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THE ROLE OF DISCLOSURES IN THE FINANCIAL STATEMENTS OF PRIVATE BUSINESS IN ACCESSING CREDIT

CFERF Executive Research Report

May 2010

IN PARTNERSHIP WITH

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Acknowledgements

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Accounting Standards for Private Enterprises

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Executive Summary

Lenders use a range of financial statement disclosures from private enterprises to determine whether they should extend a loan, and typical financial statement disclosures may not always be sufficient to meet those needs.

By their very nature, private enterprises do not report publicly. However they do produce financial statements using generally accepted accounting principles. For fiscal periods commencing on or after January 1, 2011, private companies must choose between the new Accounting Standards for Private Enterprises (ASPE) which have been recently issued by Canada's Accounting Standards Board and International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board. Based on research in 2009[1], the Canadian Financial Executives Research Foundation (CFERF) determined that approximately 25% of Canada's larger private companies were considering IFRS; the balance were planning on adopting the anticipated ASPE.

This Executive Research Report The Role of Disclosures in the Financial Statements of Private Business in Accessing Credit – prepared by the Canadian Financial Executives Research Foundation in partnership with KPMG Enterprise – set out to determine to what extent lenders rely on financial statement disclosures when making a decision to extend credit; secondly, it attempts to explore whether disclosures under the new private company standards will be sufficient for the needs of creditors. Considering that disclosures in ASPE have been significantly reduced from existing generally accepted accounting principles, a concern is whether financial statements prepared under the new simplified standards will be sufficient for lenders when making their credit decision. If not, what additional disclosures would help private companies in obtaining financing?

This study comprises the results of a survey conducted in the 24-day period from Monday, February 22, 2010 to Wednesday, March 17, 2010. During this time, 85 completed responses were obtained from private companies. Respondents represented a wide cross-section of industry, including: manufacturing; wholesale trade; finance and insurance; professional, scientific and technical services; mining and oil and gas extraction; agriculture, forestry, fishing and hunting; utilities; construction; telecommunications; transportation and warehousing; real estate and rental and leasing; retail trade; arts, entertainment and recreation.

The second phase of the research methodology involved a three-hour Executive Research Forum, which took place on March 3, 2010, in Toronto. The purpose of the forum was to allow for a free-flowing dialogue amongst company experts who were provided with specific questions in advance. A cross-section of Canadian industry groups was represented, including: private equity and venture capital; insurance; retail; manufacturing; printing and publishing and auto parts.

[1] Issues in Private Company Reporting. CFERF/KPMG, 2009

The general belief amongst financial executives who participated in the executive research forum was that lenders do look at financial statements and use them as a snapshot of a company's general overall financial health; they tend to see them as a baseline, a starting point which is considered more reliable if the statements have been audited. That said, financial statements may not be the most up to date information the lender or investor would use when making his decision. The lender is interested in the most current data on cash flow and liquidity, for example. This information may come from the borrower's interim financial reporting, rather than from the annual financial statements, which by their very nature, suffer from a time lag.

SURVEY RESULTS

- Survey respondents perceived the mandatory ASPE disclosures (presented in the survey) as providing useful information to lenders throughout the credit life cycle. Most of the disclosures are believed to be useful to lenders in assessing a borrower's liquidity, security and ability to service indebtedness (as evidenced by cash flows)

- Survey respondents were not convinced of the value of two of the newer financial statement disclosure requirements – cost of sales and government remittances payable. Respondents were much more supportive of disclosures related to debt and asset impairment.

- While survey respondents agreed additional disclosures would bring value, they felt that the cost of providing the additional information would not be warranted.

In conclusion, financial statements prepared in accordance with accounting standards for private enterprises will provide a consistency that lenders can use to compare company to company within sectors; they will be used by lenders in assessing liquidity, security and debt service capacity when granting, monitoring and renewing credits. However, historic cost based financial statements will not be the only information used by the lender in making his final decision. That decision will be based on a wide range of information which may or may not be included within the final statements. What is clear is that the lender must feel comfortable with the reliability of the information. A rapport based on trust between the borrower and the lender provides the foundation on which financial statement disclosures can build.

Introduction

In September of 2009, Canada's Accounting Standards Board (AcSB) approved a "made in Canada" set of financial reporting standards for private enterprises known as Accounting Standards for Private Enterprises (ASPE). ASPE is effective for fiscal years beginning on or after January 1, 2011. This is the same conversion date that will be used for public companies which are required to begin using International Financial Reporting Standards (IFRS). Private companies will be able to choose whether to use IFRS or ASPE. The new private company standards are already available for use; companies were eligible to adopt them for their 2009 year ends.

Like any language, financial statements are primarily a communication tool; it is important that one use appropriate, accurate and precise language. The communication should also be tailored to the needs of the audience. The AcSB recognized that financial statement users in the private company sector have the ability to obtain additional information from the private companies and therefore there is less need for mandatory disclosures. Further, the external users are generally lenders and investors who have a higher conversancy with financial reporting than the general public.

Consequently, in developing the new standards, a goal of the AcSB was to reduce the volume of required disclosures, following the cost/benefit principle. The AcSB was concerned that the value to the users of previous mandatory disclosures exceeded the cost of providing them.

Given that the primary external users of private company financial statements are lenders, the purpose of this research is to seek feedback on the relevance and usefulness of certain aspects of the new standards in the process of seeking and obtaining financing. Views were sought from both preparers of private company financial statements and external users, namely lenders and investors in the private equity and venture capital communities.

Private companies seeking financing need confidence that their choice of accounting standards (i.e. ASPE or IFRS) will not place them at a disadvantage when seeking credit, compared to public companies. That said, some companies are concerned that the financial burden posed by IFRS would outweigh any perceived benefits in comparability or transparency. Similarly, creditors and investors must feel comfortable that they have adequate financial information to decide whether to undertake the risk in extending a loan or equity capital. If the information in financial statements is inadequate, a user may make an inappropriate lending or investing decision; if the decision is to decline to support a private company's valid funding request, the financial reporting framework will have failed as an effective communication tool.

The purpose of our research is to explore the role of the new Accounting Standards for Private Enterprises (ASPE) as they relate to private companies' ability to access credit. In particular, it examines what disclosures and other information are most useful in accessing credit, to what extent those disclosures are mandatory under ASPE, and to what extent ASPE requires disclosures that are not seen as useful for this purpose. In so doing, we hope to inform Canadian senior financial executives and accounting standard setters on the role of ASPE in obtaining credit in private companies. Ultimately, our goal is to provide financial executives working in private companies with an overview of the views of their peers, as well as to provide them with a general perspective of the needs of those whom they may be approaching for financing or equity capital.

Research methodology and demographics

The Executive Research Report "The Role of Disclosures in the Financial Statements of Private Business in Accessing Credit" was prepared by the Canadian Financial Executives Research Foundation (CFERF) in partnership with KPMG Enterprise. It comprises the results of a survey of senior financial executives in private companies in Canada and the insights obtained at an Executive Research Forum that was held in Toronto on March 3, 2010. Eighty five responses were obtained between February 22 and March 17, 2010. Survey results were compiled and analyzed on the basis of industry classification (large Standard Industrial Classification groups), as well as revenue. Respondents represented a wide cross-section of industry, including: manufacturing; wholesale trade; finance and insurance; professional, scientific and technical services; mining and oil and gas extraction; agriculture, forestry, fishing and hunting; utilities; construction; telecommunications; transportation and warehousing; real estate and rental and leasing; retail trade; arts, entertainment and recreation. Respondents were also categorized by position title.

(See Appendix A for further details on survey demographics)

The purpose of the forum was to allow for a free-flowing dialogue between company experts who were provided with specific questions in advance. A cross-section of Canadian industry groups was represented, including: private venture capital; insurance; retail; manufacturing; printing and publishing and auto parts.

