



Understanding financial statements

Understanding financial statements

This brochure is also available in electronic format.

Visit the "Publications" section of our website at www.oqaq.qc.ca.



(Strength
beyond Numbers)

Table of contents

<i>The financial statements</i>	<i>page 4</i>
<i>The balance sheet</i>	<i>page 4</i>
<i>Retained earnings</i>	<i>page 5</i>
<i>Income</i>	<i>page 5</i>
<i>Cash flows</i>	<i>page 5</i>
<i>Notes to the financial statements</i>	<i>page 5</i>
<i>Measuring performance</i>	<i>page 6</i>
<i>Analyzing ratios</i>	<i>page 6</i>
<i>Management's Discussion and Analysis</i>	<i>page 7</i>
<i>Engagements entrusted to chartered accountants</i>	<i>page 8</i>
<i>The audit engagement</i>	<i>page 9</i>
<i>The review engagement</i>	<i>page 9</i>
<i>The compilation engagement</i>	<i>page 9</i>
<i>Where to find the information</i>	<i>page 10</i>
<i>Press releases</i>	<i>page 10</i>
<i>How to obtain the financial statements of listed companies</i>	<i>page 10</i>
<i>Other useful addresses</i>	<i>page 11</i>

Understanding financial statements

Because they present current year and previous year data, financial statements are a tool used primarily to meet the information needs of investors and creditors in the case of profit-oriented enterprises, and the information needs of members, investors and creditors in the case of not-for-profit enterprises. Financial statements prepared for this purpose are often used by other parties who also need information about the entity.

Informed business and investment decisions can be made based on an analysis of the financial statements. These statements allow shareholders, investors, bankers, brokers and lenders to assess an enterprise's performance and the investment and lending risks involved.

The financial statements

Management is responsible for preparing the financial statements. Even if the assistance of a public accountant is sometimes required, management always has the last word on the content of the statements, which are divided into five sections: the balance sheet, the statement of retained earnings, the income statement, the cash flow statement and the notes to the financial statements. While financial statements are usually prepared at the same date each year, they can be prepared more than once a year, for example on a quarterly basis if a company is listed.

The balance sheet

The balance sheet is prepared based on the enterprise's account balance on the last day of the period covered by the financial statements. It shows the enterprise's assets, i.e. cash, including bank accounts, accounts receivable, inventory (whether made up of raw materials, goods in process or finished goods ready for sale), work in progress, investments, capital assets (land, buildings, equipment, etc.), and intangible assets (patents, website development costs, etc.). The balance sheet also shows the enterprise's liabilities, which are mainly composed of accounts payable and other debts, whether current or long-term. Finally, it also shows shareholders' equity, i.e. the difference between assets and liabilities. Shareholders' equity belongs to the shareholders or partners and is usually made up of the share capital plus retained earnings and sometimes the contributed surplus. The balance sheet therefore provides a snapshot of the enterprise's financial position at a given point in time.



Retained earnings

The statement of retained earnings shows the cumulative income of the enterprise since its inception minus losses and dividend payments to shareholders. It sets out the detail of these changes and the amount of dividends paid to shareholders during the period. It completes the balance sheet.

Income

The income statement shows the enterprise's revenues and expenses for the period. Deducting the selling, administrative and financial expenses from revenues yields the income or loss for the period. Net income or net loss is calculated by deducting income taxes. This net value is the principal measurement of the enterprise's profitability.

Together, the balance sheet and the income statement are used to analyze the enterprise's value and performance.

Cash flows

The cash flow statement shows the cash and cash equivalents generated by the enterprise's activities during the year. It reflects the cash flows derived from operating, investing and financing activities.

The cash flow statement is used to assess the enterprise's solvency as well as its ability to reinvest in its structures and activities.

Notes to the financial statements

Finally, the notes to the financial statements describe the enterprise, its statutes of incorporation and its activities. They inform the reader about the enterprise's commitments, including outstanding lawsuits and the amounts involved.

performance

Measuring performance

Analyzing ratios

Financial ratios can be used to analyze an enterprise's financial position, which includes assessing management effectiveness, profitability, its degree of leverage, etc.

Effectiveness is the term used to describe the way the enterprise manages its assets to make sales. Inventory turnover, for example, is the ratio of annual sales to inventory. An inventory turnover of 3.2 means that the enterprise turned over its inventory three times during a given period. The higher the turnover, the shorter the time between sale and cash collection.

