Crowe Soberman™

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Financial Literacy for Credit Professionals

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Topics Covered

1. Main Types of Business Structures
2. Alternative Accounting Measurements
3. Levels of Financial Information Assurance Provided by Public Accountant
4. Ratio Analysis
5. Case Study
6. Common Abuses in Financial Reporting and Red Flags

Introduction

- In the past 15 or so years, consumer awareness and unfortunately skepticism of accounting has been building.
- Multi-million dollar decisions and out–of-court settlements by Directors and Auditors indicate that financial “reality” and financial reporting can be poles apart.

Main Types of Business Structures

- **Sole proprietorship**
  - Most common form, for smaller businesses or part-time businesses
  - Owner is the operator
  - Report business income on personal tax return, no legal structure
  - No protection of personal assets in context of being sued or debts
- **Partnership**
  - Similar to sole proprietorship but there is more than one proprietor
  - No legal structure but often will be some written agreement of percentage share
  - Each partner files personal tax return with their share of sales and expenses
- **Corporation**
  - Separate legal entity with some level of personal liability protection
  - Ownership is by shareholders of the corporation
  - File separate tax returns for the company itself
  - Owners receive distribution of profits in the form of salaries, bonus or dividend

Public Accountant as Source of Financial Information

1. Level of involvement with business

2. Credentials

3. Advisory services provided
    - Audit/assurance and tax (traditionally)
    - Insolvency, forensic/litigation, valuation

Alternative Accounting Measurements

In practical use in Canada

1. **Cash-Basis Accounting**
   Record cash receipts and cash disbursements.

2. **Accrual-Basis Accounting**
   As for 1., but, short-term receivables, payables, and prepaid amounts are recorded on balance sheets.

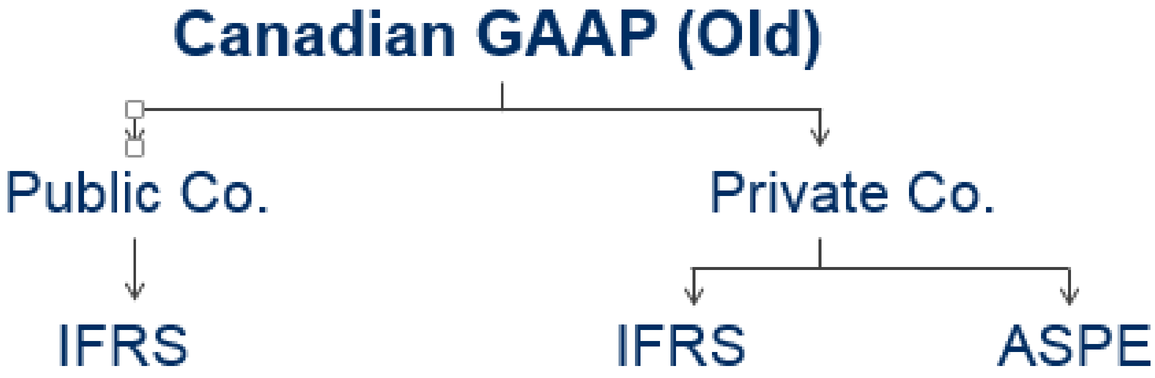
3. **ASPE/IFRS**

   As for 2., but includes many longer-term accruals, deferrals and measurements based on a series of assumptions about "general purpose" users.

4. **Disclosed Basis Accounting**
   Tailor-made accounting, based on policies set forth in the financial statements
   (eg. mutual funds, utility accounting, government reporting, some real estate accounting, etc.)

Financial Reporting-Canadian Accounting Standards History

- Prior to 2011, Canadian GAAP was the standard for financial reporting
- Commencing January 1, 2011, there are two sets of standards in Canada
  - IFRS-International Financial Reporting Standards
  - ASPE-Accounting Standards for Private Enterprise



Purpose of Preparing Financial Statements

- Compliance
- Assist readers in making economic decisions about a company by assessing:
  - Ability to generate cash and the timing and certainty of generation
  - Economic resources controlled by entity
  - Financial structure of entity
  - Liquidity and solvency of the company
  - Performance and profitability
  - Changes in financial position of the company over time

Assumptions of Canadian Accounting Standards

1. Historical Cost - most common (IFRS also has current cost, realizable value and present value)
2. Arm's Length Transactions (Fair Value)
3. Revenue Recognition (Timing/Accrual)
4. Matching Of Revenue and Expenses
5. "Objectivity"
6. General-Purpose Users
7. Materiality
8. Going Concern Applies (Continuity Of Ownership)
9. Conservatism (Prudence)
10. Consistency of Policies
11. Measurement and Disclosure
12. Valuation Alternatives

Levels of Financial Information Assurance Provided by Public Accountant

1. Audit
2. Review Engagement
3. Notice to Reader

The Audit Report

Audit Report

- Highest level of assurance
- Third party confirmation
- Test basis
- Not designed to detect fraud
- Detailed notes

Audit Report

INDEPENDENT AUDITOR'S REPORT

To [Person Engaging Public Accountant]

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [Canadian Accounting Standards for Private Enterprise/ International Financial Reporting Standards] and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Audit Report Continued..