(See Appendix B for a list of forum participants)

Fair presentation of financial statements

Accounting standards for private enterprises require that the financial statements present fairly, in accordance with generally accepted accounting principles, the financial position, results of operations and cash flows of the reporting entity. The entity is expected to exercise professional judgment in providing sufficient information about the extent and nature of transactions or events having an effect on the entity to enable the user to understand the transactions. Simply providing all of the required disclosures may not suffice. The principle of fair presentation is of enhanced importance given the significant reduction of required disclosures under ASPE compared to the predecessor Canadian generally accepted accounting principles.

"The value of a Private Enterprise GAAP is that it avoids the redundant and overly complicated disclosures of IFRS and permits broadly held private companies to prepare valuable information without the clutter."
– Survey respondent

Management makes the assertion in preparing financial statements that the financial statements are fairly presented in accordance with an underlying generally accepted financial reporting framework, which, for many, will be ASPE commencing in 2011. Generally accepted accounting principles, says Bob Young, a partner at KPMG Enterprise, embody the concept that fair presentation requires that the financial statements provide all of that information that is necessary to a user to understand the financial position, operating results and cash flows of the company; preparers of financial statements should not expect that providing all of the mandatory disclosures will necessarily result in fair presentation. Taking a checklist approach of going through all of the disclosure requirements in the compilation of disclosure requirements in the CICA Handbook may not suffice. "There's an expectation that the preparers will go beyond that and stand back and ask: 'Is this all of the information that the users will require?'" Young says.

"Where a matter is material or fundamental the requirement for extra information where necessary for fair presentation, in my view, has always been a requirement and so there's really no change there. If an extra note, or comment, or some analysis in financial statements is required for the reader to properly understand the effect, I would expect it to be there."
– Stephen Cummings, Chief Financial Officer, Lumira Capital Corp.

Public accountants often hear the comment that "no one reads the notes". It's up to the financial executive preparing the financial statements to assess how the company's stakeholders will perceive the relative value of information presented in the notes to the financial statements compared to information presented in the balance sheet, income statement, and statement of cash flows.

For instance, a private company owner may focus on the cash flows and bottom line, says John Forester, Chief Financial Officer of NUCAP Industries Inc. "The bankers on the other hand, may focus on one or two key performance measures in the balance sheet, income statement or statement of cash flows and go okay, those are fine, and they'll go right into the notes," Forester says.

Mark Walsh of the AcSB points out the importance of using the notes to explain the accounting policies one has used. According to Walsh, one of the things that the accounting standards for private enterprises do is provide more choices in a number of places. For instance, the board has reduced the required disclosures for defined benefit pension plans, but, more importantly, there are now two different ways to account for a defined benefit pension plan, Walsh notes. There are also choices for financial instruments, he adds. "I think when you've got choices like that, it's critical that the company declare its choices and say what it has done. If there's only one way to do it, then in explaining what you've done, you shouldn't spend a lot of time on that, because there only is one choice," Walsh says. There are a number of other areas providing choices, Walsh says; for example, has the company selected the future income taxes or the cash taxes approach; has the company consolidated its subsidiaries or not?

While the concept of "fair presentation" is certainly not a new concept introduced with ASPE, it will be a matter of interest to observe how private companies avail themselves of the slimmer CICA Handbook under ASPE – will the prescribed disclosures become de facto "fair presentation" – in other words, will they simply default to the minimum compliance approach? The AcSB certainly expects private companies to take the initiative to present sufficient information to adhere to the concept of fair presentation. The AcSB's Walsh notes that, in addition to listing required disclosures at the end of each section within ASPE, there is a compendium which assembles all the disclosures in one location. However, Mr. Walsh cautions, "You shouldn't just say: 'If I've met all these, I've met the requirements,' because there is the requirement to present fairly. Equally important and on the other hand, Walsh notes, "it's not a checklist because if the information is not material, you don't have to disclose it."

THE BASELINE SHOULD BE THE BASELINE

"There may be an expectation in the audit community that extra information should become more routine; this concerns me a little bit because I would expect the baseline to be the baseline and if that is met by a preparer then that should be sufficient. The only point where I would expect additional information would be where it's material or fundamental to a reader for an appreciation of its effect on the financial statements. So I'm a little bit concerned that the discussion about extra information becoming more routine then leads to a lack of understanding of what may be the baseline. I'm expecting the baseline to be the baseline, and if that's not the case then I'd like to understand that changed expectation more thoroughly."
– Stephen Cummings, Chief Financial Officer, Lumira Capital Corp.

"Financial statements need to be a summary document that provide high level information that's easy to read and understand and compare between entities. Each user is going to require additional information. I would expect to supplement the financial statements going to the bank or in a due diligence situation for example with information on the value of assets and cash flows on specific properties. I think we have to be careful in not designing the financial statements to be a document that provides too much detailed information to satisfy certain users but rather provide a summary, providing complete and clear information that can be followed up with additional detail."
– Ian Robinson, Vice President and Chief Financial Officer, Avant Garde Energy Corp.

"The audited statements are the baseline where everything comes from ... but it's that process of hitting those minimal standards and the audit that gives us comfort that wherever we're pulling our numbers from, there's some degree of consistency and controls are in place to make sure they make sense, so I think we have to not lose sight of the fact that accounting standards are there to provide that and we don't need the auditors to necessarily tell us where the value or usefulness of the information is. Our stakeholders are really good at that. They'll call up and say … here's all the stuff we want and … it's way more detailed than any kind of financial disclosure we typically make. ... the accounting standards really are the ones which I call the baseline where we operate from. If we want to move that line up into all the other disclosures, we're going to end up doing unnecessary work potentially and/or it becomes then an argument whether the bankers or the private equity guys really want to see it that way.. So there's a point where the accounting standards kind of start tripping over the stakeholders objectives and needs."
– John Forester, Chief Financial Officer, NUCAP Industries Inc.

