CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

# Reading Financial Statements— What do I need to know?

## COMMON QUESTIONS ANSWERED

John Hughes, CPA, CA
Alex Fisher, CPA, CA

STARTER'S GUIDE

FINANCIAL LITERACY

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PROFESSIONAL
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# Preface

The Chartered Professional Accountants of Canada (CPA Canada) has developed this publication to help explain some of the fundamental concepts, conventions and principles underlying financial statements, which may be of interest to readers. This publication aims to answer some key questions a novice user trying to obtain a basic understanding of financial statements might ask.

This publication is intended primarily to assist readers in:

- taking initial steps toward obtaining a greater understanding of what financial statements do, and what they do not do
- having better-informed conversations with financial advisors or others.

Even for those with no desire to obtain an in-depth understanding of accounting, we believe there is value in understanding some key accounting terms, concepts and principles, thus making this aspect of business and commerce somewhat less mysterious. However, out of necessity, this publication simplifies many matters that could easily be addressed at much greater length and in much greater detail and does not attempt to provide a complete understanding of the matters it addresses.

This publication does not attempt to provide a guide to identifying “good” versus “bad” financial statements or “healthy” versus “unhealthy” companies. Such evaluations depend heavily on the facts of a specific situation; an indication that’s troubling in one set of circumstances may be encouraging in another. For example, a current-year loss in a key business segment (see page 60) may in itself appear to be a negative sign; however, if the loss in the previous year was significantly greater, then the current loss may represent major progress toward becoming profitable. Also, a recorded profit may seem positive in itself, but a company that reports a profit may still be experiencing major challenges, such as escalating liabilities or deteriorating cash flow, (i.e., everything depends on the overall context). It is almost always unwise to focus on a single aspect of financial statements — whether apparently good or bad — without considering how it relates to all other information provided in the statements.

This Guide is not intended in any way to be a direct aid to making investing decisions. Even if a particular company could be objectively identified as a “good” company (e.g., indicated by generating consistent profit and cash on an ongoing basis), it does not follow that the securities of that company constitute a good investment. For example, the company's stock may already be "priced for perfection," thus limiting its potential for further gains. Because financial statements are often issued several months after the reporting date (see page 61), the picture shown in those statements may have been radically changed, for better or worse, by subsequent events or changes in the market.

This Guide is written primarily with reference to publicly accountable entities (i.e., public companies) reporting under International Financial Reporting Standards (IFRSs). However, aspects of the guidance may also be relevant to entities reporting under other generally accepted accounting principles, including private entities reporting under Canadian Accounting Standards for Private Enterprises or Canadian Accounting Standards for Not-for-Profit Organizations.

Public entities provide many external communications that complement and supplement their financial statements. While this Guide focuses on understanding financial statements, it also considers the value added by two other reports: the Auditor's Report and Management's Discussion and Analysis (MD&A).

As discussed on page 32, financial statements of different entities do not necessarily use the same terms in describing or addressing the same things. However, all financial statements contain the following core statements:

## Financial Statements[1]

Typically, a complete set of financial statements comprises: a statement of financial position as at the end of the period; a statement of comprehensive income for the period; a statement of changes in equity for the period; a statement of cash flows for the period; and notes, comprising a summary of significant accounting policies and other explanatory information.

1 To facilitate ease of discussion regarding specific financial statement line items, the illustrative financial statements have been presented in an illustrative manner specific to the needs of this publication. The illustrative financial statements are not necessarily prepared in compliance with IFRSs.

### *Statement of Financial Position*

The "statement of financial position" (sometimes referred to as the balance sheet) summarizes the company's financial position at a point in time. It includes:

- assets—the measurable resources the company controls as a result of past events, from which it expects to generate future economic benefits
- liabilities—the measurable obligations the company has as a result of past events, which it expects to settle out of its resources
- equity—the residual interest in its assets after deducting all of its liabilities.

| **Simplified Illustrative Consolidated Statements of Financial Position** | | |
|---|---|---|
| **As at December 31** | | |
| *(millions of Canadian dollars)* | **20X2** | **20X1** |
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | 3,468 | 6,601 |
| Investments | 2,447 | 2,034 |
| Accounts receivable | 19,597 | 10,236 |
| Other receivable | 734 | 927 |
| Inventories | 2,586 | 2,127 |
| **Total current assets** | **28,832** | **21,925** |
| **Non-current assets** | | |
| Property and equipment | 147,076 | 144,793 |
| Intangible assets | 3,000 | 3,000 |
| Exploration and evaluation assets | 14,394 | 7,383 |
| Goodwill | 7,000 | 7,000 |
| Other assets | 2,958 | 343 |
| **Total non-current assets** | **174,428** | **162,519** |
| **Total assets** | **203,260** | **184,444** |
| **Liabilities** | | |
| **Current liabilities** | | |
| Accounts payable and accrued liabilities | 11,836 | 21,640 |
| Other current liabilities | 6,711 | 1,046 |
| **Total current liabilities** | **18,547** | **22,686** |
| **Non-current liabilities** | | |
| Convertible debentures | 1,160 | 1,000 |
| Decommissioning liabilities | 20,861 | 12,761 |
| Other provisions | 1,532 | 1,731 |
| Deferred income tax liabilities | 55,565 | 47,267 |
| **Total non-current liabilities** | **79,118** | **62,759** |
| **Total liabilities** | **97,665** | **85,445** |
| **Shareholders' equity** | | |
| Share capital | 91,991 | 91,734 |
| Equity component of convertible debtentures | 100 | 100 |
| Contributed surplus | 5,487 | 4,254 |
| Accumulated other comprehensive income | 416 | 3 |
| Retained earnings | 7,601 | 2,908 |
| **Total shareholders' equity** | **105,595** | **98,999** |
| **Total liabilities and shareholders' equity** | **203,260** | **184,444** |

### *Statement of Comprehensive Income*

The "statement of comprehensive income" summarizes the company's financial performance for the period (usually a fiscal quarter or a fiscal year). This statement may have a variety of titles (perhaps referring to "operations" or "earnings" or similar) and may be presented separately as two different statements: one presenting profit or loss (sometimes called the income statement) and one presenting comprehensive profit or loss (see page 18).

**Simplified Illustrative Consolidated Income Statements**
**For the years ended December 31**

| *(millions of Canadian dollars, except per share amounts)* | **20X2** | **20X1** |
|---|---|---|
| **Revenue** | **50,529** | **52,370** |
| **Expenses** | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Impairment loss | 2,641 | - |
| Finance costs | 1,015 | 700 |
| Foreign exchange loss (gain) | 193 | (141) |
| Other expenses (income) | 197 | (107) |
| | 34,141 | 29,237 |
| **Income before income tax** | **16,388** | **23,133** |
| Current income tax expense | 3,397 | 1,168 |
| Deferred income tax expense | 8,298 | 14,496 |
| **Net income** | **4,693** | **7,469** |
| Net income per common share: | | |
| Basic | 0.13 | 0.21 |
| Diluted | 0.10 | 0.18 |

**Simplified Illustrative Consolidated Statements of Comprehensive Income**
**For the years ended December 31**

| *(millions of Canadian dollars)* | **20X2** | **20X1** |
|---|---|---|
| **Net income** | **4,693** | **7,469** |
| **Other comprehensive income (loss), net of tax** | | |
| Gains and losses from investments in equity instruments measured at fair value | 413 | (68) |
| **Total comprehensive income** | **5,106** | **7,401** |

### *Statement of Cash Flows*

The "statement of cash flows" (sometimes referred to as "statement of changes in financial position") summarizes the movements in the company's cash position for the period.

| **Simplified Illustrative Consolidated Statements of Cash Flows** | | |
|---|---|---|
| **For the years ended December 31** | | |
| *(millions of Canadian dollars)* | **20X2** | **20X1** |
| | | |
| **Operating activities** | | |
| Net income | 4,693 | 7,469 |
| | | |
| Add non-cash items: | | |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Accretion of decommissioning liabilities | 855 | 693 |
| Interest expense | 160 | 7 |
| Impairment loss | 2,641 | - |
| Foreign exchange loss (gain) | 193 | (141) |
| Deferred income tax expense | 8,298 | 14,496 |
| | 24,777 | 28,118 |
| | | |
| Change in non-cash working capital | (10,959) | (13) |
| Income taxes paid | (3,000) | (895) |
| | | |
| **Cash flow generated from operating activities** | **15,511** | **34,679** |
| | | |
| **Investing activities** | | |
| Capital expenditures | (16,087) | (42,638) |
| Other investing activity | (2,615) | 5,470 |
| **Cash flow used in investing activities** | **(18,702)** | **(37,168)** |
| | | |
| **Financing activities** | | |
| Issuance of shares | 257 | 1,406 |
| Other financing activity | (199) | (800) |
| **Cash flow generated from financing activities** | **58** | **606** |
| | | |
| Effect of translation on foreign currency cash and cash equivalents | - | (1) |
| | | |
| Decrease in cash and cash equivalents | (3,133) | (1,884) |
| Cash and cash equivalents, beginning of year | 6,601 | 8,485 |
| **Cash and cash equivalents, end of year** | **3,468** | **6,601** |
| | | |
| **Supplementary cash flow information** | | |
| Cash and cash equivalents are comprised of: | | |
| Cash in bank | 2,468 | 4,601 |
| Short-term money market instruments | 1,000 | 2,000 |
| | 3,468 | 6,601 |

### *Statement of Changes in Equity*

The "statement of changes in equity" summarizes the changes in equity during the period covered by the financial statements.

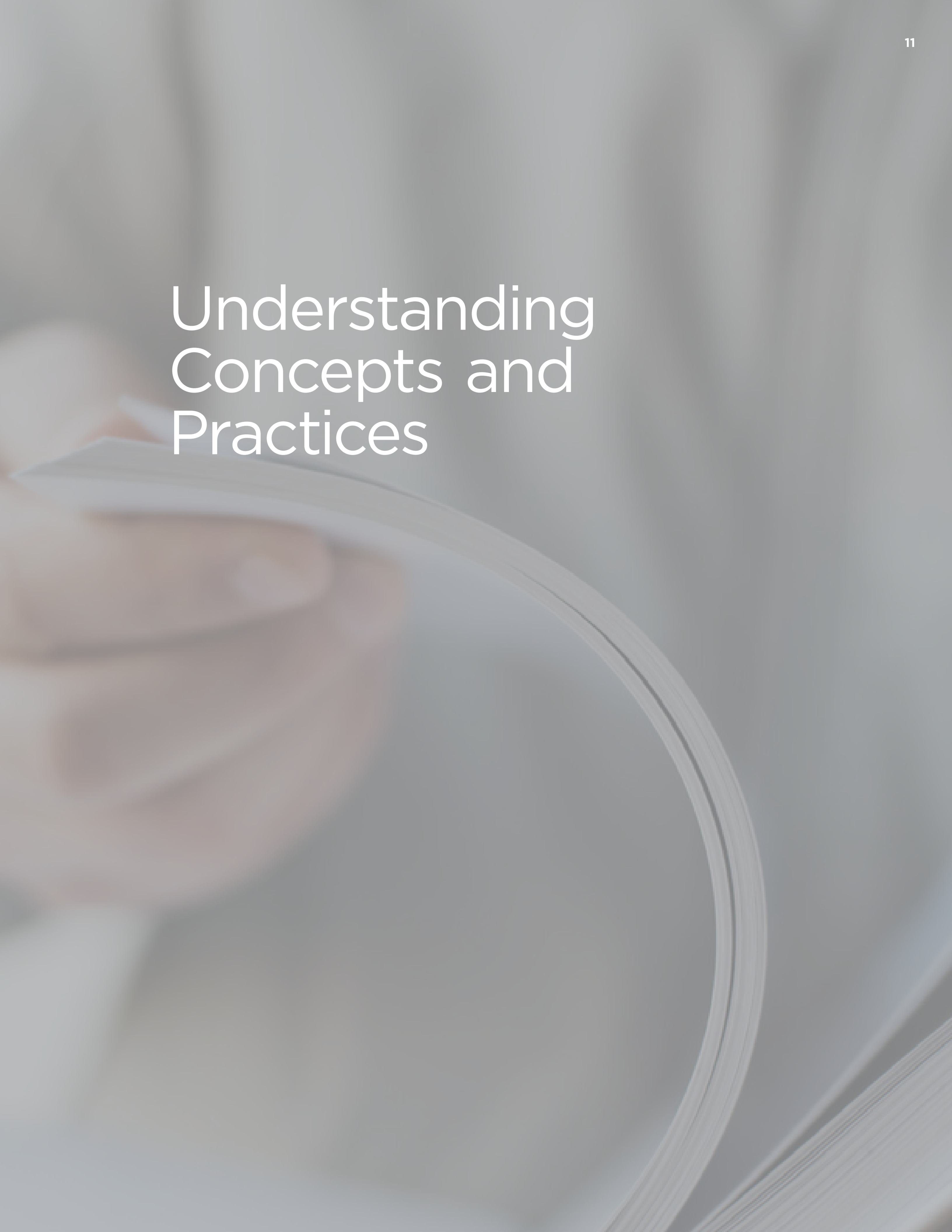
**Simplified Illustrative Consolidated Statements of Changes in Shareholders' Equity**

| *(millions of Canadian dollars)* | Share capital | Equity component of convertible debentures | Contributed surplus | Accumulated other comprehensive income | Retained earnings | Total |
|---|---|---|---|---|---|---|
| **Balance as at January 1, 20X1** | **90,328** | **100** | **2,232** | **71** | **(4,561)** | **88,170** |
| Net income for the year | | | | | 7,469 | 7,469 |
| Other comprehensive income for the year | | | | (68) | | (68) |
| Share-based compensation | | | 2,022 | | | 2,022 |
| Proceeds from shares issued | 1,406 | | | | | 1,406 |
| **Balance as at December 31, 20X1** | **91,734** | **100** | **4,254** | **3** | **2,908** | **98,999** |
| Net income for the year | | | | | 4,693 | 4,693 |
| Other comprehensive income for the year | | | | 413 | | 413 |
| Share-based compensation | | | 1,233 | | | 1,233 |
| Proceeds from shares issued | 257 | | | | | 257 |
| **Balance as at December 31, 20X2** | **91,991** | **100** | **5,487** | **416** | **7,601** | **105,595** |

## Notes to Financial Statements

The notes to the financial statements contain information on the accounting policies applied in the financial statements, judgments and estimates used in the preparation of the statements and other important information relevant to understanding the statements.