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

Audit Report Continued..

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Company as at December 31, 20X1 and the results of its operations and its cash flows for the year then ended December 31, 20X1 in accordance with Canadian accounting standards for private enterprises.

[Public accountant's signature]

[Date of auditor's statement]

[Public accountant's address]

Review Engagement

- Negative assurance (nothing has come to our attention)
- Little third party testing
- Review and analysis
- Enquiry of management
- Limited notes

Review Engagement Report

To [person engaging the public accountant]

I have reviewed the balance sheet of Client Limited as at [Date] and the statements of income, retained earnings and cash flows for the year then ended. My review was made in accordance with Canadian generally accepted standards for review engagements and, accordingly, consisted primarily of enquiry, analytical procedures and discussions related to information supplied to me by the company.

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

Based on my review, nothing has come to my attention that causes me to believe that these financial statements are not, in all material respects, in accordance with [Canadian Accounting Standards for Private Enterprise/International Financial Accounting Standards].

[Public accountant's signature]

[Date of the review engagement report]

[Public accountant’s address]

Notice to Reader / Compilation

- No assurance!!
- Warning label
- At best it is a tabulation of mathematical balances
- No notes

Notice to Reader

On the basis of information provided by management (or the proprietor), I have compiled the balance sheet of Client Limited as at [Date] and the statements of income, retained earnings and cash flows for the (period) then ended.

I have not performed an audit or a review engagement in respect of these financial statements and, accordingly, I express no assurance thereon.

Readers are cautioned that these statements may not be appropriate for their purposes.

[Public accountant’s signature]

[Date of Notice to Reader]

[Public accountant’s address]

Business Financial Statements (Beware of Assurance Level)

1. Balance Sheet + Retained Earnings
2. Income Statement or Profit/Loss
3. Statement of Cash Flow
4. Forecasts

Balance Sheet

- Assets less liabilities equals equity (or also stated as Assets = Liabilities + Equity)
- Breaks down current versus longer term assets and obligations
- Statement of “financial position” at point-in-time (changes day to day)
- Identifies capacity and stability

Basic Financial Ratio Analysis

- Measures of Liquidity - ability to meet day-to-day operating expenses and short-term obligations
  - Current Ratio = Current Assets / Current Liabilities
    - A good benchmark is 2:1 and the higher the better as there are more assets to pay liabilities
  - Quick Ratio (Acid Test) = Current Assets less Inventory / Current Liabilities
    - Eliminates inventory to assess the most readily available sources of cash

- Measures of Activity - how efficient are the operations of the company?
  - Inventory Turnover = Cost of Goods Sold / Average Inventory
    - Identifies if there is good inventory management and risk of product obsolescence
  - Receivables Turnover = Sales / Average Accounts Receivables
    - Helps identify the health of credit policies
  - Payables Turnover = Total Purchases / Average Accounts Payable
    - The higher it is the quicker bills are paid, however, this may not be good cash management!

Basic Financial Ratio Analysis

- Measures of Debt - firm's ability to meet long-term debt obligations
  - Debt Ratio = Total Liabilities / Total Assets
    - States debt as a percentage of assets held
  - Debt to Equity Ratio = Liabilities / Equity
    - How much are the assets funded by creditors then by its own equity? 1:1 is a good ratio but it is also very industry specific (capital intense industries can be higher, such as mining).

- Measures of Profitability
  - Gross Profit Margin = (Sales – COGS) / Sales
    - Relationship between direct costs to sell and the sale of goods, higher is better
  - Return on Sales (or Net Profit Margin) = Net Income / Sales
    - Includes all costs such as selling and administrative but not taxes
  - Return on Assets = Net Income After Tax / Total Assets
    - Percentage of profit earned compared to its overall assets, avoiding the use of leverage. Can show management's ability to use assets to generate profit (dependent on industry).

Financial Analysis Techniques

1. Horizontal (trend) analysis - across years
2. Vertical analysis - as a % of an item within a specific financial statement
3. Ratio analysis - evaluate performance based on liquidity, solvency, profitability and asset management

Case Study

Your boss at ABC Bank, Mr. Jonathan Holdem ("Mr. Holdem"), contacts you early Monday morning. His old friend Ms. Grace Westcorn, the president of the company Westcorn Watches, a luxury watch manufacturer, called him to inquire about increasing their credit with the bank from $1 million to $2 million. Mr. Holdem believes that since Westcorn Watches has been a good client since 1995 that they should extend credit further. However, he is looking for guidance from you before agreeing to the increase.

Given the nature of Westcorn Watches' operations, a current ratio in the range of 1.5 : 1 to 1.7 : 1 is sufficient for ongoing operations.

Westcorn Watches Background Information:

Founded in Toronto in 1982, Westcorn Watches manufactured two types of watches: analogue watches which have a traditional clock face, and automatic watches which operate based on the motion of the wrist the watch is worn on. In January 2017, the owners of Westcorn Watches stated that they planned to expand the company and start manufacturing diver watches, which are designed for underwater diving. Westcorn Watches is known for their quality products and great customer relations.