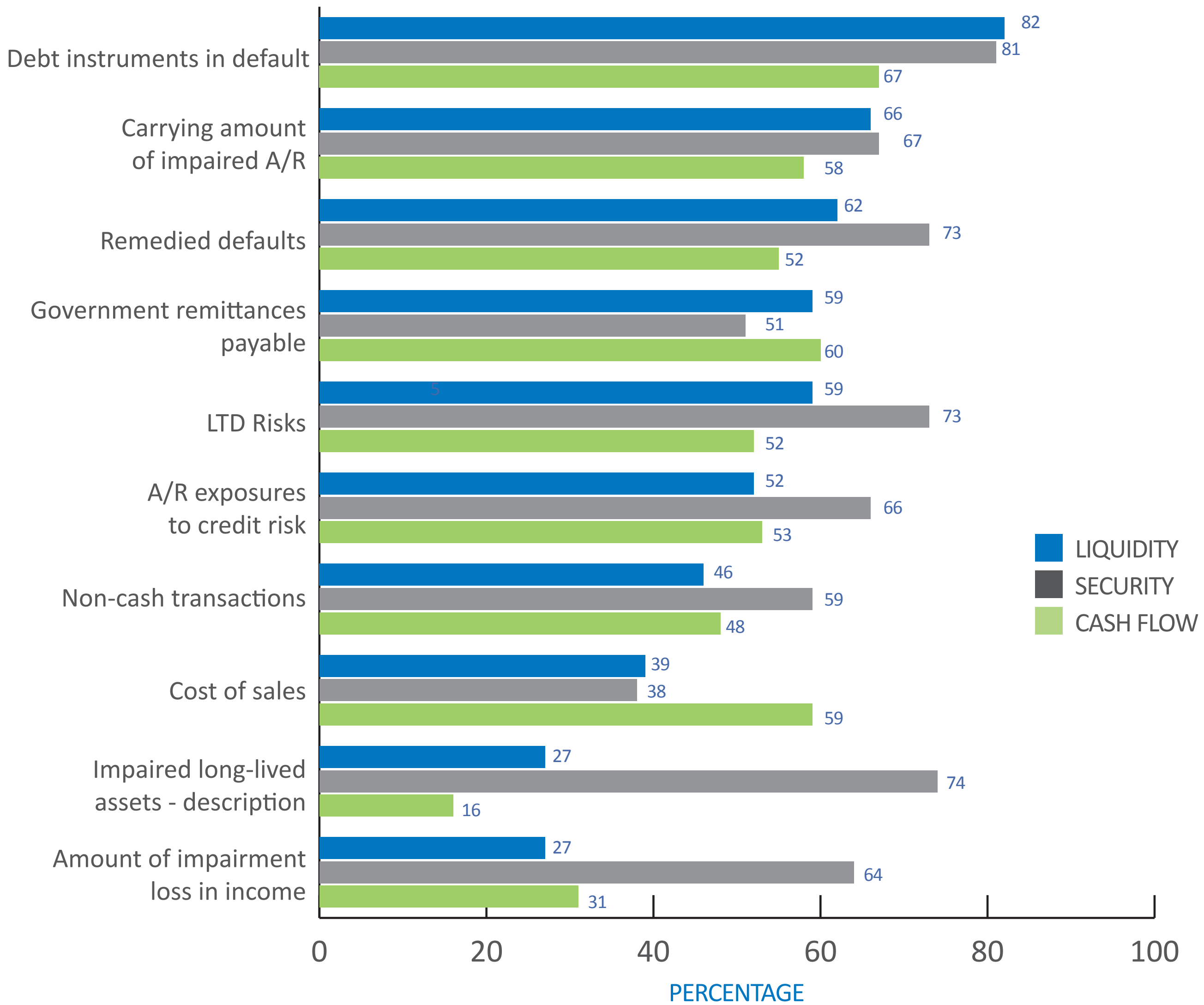
In fact, many companies will willingly step forward to disclose more than the minimum requirements in their anticipation of lenders' questions, says Tim Zahavich, Chief Financial Officer of St Joseph Communications. "As a preparer you look at the financials and you say, if I don't say something about these results I'm going to get a question, so I might as well put it in my financials." Those disclosures combined with a stamp of approval from an auditor, should ideally help ease concerns from lenders, Zahavich says.

Survey results

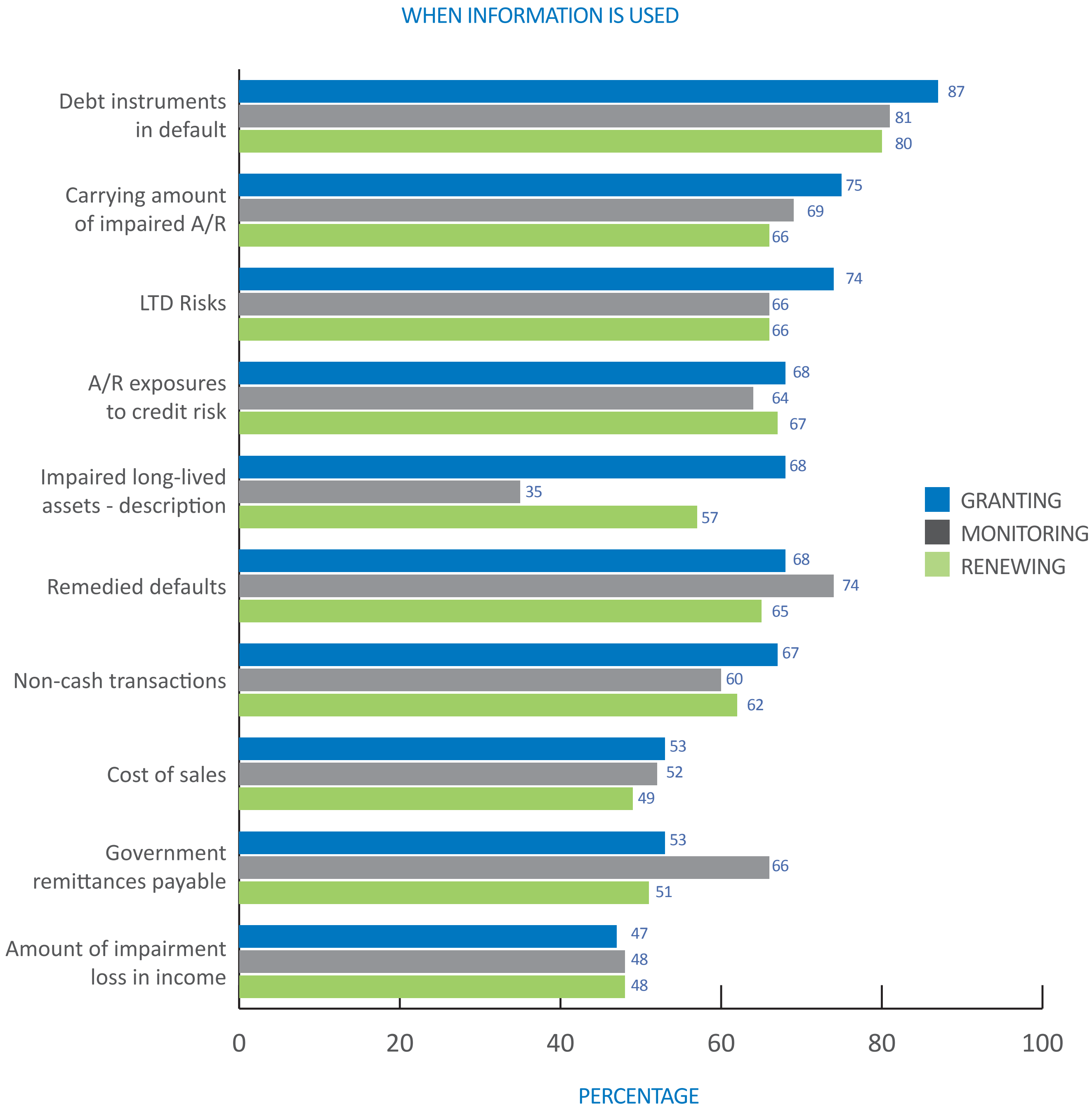
Respondents to the on-line survey provided some useful insights into the perceptions of preparers of financial statements as to the use that lenders and investors make of selected financial statement disclosures, when the information is used and the sufficiency of the information for the users' needs.

Preparers were firstly asked their views of the use made of selected disclosures required under ASPE in the financial statements (Appendix C). They expressed their belief that many disclosures feed somewhat equally into lenders' assessment of cash flow (debt service capability), security and liquidity. As would be expected, it was observed that disclosures regarding impairment were considered to be of more value to the lenders' assessment of the security for the underlying credit facility.

