97,070 to 150,473 |
| 12.80% | 150,474 to 500,000 |
| 15.00% | 500,001 and over |
| **Northwest Territories** | 5.90% | Up to 43,957 |
| 8.60% | 43,958 to 87,916 |
| 12.20% | 87,917 to 142,932 |
| 14.05% | 142,933 and over |
| **Nunavut** | 4.00% | Up to 46,277 |
| 7.00% | 46,278 to 92,555 |
| 9.00% | 92,556 to 150,573 |
| 11.50% | 150,574 and over |

The average tax rate is an individual’s total personal taxes divided by their taxable income or the dollar-weighted average of the rates in their different tax brackets. The marginal tax rate is the rate on the last dollar earned which is the most relevant for financial decision making.

From an individual investor’s perspective, an important tax consideration is how dividends are taxed compared to capital gains in Canada. When investors buy stock, they earn a regular cash dividend and realize either a capital gain or loss when they sell the shares. The following exhibit compares the effective personal income tax rates for dividends and capital gains in Canada and British Columbia:

**Exhibit 6: Taxation of Capital Gains and Dividends**

|  |  |
| --- | --- |
| **Capital Gains (CAD)** | |
| Capital gains | 100.00 |
| Taxable capital gains (50%) | 50.00 |
| Federal tax (29%) | 14.50 |
| Provincial tax (12.16%) | 6.08 |
| Taxes payable | 20.58 |
| Effective tax rate | 20.58% |

|  |  |  |
| --- | --- | --- |
| Dividends (CAD) | | |
| Dividend income | 100.00 |
| Gross-up (38% of dividend income) | 38.00 |
| Grossed-up dividend | 138.00 |
| Federal tax (29% of gross-up dividend) | 40.02 |
| Provincial tax (12.16% of grossed-up dividend) | 16.78 |
| Total personal income tax | 56.80 |
| Federal dividend tax credit (15.02% of grossed-up dividend) | 20.73 |
| Provincial dividend tax credit (10% of grossed-up dividend) | 13.80 |
| Total corporate tax paid | 34.53 |
| Taxes payable | 22.27 |
| Effective tax rate | 22.27% |

A capital gain is realized when an asset is sold for more than its adjusted cost base (ACB). ACB is the asset’s initial price plus the cost of any additions or improvements. CRA only taxes half of the capital gains to encourage risk-taking and compensate investors for some of the inflation that may have occurred since the asset was acquired. Taxable capital losses can be applied against taxable capital gains to reduce taxes owed this year or carried back three years to earn a tax refund or carried forward indefinitely to reduce taxable capital gains in future years.

The gross-up and Federal and Provincial Dividend Tax Credits help to eliminate the double taxation of dividend income. Double taxation means dividend income is taxed at the corporate tax rate when it is initially earned by the corporation and then taxed again at the personal tax rate when the dividends are distributed to shareholders. The 38% gross-up adds back corporate income tax already paid on the dividend income at the corporate tax rate of 25.0%. The grossed-up dividend is tax at the federal and provincial personal tax rates to determine total personal income taxes owed. The Federal and Provincial Dividend Tax Credits are calculated on the grossed-up dividend at the federal tax and provincial corporate tax rates. These credits together equal the amount of corporate income tax already paid on the dividend income. This amount is deducted from total personal income taxes to give the taxes payable. The taxes payable as a percentage of the initial dividend income gives the effective rate on dividends.

When saving outside of a tax-sheltered account such as a company pension plan, Registered Retirement Savings Plan (RRSP), or Tax-Free Savings Account (TFSA), capital gains are taxed at a slightly lower rate than dividends in Canada and offer a tax deferral. A tax deferral means capital gains are only taxed when the shares are sold, which can be an extended period for a long-term investor who is saving for their retirement in 20 to 30 years. For investors in tax-sheltered accounts that are funded with before-tax dollars like most pension plans and RRSPs, dividends and capital gains are not taxed if the funds remain inside the account. The dividends and capital gains are tax as normal income when funds are taken out of the account in the future. For investors in tax-sheltered accounts that are funded with after-tax dollars such as some pension plans and TSFAs, dividends and capital gains are not taxed if the funds remain inside the account. The dividends and capital gains are not taxable when taken out of the account either as taxes were paid before the funds being invested. Whether retained earnings are distributed as dividends or capital gains is irrelevant to both these types of investors.

**Corporate Income Tax**

The Federal Basic Corporate Tax Rate in Canada is 38.0%. A Federal Tax Abatement of 10.0% is deducted to make room for the Provincial Basic Corporate Tax Rate which varies between 10.0% and 16.0%. To remain competitive with other countries, the federal government gives a further General Rate Reduction of 13.0% resulting in an effective federal corporate tax rate of 15.0%. Government practice is to leave the Federal Basic Corporate Tax Rate constant at 38.0% and to adjust the federal corporate tax rate by changing the General Rate Reduction. Canadian Controlled Private Corporations (CCPC) receive a further 4.5% Small Business Deduction on the first CAD 500,000 of active business income to aid Canadian-owned small businesses. The provinces and territories give a similar deduction.

