**Introduction to Financial Statement Analysis**

**Learning Outcomes**

After completing this module, students will be able to:

1. Identify the sources of accounting and auditing standards in Canada.
2. Describe the different financial reporting disclosures required by securities regulators.
3. Explain the audit process and the role of the board of directors’ audit committee.
4. Discuss the limitations of financial reporting and how they can be addressed.

**Introduction**

A corporation’s audited financial statements and explanatory notes 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 frequently inflate their earnings to keep their financing.
* CEOs are under constant scrutiny from the board of directors and are always fearful of losing their jobs 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, maintenance, advertising, or employee training, delaying or accelerating the recognition of gains and losses on assets, 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 was usually more profitable than the audit. The partners were fearful of losing this non-audit 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 the Enron crisis and new financial legislation in the U.S., Canada adopted new international accounting and auditing standards, and the Canadian Securities Administrators passed additional National Instruments relating to financial reporting and auditing.

**1.1 | Accounting 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 have not adopted IFRS. The U.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**

In Canada, most large companies are incorporated 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. However, many of these regulations can be modified in the company’s articles of incorporation and bylaws if supported by shareholders.

Securities regulation in Canada was a provincial jurisdiction until recently, when each province had its own legislation. 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 TSX Company Manual. Most countries, including the U.S. through its Securities and 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).

The CSA 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 (NI) are adopted and implemented by each province’s securities commission, while multilateral instruments are only effective in some provinces. 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 securities regulation in Canada, but there has been limited progress to date. The Supreme Court also indicated that the federal and provincial governments should continue to work together cooperatively.

The CSA’s 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 the financial year-end. This includes a statement of comprehensive income (i.e. income statement), a statement of changes in equity, a 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, and 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 mostly numerical information in its financial statements and notes. MD&A may also include a financial outlook containing forward-looking information about a business’s 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 the audit committee.

MD&A may also include adjusted accounting figures from the company’s audited financial statements. Firms feel these “non-IFRS” 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 on a two-year comparative basis, notes to the financial statements, and MD&A, along with a chairperson’s or CEO’s message, the independent auditor’s report, and a statement on management’s responsibility for the financial statements. Many companies continue this practice, but some now issue the MD&A separately.

**Exhibit 1: Format of a Typical Annual Report**

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| Chairperson’s/president’s report |
| Management, discussion, and analysis |
| Financial statements |
| Statement of profit or loss |
| Statement of comprehensive income |
| Statement of changes in retained earnings |
| Statement of financial position |
| Statement of cash flows |
| Notes to the financial statements |
| Significant accounting policies |
| Detailed financial information |
| Management’s responsibility for the financial statements |
| Independent auditor’s report |
| Historical summary |

Other required filings under CSA’s NI 51-102 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, licenses, 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 percentage 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 their 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.** It must be sent to all shareholders when a company tries to buy back its shares at a specified price so that 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 their 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. Similar filings are required in the U.S. by the Securities and Exchange Commission (SEC). These include the 10-K and 10-Q, which are the annual and quarterly information forms required by all public companies. All U.S. filings are available through a system similar to SEDAR called the EDGAR (Electronic Data Gathering Analysis Retrieval).

**Certification of Disclosures**

CSA’s 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 under 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 independent auditor’s report, which gives an opinion about 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 is an in-depth investigation that gives a high level of assurance. Private companies can request a simpler review engagement that only provides a moderate level of assurance.

**Audit Committees**

CSA’s 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 audit partners and other 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; and
* Establish procedures such as a whistle-blower program to allow employees to make confidential, anonymous submissions concerning questionable accounting or audit matters without fear of retribution.

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

**Canadian Public Accountability Board**

CSA’s 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, which involves evaluating 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 the 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 the 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. **| Limitations of Financial Reporting**

The IFRS Committee is constantly implementing new or revised accounting standards to improve the quality of financial reporting. The IAASB is developing more comprehensive auditing standards that regulators are enforcing through stricter auditing firm oversight. Governments and securities regulators are introducing new disclosure requirements to better meet the needs of investors. Despite all the effort that goes into the preparation of a public company’s annual reports, several factors still negatively impact the quality of financial reporting.

1. Varying accounting policies and estimates

* FIFO, average cost, specific identification
* Straight-line or accelerated depreciation
* Useful life or bad debts percentage

1. Inaccurate valuation of assets, liabilities, and equities

* Historical cost versus fair market value
* Key assets such as patents or goodwill may be excluded if developed internally
* Off-balance sheet liabilities

1. Misclassification of financial assets and liabilities

* Short-term versus long-term receivables
* Short-term versus long-term investments
* Liability versus equity

1. Poor quality of earnings

* Premature revenue recognition
* Classifying operating expenses as non-operating
* Classifying non-operating revenues as operating
* Expense capitalization
* Deferral of discretionary expenses
* Delaying or accelerating the recognition of gains and losses on assets
* Timing non-recurring items like restructuring charges and any reversals

Financial analysts can adjust financial statements to make them more accurate and comparable to other companies, but insufficient information may be available in the notes. Additional information may also be time-consuming and expensive to collect, and analysts may lack the accounting expertise needed to process it.

What else can be done? Financial analysts are increasingly using cash flow-based information and ratios, as cash is more difficult for companies to manipulate. Quantitative models like the Beneish Model are also used to assess the degree of earnings manipulation.