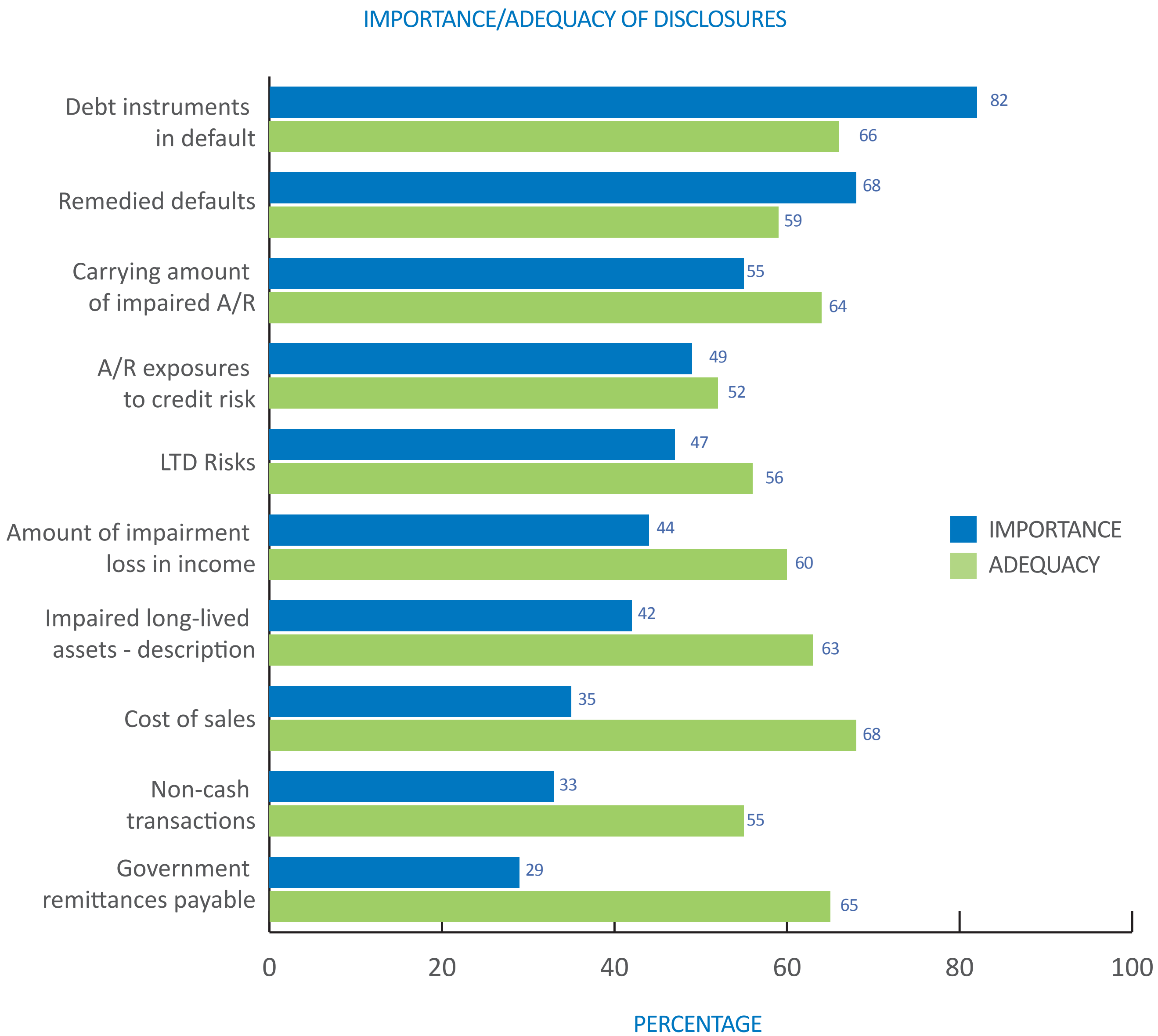
USE OF FINANCIAL INFORMATION



Survey participants were also asked their views as to when, within the credit cycle, lenders used the selected financial statement disclosures. Preparers indicated that they believed that the disclosures were, in general, of equal importance to the lenders' decisions to advance the credit initially, to subsequently monitor the credit and to ultimately determine whether to renew the credit on maturity. Preparers did not perceive that such disclosures regarding impaired assets were used to the same extent in the ongoing monitoring of credit.



Survey participants also provided insight as to their views regarding the importance and adequacy for users of selected disclosures required under ASPE in financial statements. It was interesting to note that disclosures perceived to be of lower importance include the new disclosure requirement for government remittances payable and the requirement to disclose cost of sales which was recently introduced when Canadian accounting standards for inventories were conformed with IFRS. In general, preparers of financial statements rate debt-related disclosures as more important than many other disclosures; they perceive that the information provided is adequate to meet the needs of the users.



Going beyond the prescribed minimum disclosures

Are there triggers or indicators that suggest it is necessary for management to go beyond the prescribed minimum disclosures to achieve fair presentation? This question was proposed to the research forum participants. One participant suggested that advising readers when a company was close to violating a debt covenant should be considered for disclosure. Other participants, however, were concerned that such disclosures would be overly subjective and therefore felt these disclosures are correctly not required. Many of the examples of important disclosures raised in the forum related to already prescribed disclosures, including, for example, disclosures regarding the underlying details of long term debt instruments; significant subsequent events; accounting policy choices made by management and the underlying composition of assets and liabilities. In general, participants concluded that, while the need for disclosures beyond the prescribed minimums is an important concept of fair presentation, they anticipated a low frequency of such situations.

While believing that the required disclosures are generally sufficient for fair presentation, preparers of financial statements strongly believe that full disclosure is vital for establishing and maintaining a trust relationship with lenders and investors. For companies seeking financing, full disclosure of any material information, even if the disclosure is not specifically required under ASPE, is absolutely critical to maintain a lender's confidence, says John Forester, Chief Financial Officer of NUCAP Industries Inc. Says Forester: "The financial statements have to have a minimal threshold of what I call the comfort level, that everybody says is consistency, that controls are in place and nothing that's really material or important has been hidden or omitted from the discussion ... The banker is going to ask us a lot of questions that are well beyond the financial statements, so I think the key is because we have less resources in a private company, especially when it comes to overhead groups, like finance, a minimal disclosure level is absolutely essential for trust and comfort, but we don't want to get too far beyond that because we just simply don't have the horsepower to deal with it ... for a private company, the needs are definitely reduced but you don't want to leave anything off the table that's important because if you break that trust or comfort level you're going to have a tough time getting people to support you as a strategic partner in your business."

TRIGGERS WHICH MAY WARRANT MORE DISCLOSURE

"Funding shortfall: Using an early career example … in a regulated environment, it became quite obvious that there were some material omissions in the disclosure of how the funding was generated. It became apparent that they had a funding shortfall in the company business plan from day one that had been missed by all parties, the auditors, the actuaries, the regulators and so on. In my opinion, funding shortfalls, even if it is only notable as a deviation in the business plan, should be clearly disclosed, not only in the documentation, but also as a board agenda item. As this was a regulated environment, the board must be provided with the opportunity to address whether further discussion needs to take place with the regulators. Potential funding shortfalls and deviations from an original business plan may influence its potential for continuing as a going concern if the issues are not addressed and steps taken to mitigate the risk."
– Anne Burpee, Chief Financial Officer, South Western Insurance Group Ltd.

"I think I have to challenge the statement that if you're close that you should disclose. If you're in compliance, you're in compliance. If I'm in compliance in this quarter and my projections are that I'm will be in compliance for the next eight quarters, then there is really nothing more to add in the financial statements."
– Tim Zahavich, Chief Financial Officer, St. Joseph Communications

"Anything that's important has to get on the table, but the problem is that when you do it in disclosure like that, you're red flagging, "uh-oh, there's a problem with the business" when, in fact, the fundamental business model didn't change and we were actually doing extremely well."
– John Forester, Chief Financial Officer, NUCAP Industries Inc.

Other observations on financial statement disclosures

> "Cash is king. Everybody knows that. It's cash flow, liquidity and the details in the notes to the financial statements that people probably derive the most value from, from all user groups."
> **– Michael McAloon, Chief Financial Officer, Flakeboard Company Ltd.**

According to Patrick Leung, Chief Financial Officer of Tristan Capital Inc., the most important information includes tangible items such as cash flow disclosures; the income statement; the ranking of security (creditors); and information about capital.