Required:

Analyze Westcorn Watches' financial statements using the ratios provided, and prepare a debrief for Mr. Holdem with your conclusion as to whether he should be increasing their credit.

Further information is listed on the following slides

* Note that in order to facilitate our analysis the financial statement we have provided summarizes four years of historic data. Typically only two years are provided with a public accountant prepared financial statement.

SMITH JONES
Chartered Accountants

111 Glass Street
Toronto, Ontario

WESTCORN WATCHES
FINANCIAL STATEMENTS
DECEMBER 31, 2017

Contents

SMITH JONES
Chartered Accountants

111 Glass Street
Toronto, Ontario

WESTCORN WATCHES
REVIEW ENGAGEMENT REPORT

To the Shareholder of
Westcorn Watches

We have reviewed the balance sheet of Westcorn Watches as at December 31, 2017 and the statements of earnings, retained earnings and cash flows for the year then ended. Our review was made in accordance with Canadian generally accepted standards for review engagements and accordingly consisted primarily of enquiry, analytical procedures and discussion related to information supplied to us by the company's management.

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

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

SMITH JONES
Chartered Accountants
Licensed Public Accountants

Toronto, Canada

May 10, 2018

WESTCORN WATCHES
BALANCE SHEET (UNAUDITED)
AS AT DECEMBER 31

Schedule 1

		2017	2016	2015	2014
		$	$	$	$
Assets					
Current					
Cash		100,000	300,000	200,000	100,000
Inventory		600,000	195,000	225,000	200,000
Accounts receivable		700,000	275,000	300,000	250,000
Prepaid expenses		95,000	118,000	95,000	100,000
		1,495,000	888,000	820,000	650,000
Due from shareholder	Note 2	300,000	300,000	300,000	200,000
Property, plant and equipment	Note 3	512,000	222,000	245,000	257,000
Future income taxes		31,000	42,000	40,000	47,000
		843,000	564,000	585,000	504,000
Total assets		2,338,000	1,452,000	1,405,000	1,154,000
Liabilities					
Current					
Bank indebtedness	Note 4	350,000	225,000	200,000	100,000
Accounts payable and accrued charges		550,000	264,000	230,000	220,000
Sundry payable		59,500	40,000	20,000	3,000
Government remittances payable		45,000	(32,000)	35,000	30,000
Income taxes payable		0	31,000	10,000	1,000
Deferred revenue		80,000	20,000	23,000	26,000
		1,084,500	548,000	518,000	380,000
Long term debt	Note 5	650,000	200,000	200,000	200,000
		650,000	200,000	200,000	200,000
Total liabilities		1,734,500	748,000	718,000	580,000
Shareholders' equity					
Capital stock		1,000	1,000	1,000	1,000
Retained earnings		602,500	703,000	686,000	573,000
		603,500	704,000	687,000	574,000
Total liabilities and shareholders' equity		2,338,000	1,452,000	1,405,000	1,154,000

WESTCORN WATCHES
STATEMENT OF EARNINGS AND RETAINED EARNINGS (UNAUDITED)
YEAR ENDED DECEMBER 31

	2017	2016	2015	2014
	$	$	$	$
Revenue	2,600,000	2,350,000	2,500,000	2,000,000
Cost of goods sold	2,080,000	1,809,500	1,875,000	1,460,000
Gross profit	520,000	540,500	625,000	540,000
Expenses				
Advertising and promotion	43,000	43,000	43,000	40,000
Amortization	39,000	32,000	25,000	20,000
Salaries and employee benefits	425,000	350,000	325,000	300,000
Meals and entertainment	6,000	5,000	4,500	5,000
Office and general	35,000	22,000	19,000	25,000
Professional fees	12,000	10,000	12,000	10,000
Occupancy costs	51,000	49,000	47,000	45,000
Telephone	1,000	1,000	1,000	1,000
Travel	7,000	6,000	5,000	5,000
Interest and bank charges	1,500	500	500	1,000
	620,500	518,500	482,000	452,000
Earnings (loss) before income taxes	(100,500)	22,000	143,000	88,000
Provision for income taxes	-	5,000	30,000	15,000
Net earnings (loss)	(100,500)	17,000	113,000	73,000
Retained earnings, beginning of year	703,000	686,000	573,000	500,000
Net earnings (loss) (above)	(100,500)	17,000	113,000	73,000
Retained earnings, end of year	602,500	703,000	686,000	573,000

1. Significant accounting policies

These financial statements have been prepared in accordance with Canadian accounting standards for private enterprises.

Use of estimates
The preparation of financial statements in accordance with Canadian accounting standards for private enterprises requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet date and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from the amounts estimated.

Revenue recognition
The Company recognizes revenues when goods are shipped to its customers and title has passed.

Income taxes
The Company follows the asset and liability method of accounting for income taxes. Under this method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between financial statement carrying amounts of assets and liabilities and their respective tax bases.

Inventory
Inventory is valued at the lower of cost (determined on the first-in, first-out basis) and net realizable value.

Financial instruments
The Company initially measures its financial assets and liabilities at fair value, except for certain non-arm's length transactions. The Company subsequently measures all its financial instruments at amortized cost using the straight line method. Transaction costs are recognized in net earnings in the period incurred. However, financing and transaction costs associated with debt are netted against the carrying value and amortized over the term of the related debt.