The responses to the following 30 questions address some of the matters relevant to understanding these core financial statements. They also address the distinction between interim and annual reports (see page 31), the auditor's report that accompanies annual financial statements (see page 29) and the significance of the MD&A that accompanies financial statements (see page 38).



# Understanding Concepts and Practices

## Q. *Are financial statements precise?*

Financial statements are not precise for several reasons.

There is little point in aiming for precision in financial statements since the cost would exceed any benefit to the reader. The largest Canadian banks, for instance, express their statements in millions of dollars to reflect the magnitude of their operations and the amounts they report. Typically, it makes no practical difference to a reader's understanding of a bank's statement of financial position to know whether an amount expressed as $200 million might in reality have been $199.6 million or $200.4 million. However, for a smaller entity, a transaction of a few hundred dollars might be significant to the reader. The assessment of what does or does not matter depends on the entity's size and circumstances. Preparers of financial statements rely heavily on the concept of "materiality"—that is, whether omitting or misstating a particular item would influence the economic decisions of those who use the financial statements.

Financial statements deal with matters that are inherently uncertain. Some items may be specific in nature; for example, the amount of cash on a company's statement of financial position may tie directly into the amount shown on its reconciled bank statement. But, for most other items, it is seldom that easy. A company may know what it paid to purchase inventories, but often *doesn't* know whether it can recover all those costs or, if it cannot, how large a loss it might incur. It may know how much is owed by customers as a result of past sales but often *doesn't* know whether all those customers will ultimately pay what they owe. It may know it has to pay something to settle a lawsuit in progress but likely won't know exactly how much until all negotiations are concluded. When the company prepares its financial statements and tries to measure items such as inventories, receivables and certain liabilities, it has to find answers to all these challenges—partly by looking to the guidance contained in accounting standards and partly by applying its own estimates and judgments. But no matter how conscientiously this is done, it is inevitable that not everything will turn out as the company anticipated.

Management applies professional judgment to develop and/or select an appropriate accounting policy (from a range of acceptable accounting

**FINANCIAL STATEMENTS**
A formal record of the financial activities of a business, person, or other entity. A complete set of financial statements comprises: a statement of financial position as at the end of the period; a statement of comprehensive income for the period; a statement of changes in equity for the period; a statement of cash flows for the period; and notes, comprising a summary of significant accounting policies and other explanatory information.

**MATERIALITY**
Information is material if its omission or misstatement could influence the economic decisions of financial statement users taken on the basis of the financial statements.

**ACCOUNTING POLICIES**
The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

approaches) that best reflects the company's economic reality. The preparation of financial statements requires management to make numerous estimates and lots of assumptions that affect the reported amounts. Different companies may look at similar sets of facts differently, resulting in different estimates. The application of a different policy, estimate or judgment to a particular transaction could result in the presentation of significantly different financial results. This does not mean that the financial statements cannot be trusted; it means, rather, that financial statements should be approached with a clear sense of their limitations and the recognition that the things they depict could have been measured differently by using other judgments or estimates.

The notes to the financial statements provide considerable information relevant to understanding the use of different policies, judgments and estimates. Among other things, the notes to financial statements contain:

- a description of accounting policies such as the methods applied by the company to various items in preparing its statements. For example, as discussed further on page 15, some items are measured at fair value so that at each statement-of-financial-position date they reflect an estimate of what would be paid or received to acquire or dispose of them. Other items are measured based on their original cost, even if the current fair value is significantly different
- information on areas particularly susceptible to judgments and estimates. For example, the assessment of impairment (see page 50) may be based on significant assumptions that might change in the near future. By disclosing information on these assumptions, the company allows the reader to understand the uncertainty attaching to the related asset values.

## *Q. What does "consolidated" mean in the context of financial statements?*

Financial statements of public companies rarely provide information about a single legal entity. For a variety of reasons related to tax, foreign regulatory requirements or other matters, the named public company usually carries out much, if not all, of its business through the ownership of interests in other companies or legal structures. Consolidated financial statements present the assets, liabilities, income, expenses and cash flows of a group of companies (i.e., the "parent" company and those it controls, i.e., its "subsidiaries") as a single economic entity.

For many items, this means little more than adding together the numbers reported by all the entities controlled by the parent. However, consolidation procedures can be very complex. Some of the subsidiaries may have foreign functional currencies that differ from that of the reporting entity (see page 53), and require adjustments so that all items in the consolidated statements can be presented in a single currency. Entities in the group may also carry out transactions with each other so that, for example, a sale in one subsidiary corresponds to an expense in another. Such items must be eliminated from the consolidated statements so that the statements reflect only transactions with outside parties.

Although these internal matters are often not significant for a reader's understanding of the financial statements, they might be so in some circumstances. For example, suppose a group holds a large portion of its consolidated cash within a particular subsidiary in a foreign jurisdiction that imposes controls on transfers of its currency or the subsidiary operates in an environment that is subject to economic or political unrest. In this situation, closer analysis into the details of the group helps to identify risks that are not apparent on the surface. The notes and MD&A should provide information on such matters. For another example, the parent might not have 100% ownership of the voting shares of all its subsidiaries; other entities might also have significant interests in some of them. These interests are quantified and represented in the financial statements as "non-controlling" interests. In some cases, these other investors might have powers or rights over those subsidiaries that are relevant to a financial statement user's understanding of the company's investment in these subsidiaries. The notes should also explain these matters and provide summarized information about the subsidiaries.

**PARENT**
An entity that has one or more subsidiaries.

**SUBSIDIARY**
An entity, including any unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

**CONSOLIDATED FINANCIAL STATEMENTS**
The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

## *Q. Why are assets and liabilities recognized in the financial statements measured in different ways?*

The disclosure of an entity's accounting policies often indicates that it applies different measurement principles to different items. For example, items such as property, plant and equipment are usually

**ASSET**
A resource controlled by the entity as a result of past events and from which probable future economic benefits are expected to flow to the entity.

**LIABILITY**
A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

accounted for based on the cost to the entity when it acquired them, less depreciation reflecting use (where appropriate) (see page 49). Some items, such as investments in equity securities, are measured at their fair value at the date of the statement of financial position. Others are measured at "amortized cost" or on some other basis.

It is reasonable to wonder why a single approach could not be applied to all these items. Unfortunately, there isn't a simple answer to this question. The process of setting accounting standards is often a practical matter and depends on reaching consensus among all those involved, which in turn often requires reaching a balance between the costs and benefits of providing relevant information in a particular situation. For example, it may be considered more useful to measure items at their fair value rather than at their original cost because this better reflects the conditions existing at the date of the statement of financial position. This can be easily implemented for, say, investments in publicly traded equities, because a market price is typically available for those shares. However, measurement of property and equipment at fair value would require much greater cost and effort, perhaps even the engagement of experts to carry out a valuation. Even then, the value obtained might be considered less relevant to investors if (among other things) the entity intends only to use the property and equipment in its business and has no intention of disposing of them to capitalize on any increase in their fair value. As a result of these types of considerations, IFRSs may not require measuring certain kinds of items (e.g., property, plant and equipment) at their fair value; however, it may at times allow an entity the *choice* of doing so.

Some items are measured differently, depending on how the entity uses them. For example, if an entity buys a portfolio of interest-bearing bonds with the intention of trading them, it typically measures them at fair value (which will change in response to marketplace factors such as changes in interest rates and credit quality). However, if it intends to hold such investments until maturity and to collect interest during the period the asset is held, it may measure these instruments based on their cost.[2] In the latter case, the fair values at any point in time are considered less relevant to a reader of the statements

2 The examples assume application of IAS 39 *Financial Instruments: Recognition and Measurement*.

because the holder has no intention of trying to realize the changes in those values. Even when two items are measured at fair value, the change in fair value from one period to the next may be presented in a different way in the financial statements (see page 18).

When investments are not measured at fair value, the notes to the financial statements might contain information on how fair value differs from the carrying amount. The notes also provide similar information for various other kinds of assets and liabilities. It may be challenging for a new user of financial statements to appreciate the different measurement bases applied to different items and the reasoning behind this. This challenge can best be addressed by attempting to understand each item on its own terms and by understanding what the carrying amount does and does not represent, as well as assessing the other relevant information contained in the notes.

## Q. *What is the difference between costs recognized as assets and those recognized as expenses?*

In general, assets are measurable resources that an entity controls as a result of past events, and from which probable future economic benefits are expected to result. If any of these elements is not present for a particular item, then the item is generally not recognized as an asset in the statement of financial position. To use the simplest possible example, an entity's cash is an asset because (in a normal situation) it obtained the cash from past events, has control over what is done with it and will obtain probable future economic benefits from its use—for instance by using the cash to buy inventory or other assets, by settling debts or by paying employees.

Expenses represent immediate decreases in economic benefits. For example, although an entity must pay its power bills in order to keep the lights on, and although paying such bills may be one of the many expenditures that indirectly make the entity capable of generating revenue and profit, payment generally does not directly create any new identifiable resources.

Assets are recognized as expenses as they are used up in the business.

**EXPENSES**
Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or the incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

| Simplified Illustrative Consolidated Income Statements<br>For the years ended December 31 | | |
|---|---|---|
| *(millions of Canadian dollars, except per share amounts)* | 20X2 | 20X1 |
| Revenue | 50,529 | 52,370 |
| Expenses | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Impairment loss | 2,641 | - |
| Finance costs | 1,015 | 700 |
| Foreign exchange loss (gain) | 193 | (141) |
| Other expenses (income) | 197 | (107) |
| | 34,141 | 29,237 |
| Income before income tax | 16,388 | 23,133 |
| Current income tax expense | 3,397 | 1,168 |
| Deferred income tax expense | 8,298 | 14,496 |
| Net Income | 4,693 | 7,469 |
| Net income per common share: | | |
| Basic | 0.13 | 0.21 |
| Diluted | 0.10 | 0.18 |

| Simplified Illustrative Consolidated Statements of Comprehensive Income<br>For the years ended December 31 | | |
|---|---|---|
| *(millions of Canadian dollars)* | 20X2 | 20X1 |
| Net income | 4,693 | 7,469 |
| Other comprehensive income (loss), net of tax | | |
| Gains and losses from investments in equity instruments measured at fair value | 413 | (68) |
| Total Comprehensive Income | 5,106 | 7,401 |

The distinction between assets and expenses is sometimes subtle. For example, an entity might be involved in the research and development of new products. In the early stages of a project, because it is difficult to demonstrate that the project will lead to probable future economic benefits, the entity recognizes the research expenditures as expenses. However, as the project continues, it may become clear at some point that the entity has developed a recognizable asset (i.e., there is a future benefit to the costs that have been incurred). Recognition of these costs as an asset depends, among other things, on being able to demonstrate that the company intends and has the ability to complete the project, to use or sell what comes from it and that the asset will in fact generate probable future economic benefits. This assessment may involve a number of complex judgments about the future which, despite best efforts, may turn out to be incorrect. In a situation like this, the notes to the statements should highlight the judgments and estimates involved in recognizing the asset.

In some cases, entities have a choice of whether to recognize certain kinds of expenditures as assets or as expenses (see the discussion of mining exploration costs on page 59).

Assets are not necessarily more “important” than expenses—they contribute to the entity’s success in different ways; some entities require a relatively greater asset base than others. For example, a retailer may only generate revenue on the basis of a major ongoing investment in premises and inventory, whereas a consulting company may generate revenue mainly from the know-how of its employees and have minimal investment in physical resources.

## Q. *What is the difference between net income or loss and “comprehensive” income or loss?*

In their financial statements, companies report an amount of net income or net loss. In either the same statement or in a separate but adjacent statement, they also provide an amount of “comprehensive” income or loss. In some cases, the two amounts are the same; in other cases, however, they may be significantly different, a fact that could create confusion in the mind of the investor about which measure is more meaningful.

The items added to net income or loss in calculating the "comprehensive" amount are just as much income or expenses of the entity as the other items in the income statement. However, for various reasons, accounting standard setters have agreed that they can be excluded from the *main* measure of profitability (i.e., net income or net loss). This may be because they have a more long-term nature or because their volatility might overshadow the portrayal of the core business activities. For example, suppose an entity involved in a retail business holds a large portfolio of investments that it does not use in its day-to-day business. It has no immediate plans or reason to sell these investments but, for various reasons, the entity measures them at their fair value in its statement of financial position. This fair value may change significantly from one period to the next and, if these changes were recognized as part of net income or loss, they might overshadow or distort the presentation of the retail operations. However, the amount of the fair value changes still constitutes important information for readers; consequently, it is presented as an item of "other" comprehensive income or expense in building up the "comprehensive" amount. In contrast, if the entity were actively trading the investments as part of its business, then changes in their fair value would be part of its net income or loss.

In many cases, items that are treated as "other" comprehensive income/loss are recognized later in net income or loss (a process often referred to as "recycling"). In the example above, if and when the entity eventually sells the investments, it takes the accumulated amounts recognized in "other" comprehensive income or loss in the past and reclassifies them in net income or loss at the time of sale as part of the overall gain or loss on selling the items. Therefore investors should regard these items as being relevant to their longer-term perspective of the entity's performance.

## *Q. What is the difference between the income statement and the statement of cash flows?*

The statement of cash flows summarizes movements in the company's cash position for the period. The income statement, which is a subset of the statement of comprehensive income, summarizes the revenue and expenses for a period.

### OPERATING ACTIVITIES

The principal revenue-producing activities of an entity and other activities that are not investing or financing activities.