Within the GAAP format, the cash flow statement and the notes have the most relevance, agrees Mike McAloon Chief Financial Officer of Flakeboard Company Ltd. "Of the non-notes section, I'd say the statement of changes in financial position is almost the most relevant statement today for a lot of companies," he says. In terms of financial information, private companies have the flexibility of preparing unaudited internal monthly updates which they can choose to share with any user, including owners and lenders, says McAloon. According to McAloon, by the time the audited statements are released months later, there are no surprises other than a few minor adjustments, since the critical information has already been shared. "It's that kind of open environment that is collaborative and conducive to maintaining the best relationship with all user groups, irrespective of what the GAAP guidelines are," McAloon says. .

According to John Forester, Chief Financial Officer of NUCAP Industries Inc., GAAP simply offers a "minimal comfort level" when it comes to disclosures to lenders. The key is knowing your bankers, and what is important to them, and giving them what they need to do their jobs, Forester says, whether the information is contained in an informal meeting or a more formal private company MD&A-style document. "It is a business partnership, they are strategic partners and we have to treat them that way with our disclosures," Forester says. "It's all about building trust."

The importance of different areas of the financial statements is contingent on what kind of company is reporting, according to Florian Meyer, Finance Practice Leader, Newhouse Partners Inc. For instance, the income statement would be the most important statement for a technology company which doesn't capitalize its assets (they get written off as they are developed) and receive SR and ED funding from the government.

For some lenders, earnings before interest, taxes, depreciation and amortization (EBITDA) seems to be a valued disclosure, but it is not a GAAP measure, notes Siva Sivarajah, Secretary and Treasurer of International Custom Products Inc. The high interest in EBITDA was also observed by Tim Zahavich, Chief Financial Officer of St. Joseph Communications. Says Zahavich: "Lenders always focus on EBITDA, and yet there doesn't seem to be a definition of EBITDA, and that's been the case for years and years and years, and I've always wondered why not, given how everybody seems to focus." According to

NUCAP's John Forester, while EBITDA is useful for companies, when it comes to dealing with lenders, the final net profit is still absolutely essential since interest and taxes are such major hits. "You have to show you're covering all the expenses in the business," Forester says.

In calculating and potentially reporting EBITDA, financial statement preparers are often confronted with the issue of whether non-recurring items of revenue or expense that are atypical of the company's ongoing operations should be included or excluded. "One of the areas that I find poorly documented in financial reporting is the notion of an unusual item. I do understand the issues and the abuses that have happened over the years with extraordinary items and exceptional items, et cetera, but in the context of a proper understanding of what's happened during the year, I think the use of unusual item disclosures as a component of profit before tax disclosures is useful to a reader. However, I don't find the definition anywhere of an unusual item and I wonder if that's an area that needs revisiting," says Stephen Cummings of Lumira Capital Corp. Defining EBITDA and "unusual items" would be helpful for lenders since EBITDA is commonly used when evaluating compliance with debt covenants, notes Elda Fares, Partner with KPMG.

While disclosure of EBITDA is problematic since the term is undefined, there are other measures which are defined but are so complex to calculate and understand they are of relatively little value to most users, argues Ian Robinson, Vice President and Chief Financial Officer of Avant Garde Energy Corp. For instance, some of the issues in the equity and the hedging sections of the CICA Handbook fall into this category, Robinson suggests.

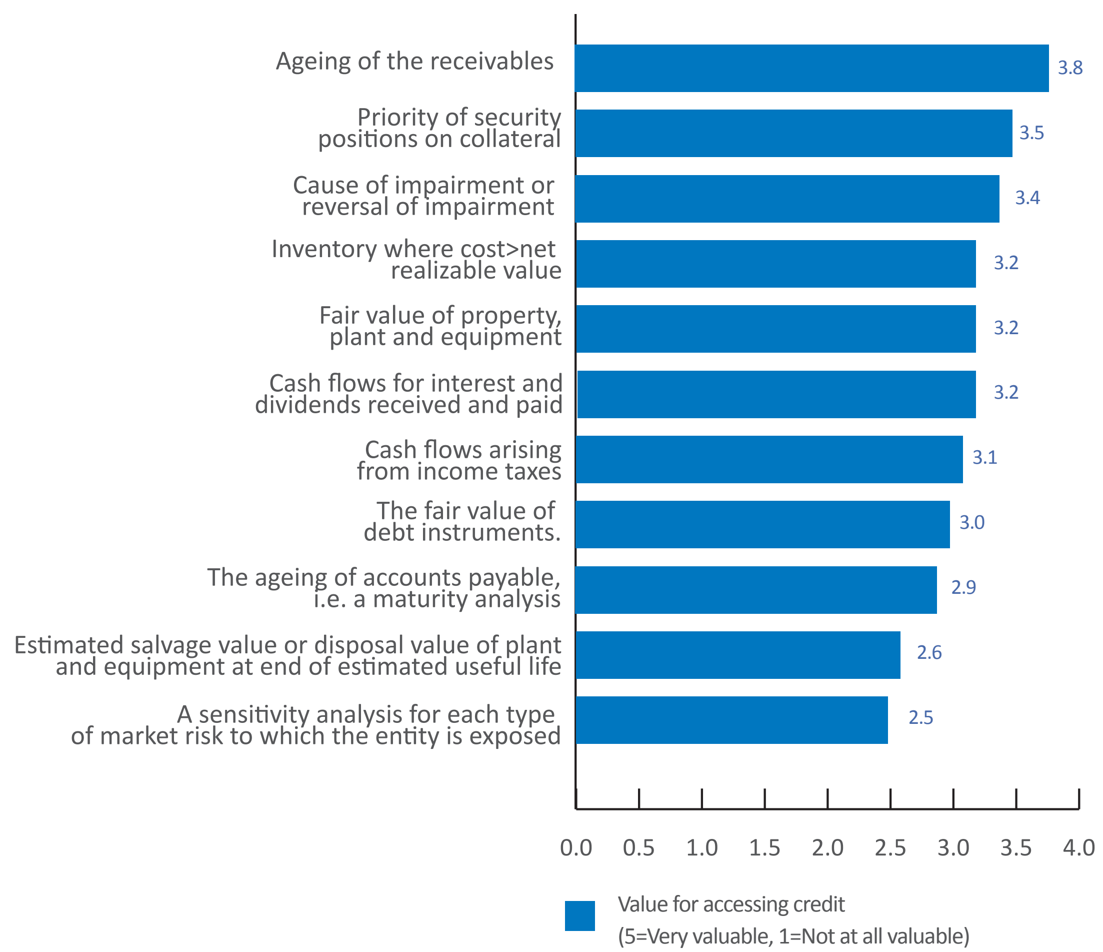
Less useful disclosures include stock options or convertible securities, because, as Patrick Leung of Tristan Capital points out, the value of shares in a private company is based on a valuation. "I found that we spend a lot of time calculating it and then spend a lot of time explaining it to people, how we're calculating it, and then spend a lot of time trying to defend a calculation that we didn't necessarily buy into," Leung says.

Requiring additional disclosures – would it be worth the cost?