1. Significant accounting policies *(continued)*

Property and equipment

Property and equipment are recorded at cost less accumulated amortization. Amortization is provided annually on bases designed to amortize the assets over their estimated useful lives as follows:

Buildings	- 5% declining balance
Equipment and furniture	- 20% declining balance
Vehicles	- 30% declining balance
Computer hardware & software	- 30% declining balance

2. Due from shareholder

Amounts due to shareholder are non-interest bearing, have no set terms of repayment, and are secured by general security agreement over the Company's assets.

3. Property, plant and equipment

		Accumulated	Net book value			
	Cost	amortization	2017	2016	2015	2014
Land	75,000	0	75,000	75,000	75,000	75,000
Building	300,000	250,000	50,000	55,000	60,000	65,000
Equipment & furniture (i)	500,000	140,000	360,000	66,000	75,000	90,000
Motor vehicles	65,000	55,000	10,000	8,000	10,000	12,000
Computer equipment	74,000	67,000	7,000	8,000	12,000	8,000
Computer software	50,000	40,000	10,000	10,000	13,000	7,000
	1,064,000	552,000	512,000	222,000	245,000	257,000

(i) New equipment of $350,000 was purchased December 2016, to develop the new diver watches product line.

4. Bank indebtedness

	2017	2016
Bank overdraft	$ 459,856	$ 137,598
Demand operating loan	$ 190,144	$ 62,402
	$ 650,000	$ 200,000
Payable in the next year	$ 350,000	$ 225,000
	$ 1,000,000	$ 425,000

The Company's banking facility provides for a maximum operating line of credit of $375,000. Borrowings under the line of credit bear interest at the prime rate of the Company's banker plus 0.75%, payable monthly. The operating line of credit is due on demand.

The facility, when utilized and the bank term loan discussed in Note 5 are secured by a general security agreement covering all assets other than real property and guarantees and postponement of claims by two directors and the parent company.

5. Long term debt

The Company's banking facility also provides for a non-revolving loan to acquire equipment in the amount of $675,000. Borrowings under this loan bears interest at the prime rate of the Company's banker plus 0.75% payable monthly. As at December 31, 2017, borrowings under this revolving facility are being classified as a long-term loan.

6. Capital stock

	2017	2016
Authorized:		
30,000 Class “A” preference shares; non-voting, redeemable at the amount paid thereon		
Unlimited number of Class “B” preference shares; non-voting, redeemable at the amount paid thereon		
Unlimited number of Class “C” special shares; non-voting, redeemable at the amount paid thereon		
10,000 Common shares		
Issued and outstanding		
2 Class “A” Preference shares	$ 100	$ 100
22 Class “B” Preference shares	$ 500	$ 500
1 Class “C” Special shares	$ 200	$ 200
2 Common shares	$ 200	$ 200
	$ 1,000	$ 1,000

7. Financial instruments

The Company initially measures its financial assets and liabilities at fair value, except for certain non-arm's length transactions. The Company subsequently measures all its financial instruments at amortized cost using the straight line method. Transaction costs are recognized in net earnings in the period incurred. However, financing and transaction costs associated with debt are netted against the carrying value and amortized over the term of the related debt.

8. Commitments

The Company has entered into vehicle leases with the following annual lease costs

2018	$24,671
2019	$21,165
2020	$14,334
2021	$ 8,109

9. Subsequent event

Subsequent to year end, the Company entered into an agreement to sell its land and building for approximately $650,000. The proceeds from the sale will be loaned to the parent company to finance the acquisition of a new building with a total cost of $900,000.

10. Economic dependence

The Company's purchases were from four (2016 - three) major suppliers representing 79% of total purchases (2016 - 84% of total purchases). The Company has a purchase agreement with one supplier. Under the terms of the agreement, the Company is required to purchase a minimum dollar amount per calendar year. The agreement may be terminated by either party by giving written notice, such termination to be effective 30 days from the receipt of such notice. The Company has provided a general security agreement, over all assets of the Company to one supplier as required under the supplier agreement.

11. Financial instruments

The Company regularly evaluates and manages the principal risks assumed with its financial instruments. The risks that arise from transacting in financial instruments include liquidity risk, credit risk, foreign currency risk, interest rate risk, and market risk. The following analysis provides a measure of the Company's risk exposure and concentrations. There are no significant changes in the risk exposures from the prior period.

Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with its financial liabilities as they come due. The Company is exposed to this risk mainly in respect of its bank indebtedness, accounts payable and accrued charges, shareholder advances and loans payable. The Company considers that it has sufficient funds available to meet its obligations as they come due.

Credit risk

The Company is exposed to credit risk in the event of non-performance by counterparties in connection with its accounts receivable. The Company does not obtain collateral or other security to support the accounts receivable subject to credit risk but mitigates this risk by dealing only with what management believes to be financially sound counterparties and, accordingly, does not anticipate significant loss for non-performance.