Profitability is determined by management's ability to control its expenditures and earn income from resources spent. A profitable enterprise is one that can make a profit. Profitability is often measured by calculating the ratio of net income to total revenues.

The debt/equity ratio also provides useful information on the enterprise's financial structure. It is calculated by dividing the amounts owing to banks and other lenders by shareholders' equity. This ratio illustrates the size of the enterprise's financial burden.



(Strength
beyond Numbers)



management Management's Discussion and Analysis

While financial statements are a vital source of information, the *Management's Discussion and Analysis* (MD&A) is also a worthwhile tool.

The MD&A allows management to communicate what the financial statements alone cannot. It provides a broader context to help users more fully understand the enterprise's performance and prospects. Essentially, the MD&A explains how an enterprise has created value for its shareholders and how it plans to continue doing so. The MD&A and the financial statements together are becoming recognized as the core business reporting package.

engagements

Engagements entrusted to chartered accountants

Listed companies are required to make their financial statements public. Securities commissions require companies to have their financial statements audited by public accountants to afford investors reasonable protection. In Quebec, only chartered accountants are allowed to audit the financial statements of listed companies.

Many companies that are not required to make their financial statements public call on chartered accountants to perform audit, review and compilation engagements. These three types of engagement provide varying degrees of credibility to the financial statements.



The audit engagement

Of the three types of engagement, the audit engagement is the one that gives the financial statements the highest level of credibility. The auditor does not guarantee that the financial statements are rigorously accurate and does not express an opinion on the effectiveness of the enterprise's management. Instead his mandate is to ensure that the financial statements issued by management were prepared in accordance with generally accepted accounting principles (GAAP). In his report, the auditor expresses an opinion as to whether the financial statements present fairly, in all material respects, the financial position of the enterprise at a given date.

When, upon completing his work, the auditor concludes that the financial statements do not present fairly the financial position of the enterprise, he includes a reservation in his report, gives the reasons for the reservation and explains how the financial statements should be amended.

The review engagement

The review engagement provides a lower level of assurance than the audit. The chartered accountant reviews the information obtained from management, assessing only whether this information is plausible and consistent with his knowledge of the enterprise and the industry in which it operates. The report stemming from this type of engagement is called a *Review Engagement Report*.

The compilation engagement

In a compilation engagement, the chartered accountant uses only the data provided to him by management to prepare the financial statements. He does not attempt to obtain audit evidence or even to review the information. However, rules of professional conduct prohibit chartered accountants from associating themselves with financial statements that they know are false or misleading.

information

Where to find the information...

Internet is now used by most companies to disseminate information.

Press releases

Important corporate news is provided regularly in press releases posted on enterprises' websites or via a press agency like CNWTelbec (www.cnw.ca) or CCNMathews (www.ccnnewswire.com).

How to obtain the financial statements of listed companies

In 1997, the Canadian Securities Administrators implemented the System for Electronic Document Analysis and Retrieval (SEDAR) (www.sedar.com), which gives free access to the annual reports and financial statements of Canadian listed companies. The system provides a wealth of information, including corporate press releases, issuer bid circulars, prospectuses, and company/mutual fund profiles. In the United States, the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) (www.sec.gov/edgarhp.htm), administered by the US Stock Exchange Commission (SEC), offers the same type of information about US companies.



addresses

Other useful addresses

Ordre des comptables agréés du Québec

www.ocaq.qc.ca

Directory of CA firms in Quebec

www.ocaq.qc.ca/repertoire

Canadian Institute of Chartered Accountants (CICA)

www.cica.ca

Commission des valeurs mobilières du Québec (CVMQ)

www.cvmq.com

Industry Canada – Canada’s Business and Consumer Site

www.strategis.ic.gc.ca

Quebec – General Inspector of Financial Institutions

www.igif.gouv.qc.ca

Quebec – Economic and Regional Development

www.mic.gouv.qc.ca



Ordre des comptables agréés du Québec
680, Sherbrooke Street West
18th floor
Montreal, Quebec H3A 2S3
Telephone: 514 288.3256
1 800 363.4688
Fax: 514 843.8375
E-mail: info@ocaq.qc.ca
www.ocaq.qc.ca