### INVESTING ACTIVITIES

The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

### FINANCING ACTIVITIES

Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

**Simplified Illustrative Consolidated Statements of Cash Flows**
**For the years ended December 31**

| *(millions of Canadian dollars)* | **20X2** | **20X1** |
|---|---|---|
| **Operating activities** | | |
| Net income | 4,693 | 7,469 |
| Add non-cash items: | | |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Accretion of decommissioning liabilities | 855 | 693 |
| Interest expense | 160 | 7 |
| Impairment loss | 2,641 | - |
| Foreign exchange loss (gain) | 193 | (141) |
| Deferred income tax expense | 8,298 | 14,496 |
| | 24,777 | 28,118 |
| Change in non-cash working capital | (10,959) | (13) |
| Income taxes paid | (3,000) | (895) |
| **Cash flow generated from operating activities** | **15,511** | **34,679** |
| **Investing activities** | | |
| Capital expenditures | (16,087) | (42,638) |
| Other investing activity | (2,615) | 5,470 |
| **Cash flow used in investing activities** | **(18,702)** | **(37,168)** |
| **Financing activities** | | |
| Issuance of shares | 257 | 1,406 |
| Other financing activity | (199) | (800) |
| **Cash flow generated from financing activities** | **58** | **606** |
| Effect of translation on foreign currency cash and cash equivalents | - | (1) |
| Decrease in cash and cash equivalents | (3,133) | (1,884) |
| Cash and cash equivalents, beginning of year | 6,601 | 8,485 |
| **Cash and cash equivalents, end of year** | **3,468** | **6,601** |
| **Supplementary cash flow information** | | |
| Cash and cash equivalents are comprised of: | | |
| Cash in bank | 2,468 | 4,601 |
| Short-term money market instruments | 1,000 | 2,000 |
| | 3,468 | 6,601 |

Income is not cash. The profit or loss of a company does not necessarily correlate to its cash flow (or cash position).

In its income statement, an entity generally "matches" revenue and expenses that result directly and jointly from the same transactions or other events. For example, at the time it recognizes revenue from selling an item, it also recognizes the expenses that make up the cost of that item. It follows that the entity's income or loss for a particular period may be very different from the cash generated during that period. The company may have completed sales during the period (which increases profit) but has not yet collected the cash from its customers. It may have incurred expenses (which decrease profit) but not yet paid them. The amounts receivable from customers represent assets in the statement of financial position; the amounts payable to suppliers or others represent liabilities. The changes in these assets and liabilities during a period are entirely relevant to calculating income or loss; otherwise, for example, a company might make itself appear more profitable than it really is, simply by not recording its obligations.

At the same time, a valuable additional perspective is acquired by looking at a company in terms of the cash raised and spent. Companies may, for example, report profit without necessarily generating cash—perhaps because the profit came from sales at the end of the year, for which the cash has not yet been received, or for many other reasons. Differences between profit/loss and operating cash may reflect short-term fluctuations, or they may contain important cautionary information about the stability of the business.

The cash flow statement is typically divided into three sections: cash generated from (or used in) operating activities, from investing activities, and from financing activities. The interplay between the three may clarify some basic facts about the company's current state. For example, a company may have a similar amount of cash at the beginning and end of the year while having raised significant cash during the year by issuing shares or debt, all of which was consumed by operating losses or used to finance a major capital expenditure or other investment. The cash flow statement provides a sharper focus on some key questions relevant to this state of affairs:

- Are the operating losses a necessary precursor to becoming profitable in the foreseeable future, a reflection of short-term challenges that will not recur, or are they likely to continue?

- If the company's operations or projected investments depend on raising significant new capital on an ongoing basis, will it be able to continue to do so, and how much will this dilute the interests of existing investors?
- Are the company's investments likely to generate sufficient future returns to justify the resources allocated to them?
- If cash inflows are primarily generated from selling assets, will the company have sufficient assets in the future to support operations?

Of course, the answers to these questions may be inherently unclear, but the MD&A (see page 38), if well prepared, should provide some understanding of management's perspective on these and similar issues.

## Q. *What are the elements and complexities of equity?*

Equity is generally defined as the residual interest in the assets of the entity after deducting all of its liabilities (i.e., equity = assets - liabilities). In theory, if all assets in the statement of financial position could be converted to cash, and all the liabilities settled at their carrying amounts, then the amount of equity would represent what would be left to distribute to shareholders. This is not an accurate measure, however, of what the entity would *actually* distribute if it were liquidated. Among other things, some assets would likely be sold for more or less than their carrying amount, and some of the entity's resources would be consumed by the costs of the liquidation.

The financial statements, particularly the statement of changes in equity, provide information on the sources of this "residual interest." Some forms of equity come from capital providers, such as stockholders who inject cash or other assets into the entity in return for shares. Other forms of equity result from the entity's operations since it was formed—net income (or net loss), net of dividends paid to stockholders, accumulated in an account called retained earnings (or deficit). Retained earnings generally refer to the accumulated historical earnings held back for use in the company instead of being distributed to shareholders.

Equity of a consolidated entity includes any non-controlling interest (see page 14), and may include amounts of accumulated other comprehensive income (see page 18), certain accumulated foreign

**EQUITY**
The residual interest in the assets of the entity after deducting all its liabilities.

**Simplified Illustrative Consolidated Statements of Financial Position**
As at December 31

| *(millions of Canadian dollars)* | 20X2 | 20X1 |
|---|---|---|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | 3,468 | 6,601 |
| Investments | 2,447 | 2,034 |
| Accounts receivable | 19,597 | 10,236 |
| Other receivable | 734 | 927 |
| Inventories | 2,586 | 2,127 |
| Total Current Assets | 28,832 | 21,925 |
| Non-current Assets | | |
| Property and equipment | 147,076 | 144,793 |
| Intangible assets | 3,000 | 3,000 |
| Exploration and evaluation assets | 14,394 | 7,383 |
| Goodwill | 7,000 | 7,000 |
| Other assets | 2,958 | 343 |
| Total Non-current Assets | 174,428 | 162,519 |
| Total Assets | 203,260 | 184,444 |
| Liabilities | | |
| Current Liabilities | | |
| Accounts payable and accrued liabilities | 11,836 | 21,640 |
| Other current liabilities | 6,711 | 1,046 |
| Total Current Liabilities | 18,547 | 22,686 |
| Non-current Liabilities | | |
| Convertible debentures | 1,160 | 1,000 |
| Decommissioning liabilities | 20,861 | 12,761 |
| Other provisions | 1,532 | 1,731 |
| Deferred income tax liabilities | 55,565 | 47,267 |
| Total Non-current Liabilities | 79,118 | 62,759 |
| Total liabilities | 97,665 | 85,445 |
| Shareholders' Equity | | |
| Share capital | 91,991 | 91,734 |
| Equity component of convertible debtentures | 100 | 100 |
| Contributed surplus | 5,487 | 4,254 |
| Accumulated other comprehensive income | 416 | 3 |
| Retained earnings | 7,601 | 2,908 |
| Total Shareholders' Equity | 105,595 | 98,999 |
| Total liabilities and Shareholders' Equity | 203,260 | 184,444 |

**NOTES**
Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements.

exchange gains and losses (see page 53) and other components such as “reserves” established to meet statutory requirements or other management objectives. Reserves are appropriations of retained earnings. The existence and size of reserves is information that is relevant to decision makers as it may indicate restrictions on the ability of the entity to distribute its equity.

More difficult components of equity arise from stock-based compensation (see page 51) or from complex financial instruments. For example, certain debt instruments may have a conversion feature allowing the holder to convert the debt into a fixed amount of shares of the company under specified circumstances. This type of debt instrument is typically presented in the financial statements based on its component parts, i.e., some of it is presented as a liability and some of it (the amount allocated to the conversion feature) is presented within equity.

Countless variations exist on these themes. The substance of the accounting can be hard to follow, and liabilities created in such situations do not necessarily represent cash that has to be paid by the entity. These situations do, however, provide information about the arrangements the entity has entered into and the impact of those arrangements on its resources.

On occasion retrospective adjustments are made to equity as a result of a change in an accounting policy or the correction of a prior-period error. Retrospective adjustments and restatements are not changes in equity but are adjustments to the opening balance of retained earnings (or another component of equity if required by an accounting standard).

## *Q. What is the importance of the notes to the financial statements?*

The notes to the financial statements (“notes”) contain a significant amount of information relevant to understanding the amounts recognized in the financial statements as well as items that have not been recognized (e.g., contingent liabilities, going concern (see page 24), debt covenants, etc.).

The notes clarify individual line items in the financial statements (e.g., causes of impairment losses), and/or reconcile or disaggregate certain information (e.g., break down revenue into segments or geographic regions). The notes are also used to explain the accounting policies used to prepare the statements, sources of estimation uncertainty, information to enable financial statement users to evaluate the entity's objectives, policies and processes for managing capital and may provide additional information on how particular accounts have been computed.

As explained on page 13, no amount included in the statement of financial position or in any other statement can ever be entirely clear on its own terms. To a greater or lesser extent, every amount depends on the accounting policies followed by the entity and on the judgments or estimates underlying that specific item. No matter how conscientiously management prepares the financial statements, no certainty ever exists that two different entities will report the same item in exactly the same way. A risk always exists that future events might cause some of the amounts in the statements to be adjusted. The notes explain the facts and circumstances relevant to understanding how these factors affect the statements.

Some of the information to be addressed in the notes is specifically prescribed by accounting standards; other aspects of the notes may vary from one entity to the next, depending on management's assessment of what is relevant to a user's understanding. IFRSs only prescribe the format and order of the notes to a limited degree. Usually (but not always) an entity describes its significant accounting policies near the start of the notes and addresses other aspects of the financial statements in the order in which they appear in the statement of financial position and the other statements. The notes are usually cross-referenced to and from the amounts in the statements.

As explained on page 38, the MD&A often provides additional information about some of the same areas addressed in the notes to the statements and may be most usefully read in conjunction with those notes.

Other questions and answers in this Guide provide a sense of matters addressed by the notes in specific areas. These include, for example:

- significant accounting policies (see page 13)
- significant judgments and estimates (see page 13)
- the impact of business acquisitions (see page 46)
- details about impairment losses and assessing impairment (see page 50)
- segment reporting (see page 60)
- events after the end of the reporting period (see page 61).

## GOING CONCERN ASSUMPTION

The financial statements are normally prepared on the assumption that an entity will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the basis used is disclosed.

## *Q. What is the significance of disclosures about "going concern"?*

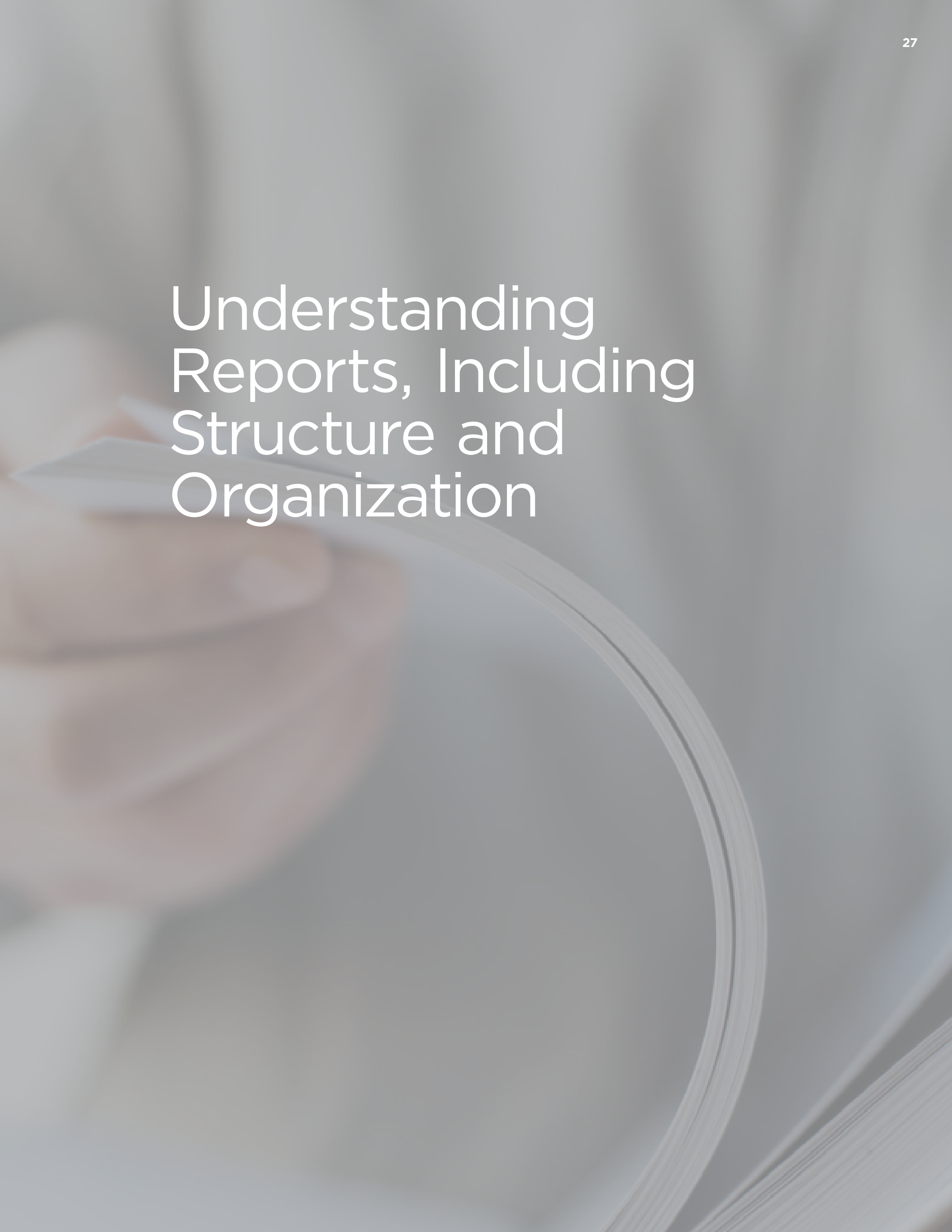
Financial statements are normally prepared on the assumption that the entity will continue to operate for the foreseeable future, and that it has no plans, or no need, to liquidate or to materially reduce the scale of its operations. Where this assumption does not hold, changes may be required in how certain items are recognized and/or measured. For example, items of property, plant and equipment are usually recognized in the statement of financial position at their initial cost and then depreciated over an estimate of their useful life (see page 49). However, if it is known that an entity will cease to operate within one year, then it is not meaningful to assume that its equipment has a remaining useful life of, say, five years. In this case, the items will more likely be measured with reference to their fair value less the costs of selling them because this better reflects the reality of how the entity will recover the remaining carrying amount.