Interest rate risk

A portion of the Company's debt has a variable interest rate. Changes in the bank's prime lending rate can cause fluctuations in interest payments and cash flows. The Company does not use derivative financial instruments to alter the effects of this risk.
The Company is not exposed to any significant market risk at the balance sheet date.

Financial Analysis Techniques

1. Horizontal (trend) analysis - across years
2. Vertical analysis - as a % of an item within a specific financial statement
3. Ratio analysis - evaluate performance based on liquidity, solvency, profitability and asset management

Income Analysis - Phase 1 – Horizontal Trend Analysis

Westcorn Watches **Schedule 2-1**

Extracts Of Unaudited Statements Of Earnings (Loss) And Retained Earnings

For The Years Ended December 31

	2017 $		2016 $		2015 $		2014 $
Revenue	2,600,000	**111%**	2,350,000	**94%**	2,500,000	**125%**	2,000,000
Cost of goods sold							
Materials	1,070,000		1,035,000		1,018,000		810,000
Direct labour	1,010,000		774,500		857,000		650,000
Gross profit	520,000	**96%**	540,500	**86%**	625,000	**116%**	540,000
Expenses							
Advertising and promotion	38,000		28,000		33,000		35,000
Amortization	39,000		32,000		25,000		20,000
Salaries and employee benefits	395,000		345,000		320,000		290,000
Meals and entertainment	6,000		5,000		4,500		5,000
Office and general	35,000		22,000		19,000		15,000
Professional fees	12,000		10,000		12,000		10,000
Occupancy costs	51,000		49,000		47,000		45,000
Repairs and maintenance	35,000		20,000		15,000		25,000
Telephone	1,000		1,000		1,000		1,000
Travel	7,000		6,000		5,000		5,000
Interest and bank charges	1,500		500		500		1,000
	620,500	**120%**	518,500	**108%**	482,000	**107%**	452,000
Earnings (loss) before income taxes	(100,500)		22,000		143,000		88,000
Provision for income taxes	-		5,000		30,000		15,000
Net earnings (loss)	(100,500)	**-591%**	17,000	**15%**	113,000	**155%**	73,000

Income Analysis - Phase 2 – Vertical Trend Analysis

Westcorn Watches — **Schedule 2-2**

Extracts Of Unaudited Statements Of Earnings (Loss) And Retained Earnings

For The Years Ended December 31

	2017 $		2016 $		2015 $		2014 $	
Revenue	2,600,000	**100%**	2,350,000	**100%**	2,500,000	**100%**	2,000,000	**100%**
Cost of goods sold								
Materials	1,070,000	**41%**	1,035,000	**44%**	1,018,000	**41%**	810,000	**41%**
Direct labour	1,010,000	**39%**	774,500	**33%**	857,000	**34%**	650,000	**33%**
Gross profit	520,000	**20%**	540,500	**23%**	625,000	**25%**	540,000	**27%**
Expenses								
Advertising and promotion	38,000	**1%**	28,000	**1%**	33,000	**1%**	35,000	**2%**
Amortization	39,000	**2%**	32,000	**1%**	25,000	**1%**	20,000	**1%**
Salaries and employee benefits	395,000	**15%**	345,000	**15%**	320,000	**13%**	290,000	**15%**
Meals and entertainment	6,000	**0%**	5,000	**0%**	4,500	**0%**	5,000	**0%**
Office and general	35,000	**1%**	22,000	**1%**	19,000	**1%**	15,000	**1%**
Professional fees	12,000	**0%**	10,000	**0%**	12,000	**0%**	10,000	**1%**
Occupancy costs	51,000	**2%**	49,000	**2%**	47,000	**2%**	45,000	**2%**
Repairs and maintenance	35,000	**1%**	20,000	**1%**	15,000	**1%**	25,000	**1%**
Telephone	1,000	**0%**	1,000	**0%**	1,000	**0%**	1,000	**0%**
Travel	7,000	**0%**	6,000	**0%**	5,000	**0%**	5,000	**0%**
Interest and bank charges	1,500	**0%**	500	**0%**	500	**0%**	1,000	**0%**
	620,500	**24%**	518,500	**22%**	482,000	**19%**	452,000	**23%**
Earnings (loss) before income taxes	(100,500)	**-4%**	22,000	**1%**	143,000	**6%**	88,000	**4%**
Provision for income taxes	-	**0%**	5,000	**0%**	30,000	**1%**	15,000	**1%**
Net earnings (loss)	(100,500)	**-4%**	17,000	**1%**	113,000	**5%**	73,000	**4%**

Ratio Analysis

Calculate the ratios below, and explain their significance.