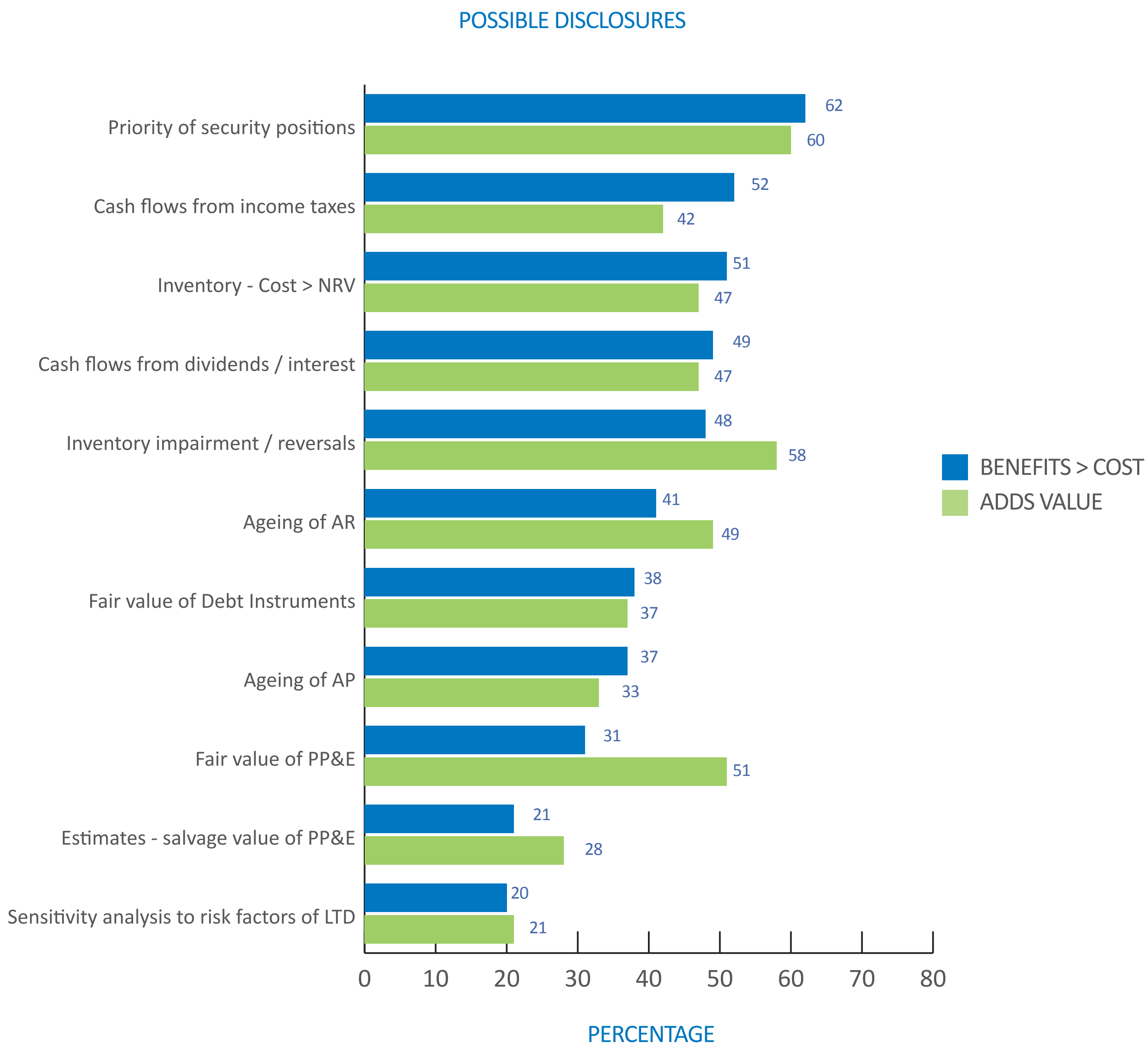
> "Many disclosures would be useful, but it depends on the lender and they would generally request supplemental information when they conduct their due diligence. To require it under GAAP would only increase compliance costs unnecessarily."
> **– Survey respondent**

In addition to surveying preparers of financial statements with regard to their perception as to the use lenders make of certain mandated financial statement disclosures, survey respondents were presented with a number of possible additional disclosures to gauge their views as to the value of such disclosures to the users of the financial statements. As we see from the chart below, the top three additional disclosures are ageing of receivables, priority of security of positions on collateral and causes of provisions of inventory impairment and reversal.

VALUE OF ADDITIONAL DISCLOSURES FOR ACCESSING CREDIT



However, while a number of the suggested disclosures were viewed as adding value, not all survey respondents agreed that the benefits of providing the additional information would exceed the costs. The following chart offers a perspective on how many survey participants considered additional disclosures either valuable or highly valuable, and whether or not the benefits exceeded the incremental costs of providing the information to users of the financial statements. We see that the largest number of respondents felt that the priority of security positions was a valuable disclosure (61%) and also viewed the benefits exceeding incremental costs (62%).



While somewhat fewer survey respondents said it would be worthwhile to separately report cash flows for income taxes, interest and dividends received and paid; it was considered to be relatively valuable. This is a required disclosure under today's generally accepted accounting principles that was not continued under ASPE.

The disclosure seen as least worth the cost of disclosure was a sensitivity analysis for each type of risk to which the entity's long-term debt is exposed (only 20% of survey respondents agreed that the benefit of providing this additional disclosure would be worth the incremental cost). Similarly, only 21% said it would be worthwhile to disclose the estimated salvage value or disposal value of plant and equipment at the end of its estimated useful life.

"Most information concerning tax payments, aged receivables and payables, inventory, fixed assets etc. and the value of same are assessed independently of the financial statements. I do not believe that accountants preparing financial statements are qualified to identify the lending values of a company's assets. Lending is an art and assessing the lending value of an asset or the impairment of the same based on an accounting rule could skew a lender's decisions prior to his own assessment. The financial statements should record fact, not subjective opinions. Subjective opinions on financial statements could also lead to a new set of liabilities."
– Survey respondent

"Note that one has to differentiate between what is used; what should be used; what is helpful to the creditor, etc. ...The cost can be minimized with the properly used XBRL and XBRL software. Otherwise cost might become prohibitive."
– Survey respondent

Accounting standards for private enterprises continue to require that the financial statements report cash flows during the period classified by operating, investing and financing activities. There is a specific requirement to disclose the amount of cash and cash equivalents for which the use is restricted. While ASPE is explicit in requiring a statement of cash flows, there are no other incremental disclosures in comparison to existing generally accepted accounting principles, even though lenders consistently observe that cash flow information is of high importance.

Cash flows are consistently identified as critical financial information in the credit decision process by lenders, since even profitable companies can be challenged with managing their cash flows. However, ASPE does not include any new or enhanced disclosures of cash flow information. As John Barraclough explains, from a cost-benefit perspective, the Accounting Standards Board's Advisory Committee on ASPE, on which he served, concluded that it didn't want the preparer to incur any more costs to businesses for something lenders could obtain directly from the CFO if it was crucial to the decision process. Such circumstances would typically be the exception such that "We felt that the current statement disclosure coupled with the auditors notes and the Lenders' ability to obtain further clarifying details directly from the CFO, were sufficient such that we chose not to pose any further restrictions," Barraclough says.