When an entity's management prepares financial statements, it assesses the entity's ability to continue as a going concern by taking into account all the available information for at least the next 12 months (and perhaps longer). For many entities, the assessment is straightforward because the entity clearly has ample financial resources, a predictably profitable business and so forth. For others, the conclusion may be subject to significant doubt, depending on factors that cannot be assessed with certainty at the time the statements are prepared. For example, it may be impossible to anticipate whether the entity will be capable of raising sufficient financing or self-generating cash flows to meet its needs over the coming year. In these circumstances, the entity highlights these uncertainties, usually at or near the start of the notes to its financial statements. The auditor also typically emphasizes this disclosure in its report (see page 29).

As noted, one of the primary objectives of the going concern disclosures is to emphasize uncertainty. Going concern disclosures are not necessarily intended to indicate the difference between a "safe" and a "risky" entity (or investment). An entity might be subject to significant challenges of one kind or another that might make an investment in its securities extremely risky, but if it is clearly capable of continuing to operate for the foreseeable future in some form, then the notes to its financial statements likely would not contain any language about going concern uncertainty. The financial statements might contain some more general language about these matters but, for a fuller sense of the entity's financial condition and prospects, a reader must consult other disclosure documents, in particular the MD&A (see page 38). Entities may also have filed other documents (including Annual Information Forms or prospectuses) setting out a comprehensive description of the risks attaching to their operations. These documents can be found on the System for Electronic Document Analysis and Retrieval (SEDAR), the electronic filing system for the disclosure documents of public companies and investment funds across Canada.

*All Canadian public companies are generally required to file their documents in the SEDAR system.*

www.sedar.com



# Understanding Reports, Including Structure and Organization

## Q. What is the importance of the auditor's report?

**AUDITOR'S REPORT**
A formal opinion, or disclaimer thereof, issued by an auditor after performing an audit or evaluation.

The auditor's report expresses an opinion on whether the financial statements have been fairly presented in accordance with IFRSs and provides some explanation of the scope of the auditor's work and of the respective responsibilities of the auditor and the company's management. The auditor's report is not an opinion that the financial statements are precise; the report specifies, rather, that the auditor planned and performed the audit to obtain *reasonable* assurance as to whether the financial statements are free from *material* misstatement. Similarly, the work of the auditor is not specifically intended to identify all frauds or other illegal acts that may have occurred within the entity, although the auditor does have a responsibility to obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, there is an unavoidable risk that material misstatement may not be detected, even though the audit is properly planned and performed in accordance with standards set for the conduct of an audit.

In theory, the report could present an opinion that an entity's financial statements are *not* fairly presented in accordance with IFRSs or that they are fairly presented except for certain matters. In practice, most investors will likely never encounter such modified reports since Canadian securities administrators require that reporting issuers file their annual financial statements accompanied by an *unqualified* auditor's report.

As noted on page 31, interim financial statements of reporting issuers are not audited, but they may be reviewed. A review generally includes only analysis, inquiry and discussion (instead of detailed audit procedures) and may not result in issuing a formal report to the shareholders. A review provides a lower level of assurance compared to an audit. An issuer's MD&A is neither audited nor reviewed by its auditor.

The existence of the auditor's report provides a basis for greater confidence in the reliability of the financial information it accompanies. However, the report comments only on the specific matter of whether the financial statements are fairly presented in accordance with specified accounting standards, and not, for example, on whether the financial statements depict a "good" or "healthy" company. On the contrary, an auditor's report may express an unqualified opinion on an entity's financial statements even when the entity faces significant challenges, as long as the statements account for and disclose all matters in compliance with the specified accounting standards.

The auditor's report will sometimes emphasize matters presented or disclosed in the statements that the auditor considers of fundamental importance to the user's understanding of the financial statements, for example, when significant doubt exists about the entity's ability to continue as a going concern (see page 24). In addition, the auditor may communicate matters other than those that are presented or disclosed in the financial statements, which the auditor believes are relevant to the user's understanding of the audit, the auditor's responsibilities or the audit report. However, a reader cannot assume that the report highlights all or even any of the matters that would be of interest to him or her; reading the audit report is not a substitute for reading the financial statements and the notes to these statements.

All things being equal, one would expect to have greater confidence in financial statements that have been audited than in those that have been reviewed, and to have greater confidence in statements that have been reviewed than in statements that have not. Still, inevitably, errors are occasionally identified in financial statements that were audited. The fact that financial statements have been neither audited nor reviewed does not mean they should be inherently regarded as unreliable; a company's management and directors have numerous motivations to prepare financial statements that are free of material errors, including the possibility of significant penalties and other consequences if they fail to meet their legal obligations.

Users must decide for themselves what weight they put on the fact that some financial statements are subject to greater assurance than others, drawing to the extent they can on such matters as the inherent risk of the entity, their personal tolerance for risk and the quality of the entity's financial reporting as a whole.

*Illustration: Illustrative Independent Auditor's Report*

**Independent Auditor's Report**

To the Shareholders of the Company

We have audited the accompanying consolidated financial statements of the Company , which comprise the consolidated statements of financial position as at December 31, 20X2 and December 31, 20X1, and the consolidated statements of income, consolidated statements of comprehensive income, consolidated statements of changes in equity and consolidated statements of cash flows for the years ended December 31, 20X2 and December 31, 20X1, and a summary of significant accounting policies and other explanatory information.

**Management's Responsibility for the Consolidated Financial Statements**
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**
In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 20X2 and December 31, 20X1, and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards.

Chartered Professional Accountants
Licensed Public Accountants
February 13, 20X3
Toronto, Ontario

## Q. How do interim reports differ from annual reports?

In Canada, companies have discretion in selecting a fiscal year-end date. Once selected, annual financial statements are prepared as of that date (e.g., statement of financial position) and for the period ending on that date (e.g., statement of cash flows).

Public companies also prepare interim or quarterly financial statements at the dates falling three months, six months and nine months from the year end. For example, a public company that prepares its annual report at the end of December will also prepare quarterly reports as of the end of March, June and September. These interim financial statements take the same basic form as the annual financial statements and contain the same core statements, along with notes. However, the notes are usually shorter in interim financial statements—often substantially shorter.

**INTERIM FINANCIAL REPORT**
A financial report for an interim period (i.e., a financial reporting period shorter than a full fiscal year).

Every public company includes in its annual financial statements a "statement of compliance" that the financial statements have been prepared in accordance with International Financial Reporting Standards. This means that the financial statements include all the information required to provide a fair presentation in accordance with IFRSs. Interim reports do not make the same claim since an entity is not required to repeat items of information previously provided in its annual financial statements if the information has not changed significantly. For example, most entities do not describe their accounting policies in their interim financial statements if the policies are the same as those used in the last annual financial statements (as is usually the case). In other words, whereas annual financial statements are designed to be read and understood on a stand-alone basis, interim financial statements are only designed to be read *in conjunction with* the most recent annual financial statements (i.e., as an update to those statements).

Also, the annual financial statements are accompanied by an auditor's report (see page 29) expressing an opinion on whether the financial statements are fairly presented in accordance with specified accounting standards. Interim financial statements are not audited although the company may engage its auditors to carry out a "review" of the statements. A review generally includes only analysis, inquiry and discussion (as opposed to detailed audit procedures) and may not result in the issue of a formal report to the shareholders. Under Canadian securities regulations, if interim financial statements have *not* been reviewed, this fact should be stated in a notice attached to the statements; if no such statement is made, a reader should be able to assume the statements were reviewed.

## *Q. Why do similar companies use such different labels, captions and formats when they prepare their statements?*

Accounting standards define (among other things) the general structure and minimum content of financial statements but typically do not dictate the exact wording to be applied in describing items, or the order in which items should be arranged and other matters of presentation. Because companies have their own philosophies, internal terminology and approach to branding, it is appropriate to allow management some discretion in presenting the company as they see it. However, it can sometimes cause confusion for readers when matters are labeled differently from one entity to the next. This issue intertwines with the use of different subtotals (see page 34).

A key example of this potential confusion relates to how entities construct their income statement. IFRSs require that entities present expenses consistently either by their nature or by their function. For example, if an entity presents separate line items for salaries and benefits, raw materials, fuel and the like, it is choosing to present its expenses by their nature, because each of these things is a distinct kind of expenditure. Alternatively, that same entity might choose to group the same expenses into categories such as “cost of sales,” “marketing costs,” “administrative costs” and so forth, each of which is a functional category made up of expenses of different natures. Total expenses and net income (or loss) will be the same either way. But if one entity chooses one method and its competitors choose the other, it can be difficult to make comparisons.

Some of the difficulty is alleviated by looking deeper into the reports. If an entity chooses to group its expenses in the income statement based on their function, it is required to provide further information in the notes about the nature of those expenses (although different companies present this supporting information in different formats and in different degrees of detail).

The MD&A frequently contains other analyses and breakdowns of performance but, once again, there may be little similarity in the way different companies choose to provide the information or the way in which they provide it. Where a particular entity seems not to provide enough information about these or other matters, it is appropriate for readers to consider whether or how this affects their confidence in the entity’s reporting as a whole.

The labels used to describe similar items can also differ. For example, some companies use the term “sales” to describe their income generation while others prefer the term “revenue” or similar caption. Even though these terms do have distinct meanings, at times they are used interchangeably. The same can be said about other terms to denote the overall return of a company, including “net income,” “earnings” or “profit.” Care must be taken to understand the definition and elements comprising the described item.

| **Simplified Illustrative Consolidated Income Statements** | | |
|---|---|---|
| For the years ended December 31 | | |
| *(millions of Canadian dollars)* | 20X2 | 20X1 |
| Revenue | 1,300,000 | 1,200,000 |
| Cost of Sales | 700,000 | 589,000 |
| **Gross Margin** | **600,000** | **611,000** |
| Distribution expenses | 82,150 | 80,670 |
| Administrative expenses | 49,490 | 47,120 |
| Gain on property disposition | 12,330 | - |
| **Earnings before interest, taxes, depreciation and amortization (EBITDA)** | **456,030** | **483,210** |
| Interest expense | 10,000 | 10,000 |
| Tax expense | 91,206 | 119,003 |
| Depreciation and amortization | 90,000 | 100,000 |
| Net Income | 264,824 | 254,207 |

## *Q. What is the importance of all the subtotals in the income statement — "gross margin," "loss before other items," etc.?*

Analyzing financial performance is not a simple task. The income statement subtracts expenses from revenue to obtain a net income or net loss that represents a total measure of the company's financial performance. Some consider net income to be one of the most important single metrics on the income statement. However, users may also be interested in measures of performance that exclude certain items of income and/or expenses. For example, net income for a particular year may be boosted by a large gain from selling a property, which will not be repeated in future years and does not arise directly from the ongoing business. In this case, in addition to looking at net income, users will likely be interested in looking at what net income (or loss) would have been *without* this large gain and then comparing *this* number to the net income or loss of the previous year. In this case, a subtotal allowing them to make that comparison may be useful.

Other common examples found in financial statements and/or the MD&A or elsewhere, and their limitations, include:

- Gross profit or loss (gross margin) — This amount is typically based on revenue after deducting the direct costs of sales but without taking into account all the other expenses of the business. For some entities, this may provide a clearer measure of the company's core activities. At the same time, however, it may be impossible to assess financial performance as a whole without knowing whether the gross profit was sufficient to cover all the other expenses.
- Earnings before interest, taxes, depreciation and amortization (EBITDA) — As the label implies, this measure goes further than gross margin in deducting *most* of the incremental expenses of the business while excluding some others (for various reasons). Users of EBITDA may be interested in a measure that excludes interest charged on loans or other noted expenses, because it:
    - — excludes interest charged on loans and other items arising from negotiations with finance providers rather than from the performance of the underlying business

— excludes taxes, which reflect appropriations by governments and authorities rather than a cost to the business

— excludes depreciation and amortization (see page 49), which are non-cash in nature.

On the other hand, interest and taxes remain real outflows that reduce the accumulated profit available for other purposes. Depreciation and amortization may provide important information about how an entity's assets are being used by operations.

- Earnings before other kinds of "non-recurring" items—An entity may expand its EBITDA measure to exclude other kinds of expenses as well on the grounds that they are "one-offs," or that they don't require cash (see, for example, the discussion of stock-based compensation on page 51). Arguments can usually be made both in favour of the utility of these measures and about their limitations.

Further difficulties arise in comparing such measures between different entities because no certainty exists that measures labeled in similar ways will include or exclude exactly the same items or that they will be computed consistently from one year to the next. Although securities regulators try to ensure that companies clearly communicate how they compute and use such measures, confusion can easily arise. For example, media reports will sometimes discuss a company's performance without clarifying that the report is based on, say, EBITDA rather than the company's profit or loss.

## Q. *What is the importance of the distinction between current and non-current (or long-term) assets and liabilities?*

In the statement of financial position, an entity will usually distinguish between assets and liabilities that are "current" and other assets and liabilities. Some entities, under certain circumstances, may present all their assets and liabilities in order of liquidity.