1. **Liquidity Ratio:**
   Current ratio = Current assets / Current liabilities
   Quick Ratio (Acid Test) = Current Assets less Inventory / Current Liabilities
   Measures short-term debt-paying ability
2. **Activity Ratios:**
   Accounts receivable turnover = Sales / Average accounts receivable
   Accounts receivable, days sales outstanding (DSO) = 365 / Accounts receivable turnover
   Inventory turnover = Cost of goods sold / Average inventory
   Inventory turnover, every X days = 365 / Inventory turnover
   Measures liquidity of receivables / inventory
3. **Profitability Ratio:**
   Gross margin ratio = Gross margin / Sales
   Return on sales (or Net Profit Margin) = Net Income / Sales
   Return on assets = Net Income After Tax / Total Assets
   Measures the profitability of the company as it sells its inventory or merchandise
4. **Coverage / Solvency Ratio:**
   Debt to equity ratio = Total debt / total equity
   Debt Ratio = Total Liabilities / Total Assets
   Measures the percentage of shareholders' equity and debt used to finance a company's assets

	2017 $	2016 $	2015 $	2014 $
Current Ratio	1.38	1.62	1.58	1.71
Quick Ratio (Acid test)	0.83	1.26	1.15	1.18
Accounts Receivable Turnover	5.33	8.17	9.09	
every X days	68.44	44.65	40.15	
Inventory Turnover	5.23	8.62	8.82	
every X days	69.75	42.36	41.37	
Debt Ratio	74%	52%	51%	50%
Debt to Equity Ratio	2.87	1.06	1.05	1.01
Gross Margin Ratio	20%	23%	25%	27%
Return on Sales	-4%	1%	6%	4%
Return on Assets	-4%	1%	8%	6%

Question

What conclusions can you draw from the financial information provided in Schedule 1 (financial statements) and Schedule 2 (horizontal and vertical analysis), and the ratios calculated (Schedule 3)? What is evident from this analysis?

Answers

Conclusions that can be drawn:

- Decreasing current ratio from 2016 to 2017
- Current ratio in 2017 is lower than is sufficient for ongoing operations, given the nature of Westcorn Watches' operations
- Accounts receivable turnover has decreased from 2015 to 2017
- Inventory turnover has decreased from 2015 to 2017
- Gross margin ratio has decreased from 2014 to 2017
- 2017 has a loss, even though revenue has increased by $250,000. Westcorn Watches has introduced a new product line (Diving Watches) which may have impacted the profitability of Westcorn Watches.
- Bank loans / third party debt increased in the year 2017.
- Debt to equity ratio has increased from about 1:1 (in the years 2014 to 2016) to 2.87:1 (in 2017)
- Invested in new equipment in 2017 to develop the new Diving Watches product line.
- Revenue has increased overall from 2014 to 2017; however, 2017 is the only fiscal year where there is a net loss.

Question

What further information would you request, after seeing the financial statements provided?

Answers

Further information that should be requested and questions to ask, may include the following:

- Were the changes in revenues in fiscal 2017 expected? (Were sales on an upward trend? Is it because of the new product line? Did they receive any new major customers, etc.)?
- Has the Company prepared any budgets or forecasts (i.e., what is the expectation for the future level of sales)?
- Is there seasonality in sales?
- What is the industry experience?
- Aging schedule of accounts receivable balances, to see how long receivables have been outstanding. For instance, it may be that certain receivables were collected quickly, while others have been outstanding for a longer period of time.
- Westcorn Watches's business plan.
- Sales and cost of sales by product line.
- Accounts receivable and inventory balances by product line.

Summary Of Certain Unaudited Items From The Statements Of Earnings (Loss) By Product Line
For The Years Ended December 31

	2017 $	2016 $	2015 $
Revenue			
Analogue Watches	1,415,000	1,530,000	1,650,000
Automatic Watches	910,000	820,000	850,000
Diving Watches	275,000	-	-
	2,600,000	2,350,000	2,500,000
Cost of goods sold			
Analogue Watches	1,140,000	1,049,000	1,091,000
Automatic Watches	790,000	760,500	784,000
Diving Watches	150,000	-	-
	2,080,000	1,809,500	1,875,000
Gross profit			
Analogue Watches	275,000	481,000	559,000
Automatic Watches	120,000	59,500	66,000
Diving Watches	125,000	-	-
	520,000	540,500	625,000

	2017	2016	2015	2014
	$	$	$	$
Inventory				
Analogue Watches	200,000	115,000	125,000	130,000
Automatic Watches	100,000	80,000	100,000	70,000
Diving Watches	300,000	0	0	0
	600,000	195,000	225,000	200,000
Accounts Receivable				
Analogue Watches	300,000	115,000	125,000	130,000
Automatic Watches	100,000	160,000	175,000	120,000
Diving Watches	300,000	0	0	0
	700,000	275,000	300,000	250,000

Ratios

Calculate the ratios below, by product, and explain their significance.

1. Activity Ratios:

   Inventory turnover = Cost of goods sold / Average inventory

   Inventory turnover, every X days = 365 / Inventory turnover

2. Profitability Ratio:

   Gross margin ratio = Gross margin / Sales

	2017 $	2016 $	2015 $
Inventory Turnover			
Analogue Watches	7.24	8.74	8.56
Automatic Watches	8.78	8.45	9.22
Diving Watches	N/A	N/A	N/A
Inventory Turnover, every X days			
Analogue Watches	50.43	41.75	42.66
Automatic Watches	41.58	43.20	39.57
Diving Watches	N/A	N/A	N/A
Gross Margin Ratio			
Analogue Watches	19%	31%	34%
Automatic Watches	13%	7%	8%
Diving Watches	45%	N/A	N/A

Question

What conclusions can you draw from financial information provided in Schedules 4 and 5, and the ratios calculated by product (Schedule 6)? What is evident from this analysis?