THE IMPORTANCE OF CASH FLOW STATEMENTS

"When you go and have a conversation with a bank, they don't start with the income statement. They go to the cash flow statement and look and see what's going on there and then kind of go back to the income statement and the notes to see: Does it make sense and does it hang together? … You almost would get to a point where, with this kind of private enterprise, the cash flow statement should be first with the notes and potentially the other pieces behind, because I think that's the way everybody works with them. And if you had seven or eight pages in a financial statement the lenders and the bankers and to some extent some of your shareholders may flip to page six first, start from there, look from that and then go backwards to the front of the group. I think it's that important."
– Steven Bryce, Vice President, Finance, Metro Retail Supply Chain Solutions

"In terms of the venture capital community and particularly in the businesses that Lumira Capital invests in, we are often investing in a cash burn company. So a statement of cash flow is important. The annual financial statements are really just a summary snapshot of a company's position and activities and the opportunity to have a third party scrutinize and concur with that reported position. What we get is adequate, but we're really looking at monthly cash flows and how those cash flows unwind over time and whether they're comparing to budget and at what point the company runs out of cash. So the month it the Company runs out of cash and how far forward in time is important to us. So it's monthly cash flows and the projection out into the future of those cash flows, which are outside of the reported financial statements, that would be most important. In terms of what's presented in the audited financials, it's generally adequate for external reporting."
– Stephen Cummings, Chief Financial Officer, Lumira Capital Corp

Forward looking information

It could be beneficial for the financial community to develop standards on forecasting, according to Florian Meyer, Finance Practice Leader at Newhouse Partners Inc. Meyer recalls a decade ago during the tech bubble seeing companies doing IPOs with nothing but a vision or a bit of software, yet having very high valuations. "There should be some kind of discipline similar to the historical preparation that you would have on the future," says Meyer, although he adds: "Whether we could ever get to that, that's a question mark." However, others say users of financial statements have a responsibility to do their own due diligence when it comes to forecasts. According to Patrick Leung, Chief Financial Office of Tristan Capital Inc., "a banker should already have an expectation of the answer from a lender and the due diligence confirms or requires a revision in that answer". "As long as you follow good modeling practices as set out from many books on the matter, any revisions in assumptions should come out in the due diligence" Leung says.

THE IMPORTANCE OF CASH FLOW STATEMENTS

"Given the initial intent of a standardized GAAP prepared set of statements and the broad audience that you want to be able to use it for, it's a generic solution to everybody's needs, and then you have the individual requirements of the ownership or the creditors ... The difficulty associated with attesting to the accuracy and completeness of a financial forecast is very risky ... I couldn't envision a situation where you'd want to have them as part of the standard financial statement package.

The role that third party service providers, whether it's your auditors or whomever, could provide in respect of forward looking information, would be attesting to the completeness in disclosure of assumptions, the mathematical formulas associated with it and give some vetting to the process. I think that approach adds value, particularly for a lender group... People can make their determination on the validity of what's being presented at that point. However, I think that it would be very problematic to try to encompass something like this into the GAAP prepared set of financials."
– Mike McAloon, Chief Financial Officer, Flakeboard Company Ltd.

"If I was a public accountant I wouldn't do it. ... I just don't see the value of having a third party involved if you've got a good relationship between lender and the borrower."
– Tim Zahavich, St. Joseph Communications

"Depending on the transaction size, the financing term, the security behind the transaction and the purpose of the transaction, lenders would typically require a current budget and a three to five year plan. Lenders are quite aware that plans are assumptive and that longer term forecasts are at risk if the underlying assumptions are at fault. Having said that, this information provides key insight as to the cash flow sources and uses but more significantly, we can assess if the targets are realistic. Typically the CFO would present such information (often including lender assumptions)."
– John Barraclough, AVP Credit, Maxium Financial Services/Desante Financial Services

"In venture capital we live in that nether world of trying to assess future value constantly and so when we invest in the type of companies we invest in, we're really looking to put equity capital into a company to help it grow very rapidly over a three four year time frame and ultimately the value that we obtain, if everything goes well, is a multiple of our invested costs. So the value of future oriented financial information is high in this context from the point of view of the PE/VC analyst and the equity stakeholders of such businesses. Contrasting the need for future oriented information with the need to report historical cash flow information in the annual financial statements highlights a different user need, both of which are important."
– Stephen Cummings, Chief Financial Officer, Lumira Capital Corp.

Other issues

LENDERS' UNDERSTANDING OF NEW ACCOUNTING STANDARDS

Several forum participants expressed concern that the divergence of standards between IFRS for public companies and ASPE for private companies will cause problems for lenders who must now adapt to two different forms of reporting when assessing financing requests. In particular, there is concern that any training done at lending institutions will focus on IFRS and training for private company standards will lag behind. "I am concerned about the readiness of financial institutions in ensuring their account management and credit groups understand the implications to future reporting of both IFRS and private company GAAP," says John Cole, Chief Financial Officer, Loewen. "Already, the transition to IFRS for public companies has required a significant investment in staff training and awareness by the banks. The introduction of private company standards will introduce a further layer of staff training requirements."

This concern was echoed in a previous CFERF study entitled "Issues in Private Company Reporting", released in the spring of 2009. In that report, financial executives cautioned that the differences between IFRS and the new private standards could pose a problem for private companies in accessing equity and debt financing due to the lack of comparability between the two standards. However, smaller companies were more preoccupied about the intense resources that would be required to convert to IFRS. (According to the study, only about 25% of leading Canadian private companies were planning to adopt IFRS).

The importance of private companies having the flexibility to report using the simplified standards of ASPE, was reiterated this year by John Forester, Chief Financial Officer, NUCAP Industries Inc. While some private companies may choose to use IFRS with a view to going public in the future, the reality is that most won't, so they have to consider their priorities. Says Forester: "One of the biggest dilemmas that every company faces is you need to make money every year and you've got to manage your costs ... So the bottom line is we need to allow companies to do what they do well, not to build too much unnecessary infrastructure and to the extent financial reporting plays a useful role without the significant cost that goes with it. That's really important to a smaller private company ... how to manage the expenses of the business and the complexity to match the business."

"Having a difference in accounting standards is problematic, but the reality is we can't impose unnecessary expenses. Because too many businesses do fail, too many businesses do struggle, too many times you spend time with your bankers going: "Okay here's how we're going to get through the next six months", and they're going to say: "Well, what are you doing about it"? Well, what you don't want to be doing is incurring unnecessary expenses to get there, and often the overhead expense is the first place anybody is going to look. Do you really need to be doing that? So that's the balancing act that we have to always keep in mind when going forward with this."
– John Forester, Chief Financial Officer, NUCAP Industries Inc.

ASSESSING FINANCIAL VIABILITY OF BORROWERS: THE LENDERS' VIEWS

The committee which helped draft the ASPE, the new financial reporting framework for private enterprises, included members of the lending community. Committee member John Barraclough, AVP Credit of Maxium Financial Services/Desante Financial Services, said lenders made a key concession to allow practitioners more discretion with respect to exercising their own judgment. Barraclough said lenders strongly believed that the AcSB had the appropriate checks and balances within the ASPE guidelines to effectively require preparers to exercise sound judgment in the context of taking the next step in disclosure if guideline prerequisites were not in compliance. Says Barraclough: "For sure there will be tension between yourself and your customer, but at the end of the day, lenders are relying upon the professional conduct prescribed by the CICA to ensure that guidelines are followed. The bottom line is lenders expect that the standards of the Institute and the professionalism of the individual preparer."

One of the benefits to a company of having fulsome disclosure, according to Mark Walsh, Principal at the Accounting Standards Board, is that the time to complete a financing will be minimized. Says Walsh: "One of the benefits to a company of having fulsome disclosure is that if you want to do a transaction with a lender, it'll go a lot quicker if the information's there upfront. Often companies do want to do these transactions fairly quickly, so there is an incentive to think through – not to disclose every little thing that's gone on – but to figure out what's really useful for the lenders to know. If they do this, they can then process that transaction a lot faster. If they've got to come back and ask additional questions, that just delays things."

"We receive financial statements from preparers, and I don't think that reduced disclosure is really going to affect the analysis that we perform after receiving those financial statements. We typically take a Directors seat on an investee company's board, so we would have fairly close insight to the reported numbers. So I don't really see that less disclosure is an issue when also coupled with the level of due diligence that we would typically perform along with our routine requirements for extra information."

– Stephen Cummings, Chief Financial Officer, Lumira Capital Corp.

Conclusion

Lenders use a range of disclosures from a private enterprise financial statement when determining whether the entity should get a loan; typical financial statements based on the new generally accepted accounting standards for private enterprises (ASPE) are likely to meet those needs. However, as preparers of financial statements for private enterprises need to maintain the trust and confidence of lenders, additional disclosures may be beneficial in obtaining financing.