Current assets are usually those that the entity expects to sell or consume or otherwise realize within 12 months from the end of the reporting period, or that it holds for purposes of trading. Cash is usually a current asset, unless the cash is in some way

**Simplified Illustrative Consolidated Statements of Financial Position**
**As at December 31**

| *(millions of Canadian dollars)* | **20X2** | **20X1** |
|---|---|---|
| **Assets** | | |
| **Current assets** | | |
| Cash and cash equivalents | 3,468 | 6,601 |
| Investments | 2,447 | 2,034 |
| Accounts receivable | 19,597 | 10,236 |
| Other receivable | 734 | 927 |
| Inventories | 2,586 | 2,127 |
| **Total current assets** | **28,832** | **21,925** |
| **Non-current assets** | | |
| Property and equipment | 147,076 | 144,793 |
| Intangible assets | 3,000 | 3,000 |
| Exploration and evaluation assets | 14,394 | 7,383 |
| Goodwill | 7,000 | 7,000 |
| Other assets | 2,958 | 343 |
| **Total non-current assets** | **174,428** | **162,519** |
| **Total assets** | **203,260** | **184,444** |
| **Liabilities** | | |
| **Current liabilities** | | |
| Accounts payable and accrued liabilities | 11,836 | 21,640 |
| Other current liabilities | 6,711 | 1,046 |
| **Total current liabilities** | **18,547** | **22,686** |
| **Non-current liabilities** | | |
| Convertible debentures | 1,160 | 1,000 |
| Decommissioning liabilities | 20,861 | 12,761 |
| Other provisions | 1,532 | 1,731 |
| Deferred income tax liabilities | 55,565 | 47,267 |
| **Total non-current liabilities** | **79,118** | **62,759** |
| **Total liabilities** | **97,665** | **85,445** |
| **Shareholders' equity** | | |
| Share capital | 91,991 | 91,734 |
| Equity component of convertible debtentures | 100 | 100 |
| Contributed surplus | 5,487 | 4,254 |
| Accumulated other comprehensive income | 416 | 3 |
| Retained earnings | 7,601 | 2,908 |
| **Total shareholders' equity** | **105,595** | **98,999** |
| **Total liabilities and shareholders' equity** | **203,260** | **184,444** |

restricted in its use over the next 12 months. Current liabilities are usually those that the entity must settle within 12 months from the end of the reporting period, and for which it does not have the right to defer settlement for more than that length of time.

The distinction between current and non-current assets and liabilities allows a reader to distinguish between items that cycle continuously as working capital and those that are used over a longer period. This distinction can be particularly useful in assessing the entity's liquidity. All other things being equal, an entity for which current liabilities exceed current assets may have greater challenges in maintaining its operations than an entity with positive net current assets. The notes to the financial statements and MD&A should acknowledge such challenges and provide an understanding of the entity's assessment of how it will fund its working capital needs for at least the coming year.

Even when current assets comfortably exceed current liabilities, a reader should bear in mind that different assets and liabilities have different characteristics that affect their degree of liquidity. For instance, cash can usually be used immediately for any desired purpose, but accounts receivable must be collected from customers, and inventory must be sold (or converted into a saleable form) and then converted into accounts receivable, which must then be collected from customers. The "financial instruments" section of the notes usually provides information on risks attaching to collecting accounts receivable—for example, on amounts that have been outstanding for longer than the due date attached to them—and about major portions of the balance collectible from single customers.

Similarly, current liabilities may not all be payable within the same time frame. Accounts payable to suppliers are usually due within a relatively short time period; however, some current liabilities may not, in fact, require payment within 12 months. For example, suppose a lender extends a loan to the entity repayable more than 12 months after the end of the reporting period. To protect its interests, the lender attaches financial tests or other "covenants" to the loan that allow it to demand immediate repayment if any test or covenant is not met. Such a loan is classified as a current liability at the date of the statement of financial position if the tests or covenants are not met as of that date, since the lender has the right to immediate repayment. However, the notes to the financial statements may contain information indicating that this will not happen in practice. For instance, the lender may have provided assurances to that effect subsequent to the end of the year. Similarly, amounts loaned to an entity by its shareholders and other related parties may be classified as current liabilities because those parties *could* demand repayment within the coming year if they so choose; however, past practice and their stated intentions may indicate that this may not happen.

**RATIO ANALYSIS**
Quantitative analysis of information (e.g., two selected numerical values) contained in a company's financial statements. Ratio analysis is used to evaluate relationships among financial statement items. The ratios are used to identify trends over time for one company or to compare two or more companies at one point in time. Ratios can be expressed as a decimal value, such as 0.20, or given as an equivalent percent value, such as 20%.

## Q. When is "ratio analysis" helpful in understanding the financial statements?

Most commentaries on using financial statements provide some discussion of various ratios that can be helpful in analyzing what the statements show. Among countless others, one might analyze gross margin and net income as a percentage of revenue, current liabilities as a percentage of current assets, net income as a percentage of equity, or debt relative to equity. Other ratios draw on measures from outside the financial statements. Analysts, for example, often assess the price of a company's stock relative to its earnings. All of these measures, if compared to the corresponding percentages applying to other largely similar companies, might help to clarify some aspects of the statements. For example, all things being equal, an entity that earns higher net income as a percentage of revenue appears to be more productive and attractive than a relatively less profitable competitor.

It is important to keep in mind, however, that all things are *never* equal and that, while such exercises may provide indicators of possible strengths and weaknesses, the picture they appear to draw may be contradicted by the facts. As an example of many possible problems, an entity currently earning a higher relative net income may not be investing adequately in new technologies or markets with the result that the current performance can only erode. In contrast, a currently less profitable competitor may have stronger future prospects. Net income in the current year may be either higher or lower than in other years because of one-off items that are not relevant to understanding future prospects (see page 34), or revenue may similarly be affected by non-recurring factors. In other words, it is important to consider the quality and sustainability of the result apparently provided by applying the ratio.

The use of such ratios may also be complicated by differences in accounting policies between entities, or by different ways of presenting their statements (see page 32). As a result, the items being compared may be unalike and therefore not directly comparable.

For example, assume Company A and Company B are two new mining exploration companies identical in every respect. Both entities are in the exploration phase and are incurring costs in evaluating and exploring mineral resources. Company A has an accounting policy of expensing exploration costs while Company B capitalizes such costs. As a result of the accounting policies adopted, Company B will have higher assets, equity and net income compared to Company A. As a result, certain ratios for Company B may appear more favourable, even though the underlying economic activity of both entities is the same.

Different ratios will often point in different directions, so that a company seems "superior" to its competitors in some ways, but inferior in others; no obvious way may exist indicating which indicators should carry the most weight.

As with most other aspects of the statements, the information apparently conveyed by the ratio may have changed subsequent to the reporting date.

Taking all these matters into account, ratios and similar tools may be helpful in forming thoughts and questions about the statements, but they can never provide all the answers to those questions.

## *Q. What is the Management's Discussion and Analysis (MD&A)?*

The MD&A provides an explanation of the company's performance, financial condition and future prospects through the eyes of management. It is filed with regulators at the same time as the financial statements (both for annual and interim statements) and is covered by the same certificate signed by the chief executive and chief financial officers. However, the annual financial statements are audited, whereas the MD&A is always unaudited.

The MD&A fills in some areas that financial statements by their nature cannot explain or do not cover. For example, financial statements usually have little or no information about a company's strategy; they do not typically address competitive pressures, new technologies, changes in management or other matters that shape the entity's operating reality.

Although the financial statements provide information on revenue and net income for the year, they do not address *why* revenue and expenses rose or fell compared to the preceding year, or what might be expected to happen in the following year. The financial statements provide information on cash flows, but they do not discuss in detail how the company's cash resources compare to what is required to implement its plans. The MD&A is expected to address these kinds of matters.

Regulators have set out certain information that must be included in an MD&A. However, entities have considerable latitude in how they format their MD&A and in the degree of detail they provide. It can therefore be difficult to find the information on a particular matter or to follow exactly what aspects of a particular issue are addressed in the notes to the statements (which often contain overlapping discussion on certain matters) versus the MD&A.

A useful MD&A will usually be constructed and referenced in a user-friendly manner, expressed in straightforward language and use charts or other techniques to make information more understandable. However, such apparent clarity and transparency do not necessarily guarantee the quality and thoroughness of the underlying explanations. In many cases, the quality of an entity's communications may only become clear over time by assessing with hindsight whether the information provided in its past MD&As was helpful in developing reasonable expectations.

Like the financial statements, the MD&A's timeliness is limited by the fact that it is prepared at a certain point in time and may be issued several months after the date of the statements it discusses. Information on material events occurring in the intervening period or subsequently should be available in the entity's news releases.

**MANAGEMENT DISCUSSION AND ANALYSIS (MD&A)**
The MD&A is a narrative in which management analyzes the company's performance during the period covered by the financial statements, explains the company's financial condition and discusses future prospects. The MD&A supplements, but does not form part of, the financial statements.

# Understanding Specifics

## Q. *What are the complexities of recognizing revenue?*

**REVENUE**
Income arising in the course of an entity's ordinary activities.

An entity recognizes revenue when it is earned, which may be prior to, at, or after cash receipt. Cash receipt is not by itself a determinative factor for recognizing revenue.

An entity recognizes revenue from selling goods when, among other things, it has transferred to the buyer the significant risks and rewards of owning the goods and can reliably measure the proceeds to be obtained from selling them. In some circumstances, the point at which this happens and the amount of revenue flowing from the transaction are obvious. For example, a convenience store selling items on a cash basis recognizes revenue simply when the customer makes the purchase and provides payment. Similarly, for sales of services, an entity recognizes revenue as it renders the services and can reliably measure the proceeds. In broad terms, an entity that generates revenue from providing contracting services might recognize 50% of the revenue to which it is entitled under a particular contract when it has completed 50% of the specified work. In some cases, this may be a relatively straightforward determination; in others, it may not be clear how the stage of completion should most reliably be measured, or questions may exist about the ability to collect the full price specified in the contract.

A single selling price might encompass a number of different goods and services. For example, a telecommunications company might sell cell phones at an initial discount from the retail price, subject to the customer entering into a multi-year contract for ongoing access to its wireless network. The company will more than recover the initial discount over the life of the contract; therefore, the cash flows under the contract do not provide a good indication of how the company truly generates its revenue and profits, or of how best to reflect the transaction in the financial statements. Variations on these difficulties exist for many entities in different industries.

An entity's description of its accounting policies will usually provide a summary of the major ways in which it earns revenue and the methods it applies in recognizing and measuring those amounts. However, this description is often too general to provide a full understanding of all the complexities that apply in the circumstances or of how the accounting policies might differ from those of other entities.

A recurring concern exists that some entities recognize revenue earlier than is appropriate, for example, by treating transactions as sales even though all aspects of the arrangement have yet to be completed. (Among other possibilities, the customer might still have the right to reject and return some of the goods or might still require the company to carry out some additional work before accepting them.) Such problems *might* be indicated, for instance, by an increase in the relative amount of accounts receivable; on the other hand, such an increase might only reflect entirely genuine and valid sales at the end of the year or other legitimate circumstances.

In other words, it is extremely difficult to detect "problems" in the way an entity recognizes and measures revenue. Still, readers will likely feel more comfortable when the accounting policy appears clear and comprehensive and when the MD&A (see page 38) provides strong supporting information about sources of revenue and the reasons for any changes from one period to the next.

## *Q. What are goodwill and intangible assets?*

When one business acquires control over another, it consolidates the assets and liabilities of the acquired business into its own financial statements based on their fair values at the date control was acquired. In most cases, the price of acquiring the business exceeds the sum total of all these assets and liabilities because a business as a whole is usually worth more than the sum of its parts (if only because the act of buying an established business eliminates the need to do the work of starting a similar business from scratch).

The portion of the acquisition cost that cannot be allocated to specific identifiable items is recognized in the financial statements as "goodwill." The term is somewhat imprecise because it does not adequately convey the strategy underlying the transaction. For example, the amount labeled as goodwill may represent a measure of management's confidence in the synergies to be obtained from joining the two businesses together and/or in the potential of the acquired business to generate more new products and markets than have yet been identified.

Goodwill is initially recognized as an asset but, because its underlying substance may be so different from one entity to the next, it may not be obvious what happens to the asset going forward. This asset is not depreciated or amortized because, among other things, there is usually no clear way to measure how much goodwill is "used up" in any given period. Accounting standards require that entities test goodwill for impairment (see page 50) at least once a year, or more often if required by the circumstances. If the test indicates that the amount of goodwill that can be recovered is less than its carrying amount in the statement of financial position (i.e., it lacks future benefit), the excess is recognized in the income statement as an impairment loss.

Like goodwill, intangible assets have no physical substance. However, unlike goodwill, they can be specifically identified and controlled. For example, a patent on an individual product can be separated and sold in the same way a physical asset is sold.

Intangible assets are not amortized if they have an indefinite life. This means that there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows. For example, a licence or other piece of intellectual property may have no clear date at which it stops generating value. Such indefinite-life intangible assets are tested for impairment.

Other intangible assets have a finite life. For example, a patent might expire at a fixed date. In this case, the initial cost is amortized over the best estimate of its useful life and the carrying amount of the asset is tested for impairment when facts and circumstances indicate this is necessary.

Goodwill highlights some of accounting's inherent limitations. A company's workforce may be just as valuable to its future prospects as its patents and licences but, because a company does not have legal rights to its people in the same way as it does to its intellectual property, the company does not recognize this asset on its statement of financial position. In addition, the entity may build up internal strengths that are just as valuable as the goodwill that arises from the acquisition of other businesses but will also not find their way onto the statement of financial position. This is one of the many reasons why the amount shown on a company's statement of financial position generally bears limited relationship to the total market value of its shares. In valuing those shares, the market implicitly attempts to identify and measure all the relevant strengths and weaknesses of a company, no matter how they arose. This is likely to include many considerations that lie beyond the scope of accounting.