Answer

Conclusions that can be drawn:

- Revenues:
  - Analogue watches have the largest revenue balances in each year; however, it has decreased from 2015 to 2017.
  - Sales of automatic watches have increased from 2015 to 2017 and 2016 to 2017.
  - Diving watches sales started in 2017.
- Gross margin ratio:
  - Analogue watches gross margin has decreased significantly from 2014 to 2017;
  - Automatic watches gross margin has increased slightly from 2014 to 2017;
  - Diving watches, although new in 2017, have the highest gross margin ratio.
  - Diving watches have the highest profitability, but lowest amount of sales, since this is a new product that started in 2017.
- Inventory turnover:
  - Analogue watches has decreased from 2015 and 2016 to 2017, and the days has increased from approximately 42 days in 2015 and 2016 to 51 days in 2017.
  - Automatic watches has fluctuated from 2015 (9.22) to 2016 (8.45) to 2017 (8.78), and the days has fluctuated from approximately 40 days in 2015, to 43 in 2016 to 42 days in 2017.

Question

What further information might you request, after analyzing the financial information provided by product on an annual basis?

Answer

Further information that can be requested, is:

- Sales and cost of sales by quarter, by product line.
- Forecasts, budgets and/or projections by product line, by quarter.

Westcorn Watches

Schedule 7

Summary Of Certain Unaudited Statements Of Earnings (Loss) Items By Quarter

For The Years Ended December 31

	2017					2016				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Revenue										
Analog Watches	615,000	550,000	150,000	100,000	1,415,000	345,000	385,000	500,000	300,000	1,530,000
Automatic Watches	335,000	350,000	175,000	50,000	910,000	180,000	215,000	225,000	200,000	820,000
Diving Watches	N/A	N/A	175,000	100,000	275,000					
	950,000	900,000	500,000	250,000	2,600,000	525,000	600,000	725,000	500,000	2,350,000
Cost of goods sold	704,000	726,000	425,000	225,000	2,080,000	393,250	468,000	558,250	390,000	1,809,500
Gross profit	246,000	174,000	75,000	25,000	520,000	131,750	132,000	166,750	110,000	540,500

	2015				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Revenue					
Analog Watches	450,000	425,000	450,000	325,000	1,650,000
Automatic Watches	125,000	250,000	300,000	175,000	850,000
Diving Watches					
	575,000	675,000	750,000	500,000	2,500,000
Cost of goods sold	430,000	500,000	570,000	375,000	1,875,000
Gross profit	145,000	175,000	180,000	125,000	625,000

	2017				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Gross Margin Ratio	26%	19%	15%	10%	20%

	2016				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Gross Margin Ratio	25%	22%	23%	22%	23%

	2015				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Gross Margin Ratio	25%	26%	24%	25%	25%

Westcorn Watches
Percentage Of Sales By Quarter And by Product Line
For The Years Ended December 31

Schedule 9

	2017					2016				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Revenue										
Analog Watches	43%	39%	11%	7%	100%	23%	25%	33%	20%	100%
Automatic Watches	37%	38%	19%	5%	100%	22%	26%	27%	24%	100%
Diving Watches			64%	36%	100%					

	2015				
	1st Qtr $	2nd Qtr $	3rd Qtr $	4th Qtr $	Total $
Revenue					
Analog Watches	27%	26%	27%	20%	100%
Automatic Watches	15%	29%	35%	21%	100%
Diving Watches					

Question

What conclusions can you draw from the financial information provided in Schedule 7, ratios calculated by quarter (Schedule 8) and percentage of sales by quarter and by product line (Schedule 9)? What is evident from this analysis?

Answers

Conclusions that can be drawn:

- Revenues:
  - Although overall 2017 has the highest revenues, the first 2 quarters in 2017 are higher than in prior years, but the 3rd and 4th quarters are significantly lower than in 2016 and 2015.
  - Analogue watch sales decreased by $400,000 from the 2nd quarter in 2017 to the 3rd quarter, and by another $50,000 in the 4th quarter. You should discuss with management what occurred in the 3rd and 4th quarter in 2017. Also, it may be that the 1st and 2nd quarter in 2017 were exceptionally good, in comparison to those same quarters in 2016.
  - Automatic watch sales also decreased by $175,000 from the 2nd quarter in 2017 to the 3rd quarter, and by another $125,000 from the 3rd to the 4th quarter in 2017.
  - Diving watch sales only began in the 3rd quarter in 2017, could these sales have impacted the analogue and automatic watch sales? What is the expectation by management going forward?

Answers Continued

Conclusions that can be drawn (continued) and further questions to be asked of management:

- Gross margin ratio:
  - Annually, as discussed previously, the gross margin has decreased from 2015 to 2017.
  - In comparing the quarterly gross margins in 2017 to prior years 2016 and 2015, it is evident that the gross margin in the 2nd, 3rd and 4th quarter have all decreased.

Further information that can be requested, is as follows:

- Forecasts, budgets and/or projections by product, by quarter.
- Provide a list of any new contracts or major new orders that the Company has received since December 2017.
- Aged listings of accounts receivable and inventory as at the end of each month in 2018.