**Exhibit 7: 2020 Federal and Provincial/Territorial Corporate Tax Rates in Canada**

|  |  |  |
| --- | --- | --- |
|  | **CCPC**  **Small Business Income** | **Regular Corporate Rate** |
| **Federal government** | 9.00% | 15.00% |
| **British Columbia** | 2.00% | 12.00% |
| **Alberta** | 2.00% | 10.00% |
| **Saskatchewan** | 2.00% | 12.00% |
| **Manitoba** | 0.00% | 12.00% |
| **Ontario** | 3.20% | 11.50% |
| **Quebec** | 5.00% | 11.50% |
| **New Brunswick** | 2.50% | 14.00% |
| **Nova Scotia** | 3.00% | 16.00% |
| **Prince Edward Island** | 3.00% | 16.00% |
| **Newfoundland and Labrador** | 3.00% | 15.00% |
| **Yukon** | 2.00% | 12.00% |
| **Northwest Territories** | 4.00% | 11.50% |
| **Nunavut** | 3.00% | 12.00% |

Other deductions or exemptions also influence the amount of corporate income tax that a business pays. Some of these include:

**Capital cost allowance.** Under the ITC, businesses must use capital cost allowance (CCA) as their depreciation method for tax purposes. CCA is a declining-balance depreciation method that categorizes assets into one of 18 different classes. The cost of individual assets in each class are pooled together to calculate CCA. Each class has a depreciation or CCA rate that is applied to the declining balance or undepreciated capital cost (UCC). The rate generally reflects the life of the assets in that class (i.e. longer life assets have lower rates) but other considerations such as encouraging capital investment may result in higher rates and a faster tax write-off.

Most asset classes are subject to the half-year rule which only allows half of the net acquisitions to be included in the class each fiscal year with the remainder added in the subsequent year. Net acquisitions are the net of all asset purchases and sales in a year. Purchases are generally more than sales because they are new assets while sales are used assets. The half-year rule was introduced because companies regularly bought assets at year-end but still claimed a full year’s CCA. For convenience, instead of requiring companies to prorate CCA based on the date of purchase, the half-year rule assumes all assets are bought halfway through the year.

**Exhibit 8: Mechanics of a CCA Pool**

|  |  |
| --- | --- |
| **Acquisitions and Disposals** | |
| Sales of assets | CAD 7,000 |
| Acquisitions | CAD 31,000 |
| Net acquisitions | CAD 24,000 |
| CCA rate | 20% |
| **CCA Class** | |
| UCC beginning | CAD 28,000 |
| Half of the net acquisitions | 12,000 |
| Balance | 40,000 |
| CCA – Year 1 | (8,000) |
| UCC ending | CAD 32,000 |
| Half of the net acquisitions | 12,000 |
| Balance | 44,000 |
| CCA – Year 2 | (8,800) |
| UCC ending | CAD 35,200 |

There are a few asset classes that do not use the declining balance method and the half-year rule to calculate CCA. For example, Class 14 assets (franchises, concessions, patents, and licenses) are amortized on a straight-line basis over the life of the property with a full year’s CCA given in the year of acquisition.

CCA pools can also generate terminal losses or recaptures. Terminal losses occur when an asset class’s UCC is positive and no assets are remaining in the class. The positive UCC means that a company has not taken enough depreciation in the past and can now recognize a tax-saving equal to the class’s UCC times the corporate tax rate. Recaptures occur whenever an asset class’s UCC is negative regardless of whether the class is empty or not. The negative UCC indicates that a company has taken too much depreciation in the past and now must pay additional taxes equal to the class’s UCC times the company’s income tax rate. Smart accountants time asset purchases so recaptures do not occur.

**Loss carrybacks and carryforwards.** ITA allows businesses to carry non-capital losses, which occur when a company loses money, back three years. These losses are applied against past taxable income reducing income taxes owed generating a tax refund. If the losses cannot be fully applied in the past three years due to insufficient income, they can be carried forward for up to 20 years resulting in lower income taxes in those years. For capital losses, which occur when assets are sold, losses can be carried back three years but only applied against other capital gains. If these gains are insufficient, the capital losses can be carried forward indefinitely but only applied against capital gains. Loss carryforwards may still be used if the business experiences a change in control, but only if the new owner continues to operate the same business.

**Investment tax credits.** Federal and provincial governments give investment tax credits (ITCs) to stimulate economic growth. ITCs are for investments such as new building and equipment, research and development, resource exploration, or employee training. They are calculated as a percentage of the eligible expenditures and are paid by reducing income taxes payable. When ITCs are given for the purchase of buildings and equipment, the capital cost added to the CCA class is also reduced by the amount of the assistance, so the company does not receive the tax benefit twice.

**Foreign tax credits.** Canadian corporations with foreign operations pay federal income tax on their worldwide income but receive a tax credit approximately equal to the foreign taxes paid to prevent double taxation. This stops companies from trying to reduce their income taxes by relocating part of their operations to another country as all income is taxed at the higher Canadian rate. If Canadian income tax rates become excessive, companies may move their operations out of Canada entirely, so governments try to remain competitive with other countries. Provinces can only tax income earned in their jurisdiction, so the federal government does not give a Federal Tax Abatement on foreign income to leave room for the Provincial Basic Corporate Tax Rate. This raises more tax revenue for the federal government.

**Exhibit 9: 2020 Corporate Tax Rates in G20 Countries**

|  |  |
| --- | --- |
| **Country** | **Rate** |
| Brazil | 34.0% |
| France | 33.3% |
| Japan | 30.6% |
| Argentina | 30.0% |
| Australia | 30.0% |
| Germany | 30.0% |
| Mexico | 30.0% |
| South Africa | 28.0% |
| Canada | 26.5% |
| India | 25.2% |
| China | 25.0% |
| Netherlands | 25.0% |
| South Korea | 25.0% |
| Spain | 25.0% |
| Indonesia | 25.0% |
| Italy | 24.0% |
| Turkey | 22.0% |
| United States | 21.0% |
| Russia | 20.0% |
| Saudi Arabia | 20.0% |
| United Kingdom | 19.0% |
| Switzerland | 18.0% |
| Singapore | 17.0% |