**GOODWILL**
An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

**INTANGIBLE ASSETS**
Identifiable non-monetary assets without physical substance.

**Simplified Illustrative Consolidated Statements of Financial Position**
As at December 31

| *(millions of Canadian dollars)* | 20X2 | 20X1 |
|---|---|---|
| **Assets** | | |
| **Current Assets** | | |
| Cash and cash equivalents | 3,468 | 6,601 |
| Investments | 2,447 | 2,034 |
| Accounts receivable | 19,597 | 10,236 |
| Other receivable | 734 | 927 |
| Inventories | 2,586 | 2,127 |
| **Total Current Assets** | **28,832** | **21,925** |
| **Non-current Assets** | | |
| Property and equipment | 147,076 | 144,793 |
| Intangible assets | 3,000 | 3,000 |
| Exploration and evaluation assets | 14,394 | 7,383 |
| Goodwill | 7,000 | 7,000 |
| Other assets | 2,958 | 343 |
| **Total Non-current Assets** | **174,428** | **162,519** |
| **Total Assets** | **203,260** | **184,444** |
| **Liabilities** | | |
| **Current Liabilities** | | |
| Accounts payable and accrued liabilities | 11,836 | 21,640 |
| Other current liabilities | 6,711 | 1,046 |
| **Total Current Liabilities** | **18,547** | **22,686** |
| **Non-current Liabilities** | | |
| Convertible debentures | 1,160 | 1,000 |
| Decommissioning liabilities | 20,861 | 12,761 |
| Other provisions | 1,532 | 1,731 |
| Deferred income tax liabilities | 55,565 | 47,267 |
| **Total Non-current Liabilities** | **79,118** | **62,759** |
| **Total liabilities** | **97,665** | **85,445** |
| **Shareholders' Equity** | | |
| Share capital | 91,991 | 91,734 |
| Equity component of convertible debtentures | 100 | 100 |
| Contributed surplus | 5,487 | 4,254 |
| Accumulated other comprehensive income | 416 | 3 |
| Retained earnings | 7,601 | 2,908 |
| **Total Shareholders' Equity** | **105,595** | **98,999** |
| **Total liabilities and Shareholders' Equity** | **203,260** | **184,444** |

**BUSINESS ACQUISITION REPORT (BAR)**
A disclosure document required by certain securities regulators. This document describes the significant businesses acquired by a company and the effect of these acquisitions on the company.

*The Canadian Securities Administrators (CSA) is an umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonize regulation of the Canadian capital markets.*

www.securities-administrators.ca

## *Q. How does one assess the success of an acquisition?*

When an entity acquires another business, it reflects the assets, liabilities, operations and cash flows of that business on an ongoing basis in its consolidated financial statements (see page 14). In the year of acquisition, the entity provides summary information in the notes to the financial statements on the revenue and profit or loss of the acquired business included in its own statement of comprehensive income since the acquisition date. It also provides summary information on what its revenue and profit or loss *would* have been if the acquisition had taken place on the first day of the reporting period. (Similar information, along with historical financial information of the acquired business, is sometimes contained in a Business Acquisition Report filed separately with a securities regulator and available to the public.) Although this information provides some sense of the relative contribution from the acquired entity, it has limited usefulness, since the numbers generated in the short term may not provide a good indication of what can be expected in the future.

The entity is not specifically required to report in *subsequent* periods on how the acquired business affected the amounts included in its financial statements. Even if it wanted to do so, it might not be possible; the entity might integrate the acquired business with its own activities to the extent that it ceases to track the two separately. Nevertheless, readers are often interested in understanding how an acquisition affects the entity's financial condition and financial performance so they can assess whether the investment generated the benefits anticipated and communicated by management at the time.

For some entities that frequently acquire new businesses, concerns sometimes exist among investors that the acquisitions might mask difficulties in existing operations. For example, reports of steadily increasing profit arising primarily from newly acquired businesses might obscure the effect of losses in established activities. Depending on the circumstances, such a strategy might be beneficial in the long term by replacing areas of decline with new sources of strength, or it might indicate a risk that the entity cannot sustain its apparent momentum.

Even more than in many other areas, a reader wishing to understand such matters should study the MD&A carefully and consider the implications when matters of interest are not addressed. When major acquisitions occur in the current or recent periods, it is reasonable to expect an MD&A discussion that distinguishes, at least to some extent, between the relative contributions of the acquired and pre-existing businesses and that compares the benefits realized to those anticipated at the time of the acquisition. Readers should also remain alert to impairment-related disclosures pertaining to assets of recently acquired businesses (see page 50).

## Q. What are the ways of accounting for investments in equity securities?

The majority of investments in the equity securities of other entities, such as minority positions in equities of listed companies, are measured at fair value (see page 15). When an entity's investment in another entity gives it control over that entity, it consolidates that entity's activities into its financial statements (see page 14). However, alternative ways of accounting for investments exist that have different accounting implications.

An entity may have "significant influence" over another entity in the sense that it may have the power to participate in its key policy decisions without being able to *control* those decisions (e.g., by having the ability to appoint one out of five board members rather than three or more out of five). An entity is generally assumed to have such influence when it holds a significant amount (e.g., 20% or more) of the voting power in another entity (although that determination depends on the specific facts in each case). An entity measures its investment in another entity over which it has significant influence (but not control) by applying the "equity method" of accounting. This means, in broad terms, that the entity includes its proportional share of the investee's profit or loss (say, 20%) in its own profit or loss and increases or decreases the investment's carrying amount in its statement of financial position accordingly. Distributions by the investee are not recognized as income by the investor but rather as a reduction of the investment in that investee.

Sometimes an entity may share "joint control" over another entity (known as a "joint arrangement") with one or more other investors. This means that decisions about the joint arrangement's key activities require the unanimous consent of all the parties sharing control (in effect, the investors all have a veto over those decisions). Two different kinds of joint arrangement exist. A *joint venture* is one in which the parties that have joint control (i.e., the joint venturers) have rights to the net assets of the arrangement. Investors in a joint venture measure their investment by applying the equity method, as described above. The other type of joint arrangement is a *joint operation* where the parties that have joint control (i.e., the joint operators) have rights to the assets and obligations for the liabilities of the arrangement. Joint operators recognize and measure their share of the joint operation's assets, liabilities, revenue and expenses in their financial statements. For example, two early-stage mining entities might decide to collaborate on a joint-control basis on a particular exploration project. If the arrangement is a joint operation, each of the entities accounts for the project by recognizing its share of the assets, liabilities, revenue and expenses, as set out in the agreement between them. If it is a joint venture, each of the entities recognizes an asset measured using the equity method and recognizes investment income (or loss) by applying the equity method.

The notes to the financial statements provide a fuller sense of the economic impact of strategic investments. They may include supplementary information about the investments, which may include summarized financial information of the investee and information about any significant restrictions in transferring funds to or from the investee.

The following illustration summarizes (in broad terms) the various accounting approaches for equity investments.

*Illustration: Some Approaches to Accounting for Equity Investments*

| **Non-Strategic Equity Investments** | **Strategic Equity Investments** | | |
|---|---|---|---|
| **Financial Instrument** | **Significant Influence or Joint Venture** | **Joint Operation** | **Control** |
| Fair Value | Equity Method | Separate recognition and measurement of its share in the joint arrangement's assets, liabilities, revenue and expenses | Consolidation |

## Q. *What are depreciation and amortization?*

Depreciation and amortization are the systematic allocations of the cost of an asset over its useful life.

The term depreciation is typically associated with tangible assets; the term amortization is typically used in the context of intangible assets.

When an entity invests in property, plant, equipment or intangible assets with a finite life (see page 44), it recognizes them initially in its statement of financial position based on what it paid to acquire or construct those assets. With the exception of land, the capacity of such assets to contribute to the business becomes somewhat less each year. The entity reflects this declining capacity by recognizing a portion of the carrying amount as an expense in each period to represent the cost of using up that asset. Of course, this cost is impossible to estimate precisely; for instance, assets may turn out to have a much longer useful life than originally anticipated or, conversely, may not contribute as much to the business as was expected. In the latter case, the carrying amount may have to be reduced by changing the estimates about the useful life and/or residual value or by recognizing an impairment loss (see page 50).

For example, a company purchases a machine for $100,000 that is expected to have a useful life of five years and no residual value at the end of its useful life. For the next five years, in its annual financial statements, the company recognizes an annual depreciation expense of $20,000.

Because the entity has already paid for the assets, depreciation and amortization do not represent cash outflows; for that reason, users sometimes place less emphasis on these items than on other expenses. On the other hand, the fact of assets being used up is not irrelevant to assessing performance. If the assets on which an entity relies to generate profit are being used up, it will have to invest to replace them at some point. The amount recognized as depreciation does not necessarily indicate the cost of replacing these assets because, for instance, a piece of equipment may cost much more to purchase now than it did in the past. It is reasonable to expect some disclosure—perhaps in the MD&A—about how the company assesses these issues. This intertwines with other aspects of sound management and business continuity. For example, a company may have an established practice of paying dividends at a certain

### DEPRECIATION AND AMORTIZATION
The systematic allocation of the depreciable amount of an asset over its useful life; sometimes referred to as depreciation or depletion. The term depreciation is typically associated with tangible assets; the term amortization is typically used in the context of intangible assets.

### DEPRECIABLE AMOUNT
The cost of an asset (or other amount substituted for cost in the financial statements) less its residual value.

### USEFUL LIFE
The period over which an asset, singly or in combination with other assets, is expected to contribute directly or indirectly to the future cash flows of an enterprise. Typically, the useful life is either the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

### RESIDUAL VALUE (OF AN ASSET)
The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Simplified Illustrative Consolidated Income Statements**
**For the years ended December 31**

| *(millions of Canadian dollars, except per share amounts)* | 20X2 | 20X1 |
|---|---|---|
| **Revenue** | **50,529** | **52,370** |
| Expenses | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Impairment loss | 2,641 | - |
| Finance costs | 1,015 | 700 |
| Foreign exchange loss (gain) | 193 | (141) |
| Other expenses (income) | 197 | (107) |
| | 34,141 | 29,237 |
| **Income before income tax** | **16,388** | **23,133** |
| Current income tax expense | 3,397 | 1,168 |
| Deferred income tax expense | 8,298 | 14,496 |
| **Net income** | **4,693** | **7,469** |
| Net income per common share: | | |
| Basic | 0.13 | 0.21 |
| Diluted | 0.10 | 0.18 |

**Simplified Illustrative Consolidated Statements of Comprehensive Income**
**For the years ended December 31**

| *(millions of Canadian dollars)* | 20X2 | 20X1 |
|---|---|---|
| **Net income** | **4,693** | **7,469** |
| **Other comprehensive income (loss), net of tax** | | |
| Gains and losses from investments in equity instruments measured at fair value | 413 | (68) |
| **Total comprehensive income** | **5,106** | **7,401** |

level but, if it is not retaining sufficient funds to invest in maintaining its productive capacity, this practice may not be sustainable beyond the short term.

## Q. *What are impairment losses?*

In its financial statements, an entity applies procedures to ensure its assets are not shown at amounts greater than it can recover (i.e., the asset's future benefit) from using or selling them. If a particular asset or group of assets is considered as "impaired," the entity recognizes an impairment loss by reducing the amounts shown in the statement of financial position to the amounts it estimates can be recovered. An impairment loss is a non-cash item, which is presented as part of profit or loss.

For example, if an entity is carrying a piece of specialized machinery at an amount of $1,000,000 but then estimates that the present value of all the cash flows that will ever be generated from using and selling the machine is only $900,000, the entity recognizes a loss of $100,000 (assuming no other use or fair value exists for this asset).

Since, in practice, it is usually impossible to carry out this exercise for every individual asset, entities apply impairment procedures to groups of assets labeled cash-generating units. IFRSs contain specific guidance on such matters as how to identify these units, how to carry out the calculations and, in some circumstances, how to reverse impairment losses if estimates of the recoverable amounts improve.

In some cases, recognizing an impairment loss on an asset means the asset has no remaining potential, and that its carrying amount after subtracting the impairment loss is zero; in other cases, however, the loss might cover only *part* of the carrying amount. In the latter case, an entity might have to recognize additional impairment losses in the future if its expectations about the asset's recoverability continue to worsen. Alternatively, if the estimates underlying the impairment loss change for the better, the impairment loss might be partially or fully reversed. The relevant notes to the financial statements should provide an understanding of these kinds of situations and provide key information relating to how the entity made its estimates.

As noted above, an impairment loss is the amount by which the carrying amount of an asset (or group of assets) exceeds its recoverable amount (i.e., its future

**Simplified Illustrative Consolidated Income Statements**
For the years ended December 31

| *(millions of Canadian dollars, except per share amounts)* | 20X2 | 20X1 |
|---|---|---|
| Revenue | 50,529 | 52,370 |
| Expenses | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Impairment loss | 2,641 | - |
| Finance costs | 1,015 | 700 |
| Foreign exchange loss (gain) | 193 | (141) |
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| | 34,141 | 29,237 |
| Income before income tax | 16,388 | 23,133 |
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| Net income per common share: | | |
| Basic | 0.13 | 0.21 |
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For the years ended December 31

| *(millions of Canadian dollars)* | 20X2 | 20X1 |
|---|---|---|
| Net income | 4,693 | 7,469 |
| Other comprehensive income (loss), net of tax | | |
| Gains and losses from investments in equity instruments measured at fair value | 413 | (68) |
| Total comprehensive income | 5,106 | 7,401 |

benefit). An impairment loss is a non-cash occurrence that affects how an entity measures the amounts in its financial statements, but it does not affect how much cash the entity generated or spent related to this asset or asset group. Therefore, commentators may sometimes talk about a company's performance by using numbers that exclude the impact of these losses (see page 34). However, impairment losses directly affect the entity's overall comprehensive income or comprehensive loss and are therefore part of how IFRSs define "financial performance" as a whole.

An impairment loss usually means, in one way or another, that something did not work out as well as the entity expected. For example, with hindsight, the entity may think it overpaid for something. In isolation, this might cast a negative light on how management makes decisions about investing the entity's resources. However, an impairment loss might also be a sign of the entity addressing problems that lie in the past and that may not affect future performance. The fact of recognizing an impairment loss on one group of assets does not necessarily say anything about the potential of the entity's other assets. The entity's disclosure, as a whole, particularly in its MD&A, should help to provide a sense of what message readers should take from the recognition of a particular impairment loss.