Discussion Points

- As the credit experts, advise what action you would take to extend the credit to Westcorn Watches? Discuss the pros and cons of extending the credit or not.

- You would grant credit if you think the Company is profitable or will be a profitable customer in the future, but not if the Company is not a going concern.

Possible reasons for Not Extending Credit

- Would extending credit be “throwing good money after bad”?
- Profit margins declining – Profit margins would decline if extending credit?
- Liquidity issues: high inventory levels, does this imply that they cannot sell the inventory?
- Diving watches: new and uncertain product, no guarantee whether the product will succeed or not

Possible Reasons for Extending Credit

- Westcorn Watches has a good reputation, and is known for their quality products and great customer relations.
- The Company has been in business for over 35 years.
- Diving watches: This is a new product line; (there were sales in the first 2 quarters it was in the market, comparable to the other two product lines). The decision to start the diving watches product line may have been in response to market needs.
- If ABC Bank does not advance funds, the current investment they have will be at risk.

Common Abuses in Financial Reporting

Potential Accounting "Gimmickry"

1. Capitalize vs. Expense:
    a. Interest
    b. Property Taxes
    c. Other Carrying Costs
    d. Other Situations
2. Development Costs: Included Where?
3. Classification of Assets: (Loss Deferrals)
    a. Inventory
    b. Land Held For Future Use
    c. Revenue Producing Property
    d. Other

Potential Accounting "Gimmickry" continued..

4. Timing of Start-Ups – When Does Income Appear?
5. Variable Rent Clauses e.g. % of Sales
6. Hiding Losses in Subsidiaries
7. Depreciation Policies
8. Basic Revenue Recognition
9. Financing Costs

Red Flags of Fraud or Misrepresentation

- How is the cash position of the company?
- What is the growth trend? Is there unrealistic growth in assets or sales?
- What is the relationship of sales to cash and AR?
- How does it compare with other similar companies?
- What is the general trend in its industry or the economy in general?
- Past auditor qualification and / or recent change in auditor
- Timing of issuance of financial statement relative to year end (and prior years)
- Timing of income tax reporting
- Management compensation source - bonuses and incentive pay?
- Gut feel - not to be underestimated!

Valuations / Litigations / Forensics

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Jim Muccilli, Partner

Experience

Jim Muccilli is a partner in the Valuations | Forensics | Litigation Group at Crowe Soberman.

He joined the firm in 2010, and was formerly a sole practitioner. He consults on matters involving economic loss assessment, business valuation and forensic accounting.

Professional Summary

- Jim has qualified as an expert witness in Federal and Provincial Courts, and has testified at Arbitration and Mediation Hearings before the Ontario Municipal Board and Ontario Insurance Commission.
- Jim has practical experience assisting in resolving financial disputes, preparing expert reports for trials and preparing business valuations for a variety of purposes. He also performs critical analysis and commentary of reports prepared by other specialists.

Professional Affiliations

- American Society of Appraisers
- Canadian Institute of Chartered Business Valuators
- Examiners - Life Member
- Chartered Professional Accountants of Canada (CPA Canada)
- The Canadian Institute of Chartered Accountants (CICA)
- Chartered Professional Accountants of Ontario (CPA Ontario)
- National Association of Certified Fraud
- AICPA Forensic and Valuation Services (FVS) Section

Client & Industry Focus

- Business and securities valuation
- Economic loss assessment
- Investigative and forensic accounting

Education

- Bachelor of Business Administration (BBA), York University
- Master of Business Administration (MBA), York University

Julie Zylberlicht, Senior Manager

Experience

Julie Zylberlicht joined Crowe Soberman in 2008, and currently works as a senior manager in the Valuations | Forensics | Litigation Support Group, with an audit background from her years at a mid-sized accounting firm in Montreal. She offers several specialties and is responsible for providing clients with a vast array of services.

Professional Summary

- Julie has extensive experience in the areas of matrimonial matters, shareholder and partnership disputes, corporate and commercial damage claims, corporate reorganizations, and other litigation support.
- Julie is the treasurer of the Dor L'dor chapter of the Canadian Hadassah Wizo organization and sits on committees of Bialik Hebrew Day School. She also volunteers for the ICAO annual Tax Clinic, which organizes free CA services for low-income individuals.

Professional Affiliations

- Chartered Professional Accountants of Ontario (CPA Ontario)
- Chartered Professional Accountants of Canada (CPA Canada)
- Canadian Institute of Chartered Business Valuators (CICBV)
- Certified in Financial Forensics (CFF)
- AICPA Forensic and Valuation Services (FVS) Section

Client & Industry Focus

- Valuations/Fair market value
- Family law matters
- Economic loss assessment
- Damage quantification
- Shareholder disputes
- Professional negligence claims
- Commercial disputes
- Business interruption Insurance and litigation claims
- Personal injury claims for lost earnings or additional care costs

Education

- Bachelor of Commerce (Honours) (BCom., Hons.), McGill University
- Graduate Diploma in Chartered Accountancy (CA), Concordia University

Thank You