**STOCK OPTION**
A contract that gives the holder the right but not the obligation to purchase the entity's shares at a fixed or determinable price for a specific period of time.

**Simplified Illustrative Consolidated Income Statements**
For the years ended December 31

| *(millions of Canadian dollars, except per share amounts)* | 20X2 | 20X1 |
|---|---|---|
| Revenue | 50,529 | 52,370 |
| Expenses | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
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| Net income per common share: | | |
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**Simplified Illustrative Consolidated Statements of Comprehensive Income**
For the years ended December 31

| *(millions of Canadian dollars)* | 20X2 | 20X1 |
|---|---|---|
| Net income | 4,693 | 7,469 |
| Other comprehensive income (loss), net of tax | | |
| Gains and losses from investments in equity instruments measured at fair value | 413 | (68) |
| Total comprehensive income | 5,106 | 7,401 |

## Q. *What is "stock-based compensation" (including stock options and other kinds of share-based units), and how does the accounting work?*

Companies often compensate some of their employees (usually including the most senior executives) at least partly based on the performance of the company's stock rather than solely in cash. For example, the executives might receive options to buy stock in the future at a particular price (the "exercise price"). If the market price of the stock rises higher than the exercise price, then the executives will generate extra value by exercising the options and acquiring the stock at a below-market price. However, at the time the options are granted, no one can know whether the stock will rise in the future and, if it does, by how much. Therefore, the ultimate gains, if any, to be realized from these awards are not known at the time they are granted to the employees.

Nevertheless, the stock options have a value at the time they are granted (i.e., others would be willing to pay something to acquire those options). The value at the time they are granted (as determined by an appropriate valuation method) is recognized as an expense over the period in which the employees earn the options (for example, they may be required to remain with the company for a defined period of time before being entitled to the award). In concept, this value represents the cost of the additional services provided by the employees in return for the awards because, in theory, the awards should incentivize them to work harder or more effectively than they would have done otherwise.

For example, if the value of a stock option awarded to an employee was $12 and the employee was required to remain with the company for three years in order to exercise this option, an annual expense of $4 would be recognized in the company's financial statements.

There are many variations on this basic model. Some awards use the value of the company's stock as a reference point but are ultimately settled in cash. In other cases, the value of the award may depend on meeting future targets of various kinds. These variations have different accounting consequences; in broad terms, however, the object in each case is the same—to recognize the cost of the services received in return for the awards granted as those services are received.

As noted above, the expense recognized might not be the same as the gains (if any) ultimately received by the employees through exercising their options. For that reason, some users place little weight on the amounts recognized as expenses, preferring to focus on earnings measures that exclude these items (see page 34). However, some place more weight on the fact that when companies allow their executives to acquire stock at a below-market price, this effectively dilutes the relative value of other stockholders' holdings. Although stock compensation expense does not recognize or measure this dilution, it gives some broad representation to the fact that the dilution exists.

Note: Stock-based payments may also be issued to non-employees (e.g., suppliers), as payment for goods and services. The essential theory of accounting for such payments is the same—the entity recognizes the share-based payment transaction in its financial statements when the goods are delivered or services provided.

## Q. *How does foreign exchange accounting work?*

When Canadian entities carry on business in foreign countries and transact in foreign currencies, they incur gains and losses from the point of view of the currency in which they prepare their statements (usually the Canadian dollar, although some Canadian entities choose to prepare their statements using the U.S. dollar or even, in less common cases, other currencies). For example, an entity makes a foreign currency purchase and records this transaction as the acquisition of an asset and the incurrence of a liability in Canadian dollars using the exchange rate at the date of the transaction. Subsequently, if movements in exchange rates mean that fewer Canadian dollars are required to settle the liability than were recognized at the time of the transaction, a gain has occurred. Unless the company applies hedge accounting (a complex accounting method), such gains or losses are recognized as part of profit or loss similar to any other gain or loss.

For example, a Canadian company (which presents its financial statements in Canadian dollars, its functional currency) purchases $1,000 in inventory from a U.S. retailer, payable in U.S. dollars. On recognition, the exchange rate was 1:1; therefore, the payable was recorded at $1,000 Canadian dollars. At the time of payment, however, the Canadian dollar was stronger than the U.S. dollar at an exchange rate of 1.25:1. Therefore the company was able to settle the U.S. payable for $800 ($1,000 ÷ 1.25) Canadian dollars and thus realized a foreign exchange gain of $200 Canadian. The gain is a non-cash item that results from recognizing the payable at an amount different from the ultimate payment.

Canadian entities may have interests in entities for which the functional currency of operations is different from their own. For example, an entity that carries out and reports most of its activities in Canadian dollars may control a subsidiary that carries out most of its activities in U.S. dollars and determines that the functional currency of this foreign operation is the U.S. dollar. In this situation, exchange gains and losses arise on translating the U.S. subsidiary's assets and liabilities (denominated in U.S. dollars) and operations into Canadian dollars. Those gains and losses are less relevant to understanding current performance and prospects because, in the real world, the U.S.-dollar subsidiary will not *actually* be buying or selling

**FOREIGN CURRENCY**
A currency other than the functional currency of the entity.

**FUNCTIONAL CURRENCY**
The currency of the primary economic environment in which the entity operates.

**PRESENTATION CURRENCY**
The currency in which the financial statements are presented.

**Simplified Illustrative Consolidated Income Statements**
For the years ended December 31

| *(millions of Canadian dollars, except per share amounts)* | 20X2 | 20X1 |
|---|---|---|
| Revenue | 50,529 | 52,370 |
| Expenses | | |
| Operating expenses | 12,516 | 11,010 |
| Salaries, bonuses and benefits | 4,949 | 4,712 |
| Share-based compensation | 1,233 | 2,022 |
| Depreciation expense | 11,397 | 11,041 |
| Impairment loss | 2,641 | - |
| Finance costs | 1,015 | 700 |
| Foreign exchange loss (gain) | 193 | (141) |
| Other expenses (income) | 197 | (107) |
| | 34,141 | 29,237 |
| Income before income tax | 16,388 | 23,133 |
| Current income tax expense | 3,397 | 1,168 |
| Deferred income tax expense | 8,298 | 14,496 |
| Net income | 4,693 | 7,469 |
| Net income per common share: | | |
| Basic | 0.13 | 0.21 |
| Diluted | 0.10 | 0.18 |

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Canadian dollars to raise U.S. dollars. For that reason, these gains and losses are not recognized as part of profit or loss but, rather, as a separate component of equity until disposal of the foreign operation (see page 18).

Exchange gains and losses, however they are presented, can provide important information about a key source of risk and volatility. An entity exporting from Canada to the U.S. might suddenly find itself uncompetitive when a rise in the Canadian dollar renders its products more expensive than U.S.-generated equivalents. At the same time, other entities selling entirely within Canada but sourcing much of their raw materials in the U.S. might experience benefits.

The financial statements and MD&A should describe these risks and provide some indication of how changes in exchange rates could affect profitability. These matters can be more difficult to understand, however, when the entity has operations in a number of foreign countries and exposure to a number of different currencies.

Markets provide ways to "hedge" against risks attaching to exchange rates. For example, a Canadian entity could enter into contracts to exchange a specified amount of Canadian dollars at a future date for a specified amount of U.S. dollars at a specified exchange rate. The accounting for these kinds of instruments can be complicated, but the information provided about such hedges should assist in understanding an entity's major sources of exchange risk, and whether or how it chooses to manage such risk.

## Q. *What do the tax numbers in financial statements mean?*

Financial statements typically contain two types of tax figures:

- current tax
- deferred tax.

Current tax is the amount of taxes payable (recoverable) to (from) a tax authority (e.g., Canada Revenue Agency) in respect of the taxable profit (tax loss) for a period.

Deferred tax (asset or liability) arises because the accounting methods used to prepare financial statements are different from the methods used to calculate taxes payable (recoverable) to (from) the tax authority. Deferred tax is an accounting concept and does not represent the tax owing to or recoverable from a tax authority.

In Canada, when the *Income Tax Act* (ITA) specifies how an entity must account for a particular transaction and economic event, that particular method is used for tax purposes (i.e., to prepare the tax return and ultimately pay taxes), but a different method may be used for financial reporting purposes to calculate profit or loss. For example, an item of machinery might be depreciated in the financial statements over its useful life of, say, five years (see page 49) but, to encourage investment, the government might allow expensing it immediately for tax purposes, thereby reducing taxable profit immediately and accelerating the tax benefit.

The financial statements could simply record the actual tax payable for each period after taking the benefit of such special treatments into account. In this case, however, an entity's apparent tax rate might change significantly from one period to the next, depending on what kind of expenditures it made in each period. Accounting for deferred taxes is most easily regarded as a mechanism to remove the distortion that would result from recording taxes solely based on the amounts currently payable to the tax authority and is required by IFRSs.

Deferred tax liabilities generally represent items, such as the machinery described above, for which future accounting expenses will exceed the related tax benefits (because those tax benefits have already been received). Deferred tax assets generally represent the reverse—items for which future tax benefits will exceed the related accounting impact.

Another common example of a deferred tax asset arises from accumulated losses. For example, if a new entity starts off by incurring losses, it is not liable to pay current income tax. These losses are accumulated to reduce the income tax payable on profit of future periods. The future tax benefit of these past losses constitutes an asset having real benefit in reducing tax in future periods. However, to avoid recognizing an asset that might never generate economic benefits (if the entity never becomes profitable), the deferred tax asset is only recognized if it is considered probable that future taxable profit will be available to use the loss carryforwards.

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It is sometimes thought that deferred tax accounting reflects taxes that have been “postponed,” but this is not correct. For businesses, as for individuals, the ITA allows a variety of different treatments for different items. It is only from the specific perspective of financial statements, and the differences between accounting and tax treatments, that a “deferral” is created.

All things being equal, deferred tax assets and liabilities will reverse eventually as accounting and taxable profit come into alignment. In practice this reversal might be postponed indefinitely, for example, if an entity invests substantially each year in new machinery thereby generating new tax deductions and new deferred tax liabilities.

Even if it may be difficult for readers to understand the details of these amounts, tax-related disclosures as a whole can provide important information. For example, if an entity’s effective tax rate goes up from previous years, because less of its income is being taxed at a lower overseas rate, this may raise questions about the strength of its foreign operations. If an entity reports significant new deferred tax assets or liabilities, this may say something about the direction of the business and its prospects. For example, as explained above, new deferred tax assets may reflect a change in management’s assessments of the probability of future taxable profits.

## Q. *What are earnings per share (EPS) and diluted earnings per share?*

Earnings per share (EPS) is a widely used performance metric that depicts the amount of a company’s profit or loss that belongs to a single share.

It is insufficient to compare the performance of two entities based on the gross numbers alone. Two entities might each earn profit of $1 million, but if one entity has only 10 equal shareholders and the other has 10,000, there is a significant difference in what this result means for its investors. By expressing total profit or loss in terms of the smallest unit of ownership — a common share — the information on earnings per share provides a better basis for comparability and for relating performance to an investor’s own holdings.

However, this measure alone does not provide complete information. At any given time, an entity may have granted stock options (see page 51)

allowing the option holders to acquire common shares at prices below the market price. Similar rights may have been granted to others. Finance providers, for example, often negotiate the right to convert all or a portion of amounts owed to them into shares, if this is to their advantage. These instruments, if exercised, will increase the number of shares outstanding, while bringing less cash or other resources to the company than it could raise by selling more shares at the current market price. The reduced amount of cash and other resources available to the business could result in a failure to increase profit in the future by an amount sufficient to maintain the current level of earnings per share. The information on "diluted" earnings per share provides a measure of how these kinds of outstanding instruments could cause the present EPS to fall.

If such instruments (e.g., convertible debt) do not exist, then basic and diluted EPS will be the same. Basic and diluted EPS will also be the same when all the outstanding options and other such instruments can only be exercised at prices higher than the current market price of the company's shares. In these circumstances, there is no prospect of earnings per share being "diluted" on the basis of the current facts.

Media often report a company's results in terms of EPS or diluted EPS. Among other things, this provides a very direct way of assessing the current market price of the shares as a multiple of EPS (a price/earnings ratio). The EPS multiple is only a cursory starting point for analysis, however, since disagreement frequently exists as to what multiple is appropriate for a particular company's shares.

## Q. *What information do financial statements provide about dividends and similar distributions?*

Dividends are payments declared by a company's board of directors and distributed to the shareholders out of accumulated profit, normally on the basis of a fixed payment for each common share. Financial statements disclose the total amounts of dividends recognized during the period and the amount of dividends per share.

Some entities are constituted as trusts rather than corporations and make regular cash distributions to their investors. These distributions may not be labeled as dividends; the tax implications differ from those of dividends both for the entities and for their investors.

**EARNINGS PER SHARE (BASIC)**
Profit or loss attributable to ordinary equity holders of the parent entity (the numerator) divided by the weighted average number of ordinary shares outstanding during the period (the denominator).

**EARNINGS PER SHARE (DILUTED)**
Profit or loss attributable to ordinary equity holders of the parent entity (the numerator) divided by the weighted average number of ordinary shares outstanding during the period (the denominator) after taking into effect all the ordinary shares that would be added through the conversion of all convertible preferred shares, convertible debentures and the exercise of all stock options and warrants.

**DIVIDEND**
Payments declared by a company's board of directors and distributed to the shareholders out of accumulated profit.

In each case, investors will want to understand the entity's policy for distributing cash to its investors and the sustainability of that policy.

An entity that pays regular dividends or makes other distributions may or may not be a more attractive investment than one that does not. Most entities require some amount of ongoing investment to maintain or increase their productive capacity. Some entities may best serve the long-term interests of investors by building up their cash resources for future use rather than by making current distributions. Other entities may generate sufficient cash flow both to invest in the future and to make distributions to investors. Others may be funding their distributions only by investing inadequately for the future. Such distributions indicate that the dividend may not be maintained beyond the short or medium term. In extreme cases, entities might even incur debt for the purpose of maintaining their distributions.

The cash flow statement (see page 19) provides an overview of how dividends and similar payments compare to amounts generated from other sources. Investors should expect the MD&A to provide a clear explanation of the entity's distribution policy and to explain how it can maintain this policy, given the nature of its operations and its ongoing investment needs. Investors should also consider their own needs for immediate investment income and their own tax situations.

Like dividends and other distributions, many other aspects of the financial statements may constitute either relative strengths or weaknesses, depending on all the facts of the situation. For example, all other things being equal, an entity that carries a significant amount of debt may appear less attractive than a comparable entity without debt. This impression is likely to be accurate when, for instance, the entity is struggling to service its debt and therefore to continue as a going concern. However, in other situations, the cost of debt (in the form of interest) may be less than the cost of equity (in the form of shareholders' expectations for dividends and/or capital gains on their shares), especially when one takes into account that interest payments can be deducted for income tax purposes against profit. This is merely another example of how, as previously noted, it is almost always unwise to focus on a single aspect of financial statements—whether apparently good or bad—without considering how it relates to everything around it.

## Q. *How do financial statements treat mineral properties?*

Most aspects of accounting apply in the same way to all entities, whatever industry they may be in. However, some industries raise specific challenges that don't exist anywhere else. To take a common example in Canada, the life cycle of a mineral property typically involves a number of different stages. In broad terms, an entity may start by exploring the property. If this process generates favourable results, the entity may progress to develop the property for mining and eventually operate it as a revenue-generating mine. Some costs are incurred before the entity can demonstrate that it is technically feasible and commercially viable to extract a mineral resource from the property; others are incurred after it has made that determination.

The entity may treat the costs it incurs on the property in different ways in its financial statements, depending on when in the process they are incurred. Costs incurred *after* the point of demonstrating technical feasibility and commercial viability will usually be treated as an asset, although the labels placed on such assets vary among different entities. IFRSs allow a choice of treating costs incurred *before* that stage (i.e., in the course of exploring and evaluating the property) as either assets or expenses (see page 17).

As for all assets, entities regularly assess the carrying amounts of their mining-related assets for impairment and recognize a loss where their recoverable amount exceeds their carrying amount (see page 50). However, the assessment for impairment can be even more challenging in this area than in others, given the difficulty of assessing the future progress of exploration and development projects, the volatility of mineral prices, etc. Because of differences in their policies and judgments, two early-stage mining entities with largely similar prospects may generate quite different financial statements.

For this and other reasons, the financial statements of an entity in a resource-based industry can only provide limited information about its potential and must be assessed in combination with other publicly available information. In particular, Canadian regulators require the filing of technical information about major mineral projects that has been prepared by appropriately qualified individuals and that addresses such matters as the content and quality of the mineral deposits and their economic viability.

Although this information can be difficult for a non-specialist to understand, it provides a perspective that is usually entirely absent from the statements. For early-stage entities, the financial statements are often most useful as a supplement to this information by illustrating the entity's financial resources and providing a basis for assessing the financing challenges ahead if the projects ever go into production.

In practice, small entities are often less likely to develop their own production projects than to negotiate with larger entities, for example, to transfer the rights in a project in return for a royalty interest in the future revenue. A mining entity provides information in its financial statements about the collaborations and other agreements it has entered into.

Other industries may also have distinctive business models and issues that give rise to unique accounting challenges. Companies in these industries may also provide other kinds of reports on their activities.

## *Q. What is segment reporting?*

In its statement of financial position and other statements, an entity pulls perhaps millions of transactions and several separate legal entities into a single summarized presentation. Inevitably, these statements cannot provide detailed information about all the different lines of business that may be contained within the entity. However, the notes allow the reader to obtain somewhat more detail by providing information on how revenue, profit or loss and other key measures break down among the entity's most important operating segments. In broad terms, the information is based on the information prepared internally and provided to the entity's most senior management (i.e., chief decision maker(s)).

The number of segments identified in the notes depends entirely on the complexity of the entity and on how management has organized the entity for its own oversight purposes. Some segments may contain many different lines of business and could in theory be broken out in greater detail; however, for practical purposes, these additional levels of information are typically not provided in the financial statements.

Because the segment information flows from the decisions made by management about how to organize the entity, two similar entities might have quite different kinds of segment reporting. One entity might organize itself by geographic region, another with reference to customer groups and another with reference to different manufacturing processes. The differences may be meaningful in themselves in that they say something about how the company's management looks at its opportunities and strategies.

However, it can be difficult to use segment reporting to make comparisons between companies. In this matter, as in many others, the MD&A may provide additional relevant information, such as further breakdowns of revenue by key lines of business.

These limitations aside, this information provides some additional perspective about the entity. For example, segment information may make it clearer how different portions of the entity's revenue are likely to be sensitive to different kinds of movements in the economy and therefore allow a better understanding of the underlying risks.

## *Q. How do financial statements treat events occurring after the end of the reporting period?*

Because of the work involved in preparing and (when required) auditing financial statements, these documents are not issued until sometime after the date of the statement of financial position. For annual statements of entities not listed on the Toronto Stock Exchange (for example), this period might be as long as four months. Inevitably, significant events may occur during that period. The impact of these events on the financial statements depends on their nature.

Some kinds of events provide additional evidence about conditions that existed at the date of the statement of financial position. For example, an entity with a reporting period ended December 31 might discover while preparing its statements during January that a significant customer has just declared bankruptcy. In most cases, this confirms that the customer was already in severe financial difficulty at the end of December and that amounts receivable from the customer at that date were already impaired (see page 50). The entity therefore adjusts the amounts in its December 31 statement of financial position by recognizing a loss to reflect the information learned subsequently.

Other kinds of event *do not* provide any additional evidence about conditions that existed at the date of the statement of financial position. For example, the same entity in January made a major purchase of equipment requiring significant new financing. Even if it had virtually decided in December to make this purchase, this is not a reason for recognizing the transaction in the statement of financial position before it actually happens. However, knowledge of the subsequent transaction might influence how readers interpret the statements because of the impact of the financing on the entity's debt structure and the company's strategic direction. In this case, if material, the entity discloses information about the event in the notes to the statements, including describing its nature and an estimate of its financial effect. Other examples may include business combinations, issuances of shares, or significant litigation arising after the end of the year.

It is not usually necessary to wait until the financial statements are issued for the entity to provide information about important subsequent events. Most entities issue news releases on a regular basis that are available on their websites or from various other online sources. Some of these releases provide prompt information about events that will later be documented in the notes to the financial statements; others may address matters outside the scope of the statements. For example, major changes in personnel are often not disclosed in the statements because they do not directly affect any of the amounts reported, but they may be communicated in news releases. This is an important illustration of why it is always necessary to assess the information in an entity's financial statements in conjunction with the disclosures it makes in other documents.

## Glossary

The following selected definitions have been abbreviated and simplified for the purpose of this publication.

**Accounting policies** — The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

**Accrual basis of accounting** — Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

**Amortization** — The systematic allocation of the depreciable amount of an asset over its useful life; sometimes referred to as depreciation or depletion.

**Annual Information Form (AIF)** — A disclosure document required by certain regulators. An AIF provides material information about a company and its business in the context of its historical and possible future development. The AIF describes the company and its operations, prospects, risks and other factors that impact its business.

**Asset** — A resource controlled by the entity as a result of past events and from which probable future economic benefits are expected to flow to the entity.

**Auditor's report** — A formal opinion, or disclaimer thereof, issued by an auditor after performing an audit or evaluation.

**Business** — An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

**Business Acquisition Report (BAR)** — A disclosure document required by certain securities regulators. This document describes the significant businesses acquired by a company and the effect of these acquisitions on the company.

**Business combination** — A transaction or other event in which an acquirer obtains control of one or more businesses.

**Carrying amount**—The amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation (amortisation) and accumulated impairment losses.

**Cash-generating unit**—The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

**Component of an entity**—Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

**Compound financial instrument**—A financial instrument that, from the issuer's perspective, contains both a liability and an equity element.

**Comprehensive income**—The total of "profit or loss" and "other comprehensive income."

**Consolidated financial statements**—The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

**Control**—An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Accounting Standards for Private Enterprises (see *CPA Canada Handbook—Accounting*) defines control as the continuing power to determine the strategic operating, investing and financing policies of an enterprise without the co-operation of another.

**Cost**—The amount of cash or cash equivalents paid or the fair value of any other consideration given to acquire an asset at the time of its acquisition or construction or, when applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of an accounting standard.

**CPA Canada**—Chartered Professional Accountants of Canada is the largest professional accounting body in Canada.

**Current tax**—The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

**Depreciable amount**—The cost of an asset (or other amount substituted for cost in the financial statements) less its residual value.

**Depreciation**—See amortization.

**Dividend**—Payments declared by a company's board of director's and distributed to the shareholders out of accumulated profit.

**Earnings per share (basic)**—Profit or loss attributable to ordinary equity holders of the parent entity (the numerator) divided by the weighted average number of ordinary shares outstanding during the period (the denominator).

**Earnings per share (diluted)**—Profit or loss attributable to ordinary equity holders of the parent entity (the numerator) divided by the weighted average number of ordinary shares outstanding during the period (the denominator) after taking into effect all the ordinary shares that would be added through the conversion of all convertible preferred shares, convertible debentures and the exercise of all stock options and warrants.

**Equity**—The residual interest in the assets of the entity after deducting all its liabilities.

**Equity instrument**—A contract that evidences a residual interest in the assets of an entity after deducting all its liabilities.

**Equity method** —A method of accounting whereby the investment is initially recognized at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss; the investor's other comprehensive income includes its share of the investee's other comprehensive income.

**Expenses**—Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or the incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

**Fair value**—The price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Financial instrument**—Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

**Financial statements**—A formal record of the financial activities of a business, person, or other entity. A complete set of financial statements comprises: a statement of financial position as at the end of the period; a statement of comprehensive income for the period; a statement of changes in equity for the period; a statement of cash flows for the period; and notes, comprising a summary of significant accounting policies and other explanatory information.

**Financing activities**—Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

**Foreign currency**—A currency other than the functional currency of the entity.

**Functional currency**—The currency of the primary economic environment in which the entity operates.

**Future economic benefit**—The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

**Gains**—Items other than revenue that meet the definition of income and may or may not arise in the course of the ordinary activities of an entity.

**Going concern assumption**—The financial statements are normally prepared on the assumption that an entity will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations. If such an intention or need exists, the financial statements may have to be prepared on a different basis. If so, the basis used is disclosed.

**Goodwill**—An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

**Impairment loss**—The amount by which the carrying amount of an asset or a cash generating unit exceeds its recoverable amount (i.e., the amount of future benefit).

**Income**—Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity (other than those relating to contributions from equity participants). The definition of income encompasses both revenue and gains.

**Intangible assets**—Identifiable non-monetary assets without physical substance.

**Interim financial report**—A financial report containing either a complete set of financial statements or a set of condensed financial statements for an interim period.

**Interim period**—A financial reporting period shorter than a full fiscal year.

**International Financial Reporting Standards (IFRSs)**—Accounting standards and interpretations issued by the International Accounting Standards Board in London, U.K.

**Inventory**—Assets held for sale in the ordinary course of business, in the process of production for such sale or in the form of materials or supplies to be consumed in the production process or in the rendering of services.

**Investing activities**—The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

**Joint arrangement**—An arrangement in which two or more parties have joint control. There are two types of joint arrangements: a joint operation and a joint venture.

**Joint operation**—A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

**Joint venture**—A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

**Liability**—A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**Losses**—Items that meet the definition of expenses, other than expenses arising in the course of the ordinary activities of the entity. They may, or may not, arise in the course of the ordinary activities of the entity.

**Management Discussion and Analysis (MD&A)**—The MD&A is a narrative in which management analyzes the company's performance during the period covered by the financial statements, explains the company's financial condition and discusses future prospects. The MD&A supplements, but does not form part of, the financial statements.

**Materiality**—Information is material if its omission or misstatement could influence the economic decisions of financial statement users taken on the basis of the financial statements. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

**Non-controlling interest**—The equity in a subsidiary not attributable, directly or indirectly, to a parent. Sometimes referred to as "minority interest."

**Notes**—Notes contain information in addition to that presented in the statement of financial position, statement of comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows. Notes provide narrative descriptions or disaggregations of items presented in those statements and information about items that do not qualify for recognition in those statements.

**Operating activities**—The principal revenue-producing activities of an entity and other activities that are not investing or financing activities.

**Parent**—An entity that has one or more subsidiaries.

**Presentation currency**—The currency in which the financial statements are presented.

**Profit or loss**—The total of income less expenses, excluding the components of other comprehensive income.

**Prospectus**—A disclosure document required by certain regulators. A prospectus provides details about an investment offering for sale to the public. A prospectus should contain the facts that an investor needs to make an informed investment decision.

**Ratio analysis**—Quantitative analysis of information (e.g., two selected numerical values) contained in a company's financial statements. Ratio analysis is used to evaluate relationships among financial statement items. The ratios are used to identify trends over time for one company or to compare two or more companies at one point in time. Ratios can be expressed as a decimal value, such as 0.20, or given as an equivalent percent value, such as 20%.

**Residual value (of an asset)** — The estimated amount that an entity would currently obtain from disposal of an asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**Retrospective application** — Applying a new accounting policy to transactions, other events and conditions as if that policy had prevailed at the time of the transactions, events or conditions.

**Revenue** — Income arising in the course of an entity's ordinary activities.

**Stock option** — A contract that gives the holder the right but not the obligation to purchase the entity's shares at a fixed or determinable price for a specific period of time.

**Subsidiary** — An entity, including any unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

**Useful life** — The period over which an asset, singly or in combination with other assets, is expected to contribute directly or indirectly to the future cash flows of an enterprise. Typically, the useful life is either the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

# Reading Financial Statements— What do I need to know?

## Common Questions Answered

The Chartered Professional Accountants of Canada (CPA Canada) has developed this publication to help explain some of the fundamental concepts, conventions and principles underlying financial statements, which may be of interest to readers.

This publication aims to answer some key questions a user trying to obtain a basic understanding of financial statements might ask.

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