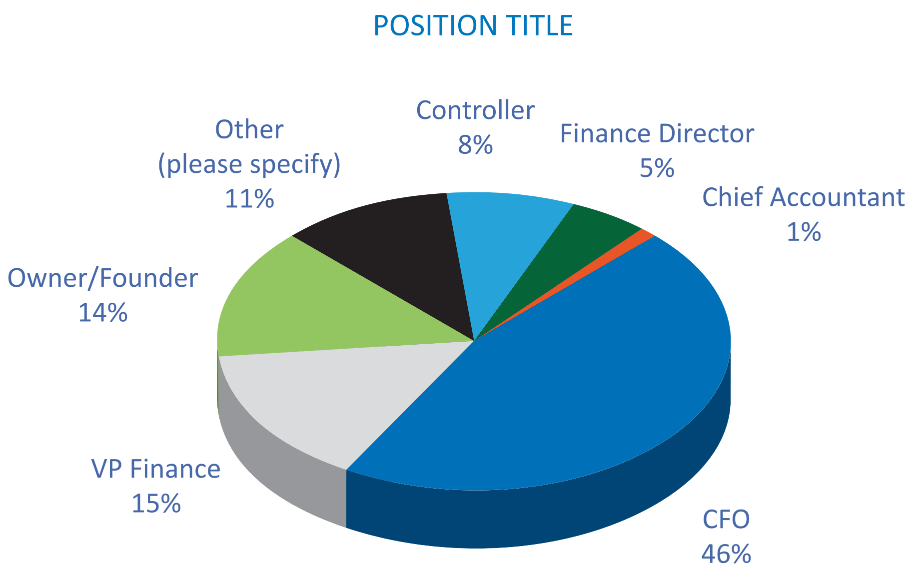
When lenders look at financial statements and use them as a snapshot of a company's general overall financial health, they tend to see them as a baseline, a starting point which is considered more reliable if the statements have been audited. That said, financial statements may not be the most current information available to the banker when making their decision, given the time it takes to finalize and audit the annual financial statements.

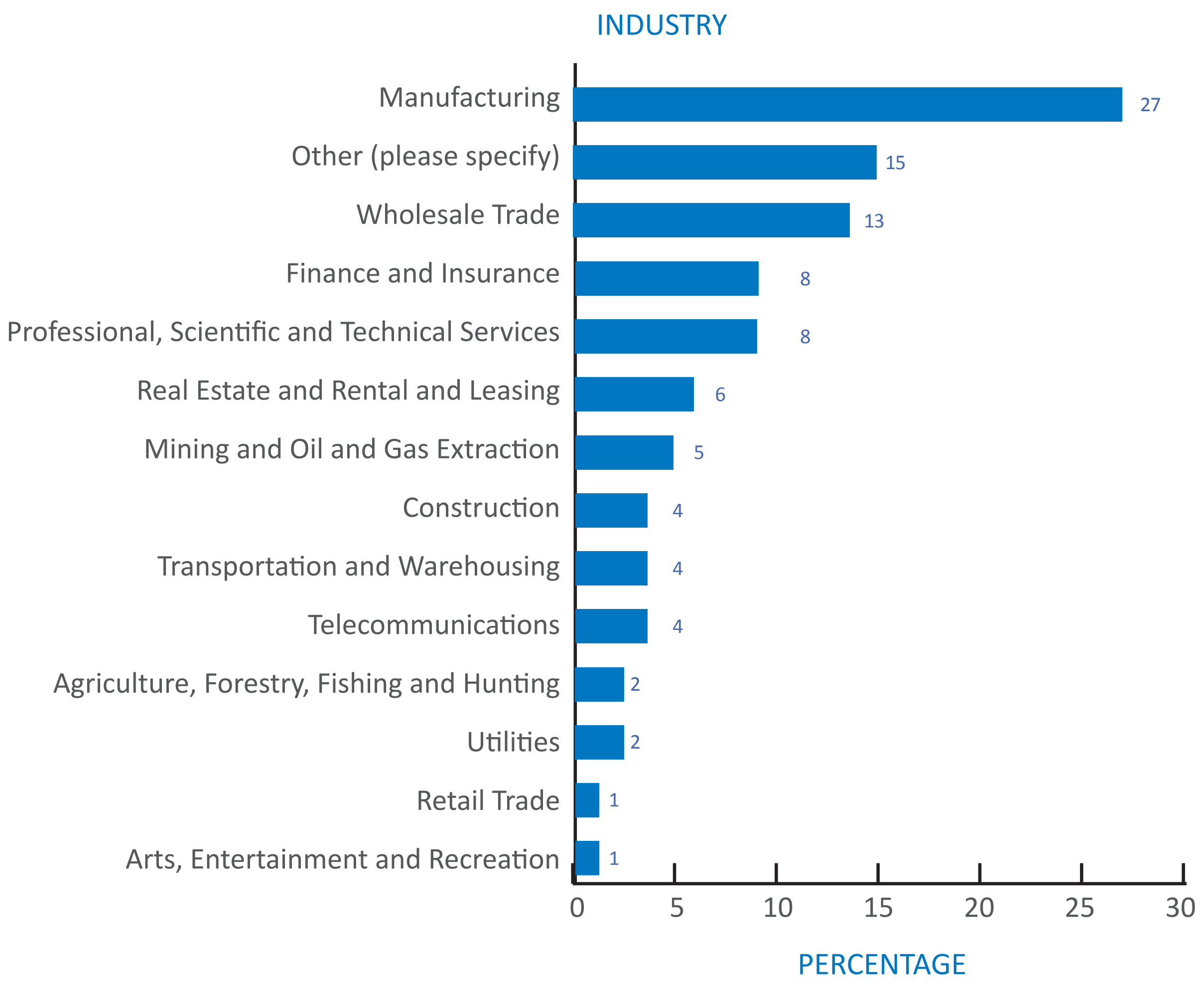
While some might question why a lender would use unaudited financial information, companies believe that when a solid, stable relationship based on trust has been formed between a company and its creditor, the lender will be more likely to accept such financial information as reliable, and the company can then develop a routine information sharing relationship with its lender on that basis. Some study participants observed that while owner-shareholders may focus on the "bottom line", lenders are generally more sophisticated and interested in the cash flow information, the notes accompanying the statements, and/or other additional disclosures.

Survey respondents confirmed that most required disclosures under ASPE are perceived to be of value to the lender relationship throughout the life cycle of a credit. While additional disclosures would be of value, most were not perceived to bring a benefit sufficient to warrant the costs of preparation.

In conclusion, accounting standards for private enterprises which will be soon be used in preparing financial statements of private companies provide a consistency that lenders can use to compare company to company within sectors, and in assessing liquidity, security and cash flow. The information is perceived as useful in granting, monitoring and renewing credit, due to the use of consistent standards and principles. However, because the annual financial statements may not present the most up to date picture of a company's finances, the annual statements likely will not be the only tool used by the lender in making its final decision. That final decision will be based on a wide range of information which may or may not be included in financial statements, including cash flow and compliance with debt covenants, and internal company information with which the banker feels comfortable. What is clear is the importance of the company establishing a solid rapport with its lender – financial statement disclosures can never replace trust.

Appendix A – Survey Demographics




INDUSTRY
Manufacturing
Other (please specify)
Wholesale Trade
Finance and Insurance
Professional, Scientific and Technical Services
Real Estate and Rental and Leasing
Mining and Oil and Gas Extraction
Construction
Transportation and Warehousing
Telecommunications
Agriculture, Forestry, Fishing and Hunting
Utilities
Retail Trade
Arts, Entertainment and Recreation
27
15
13
8
8
6
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4
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2
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1
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5
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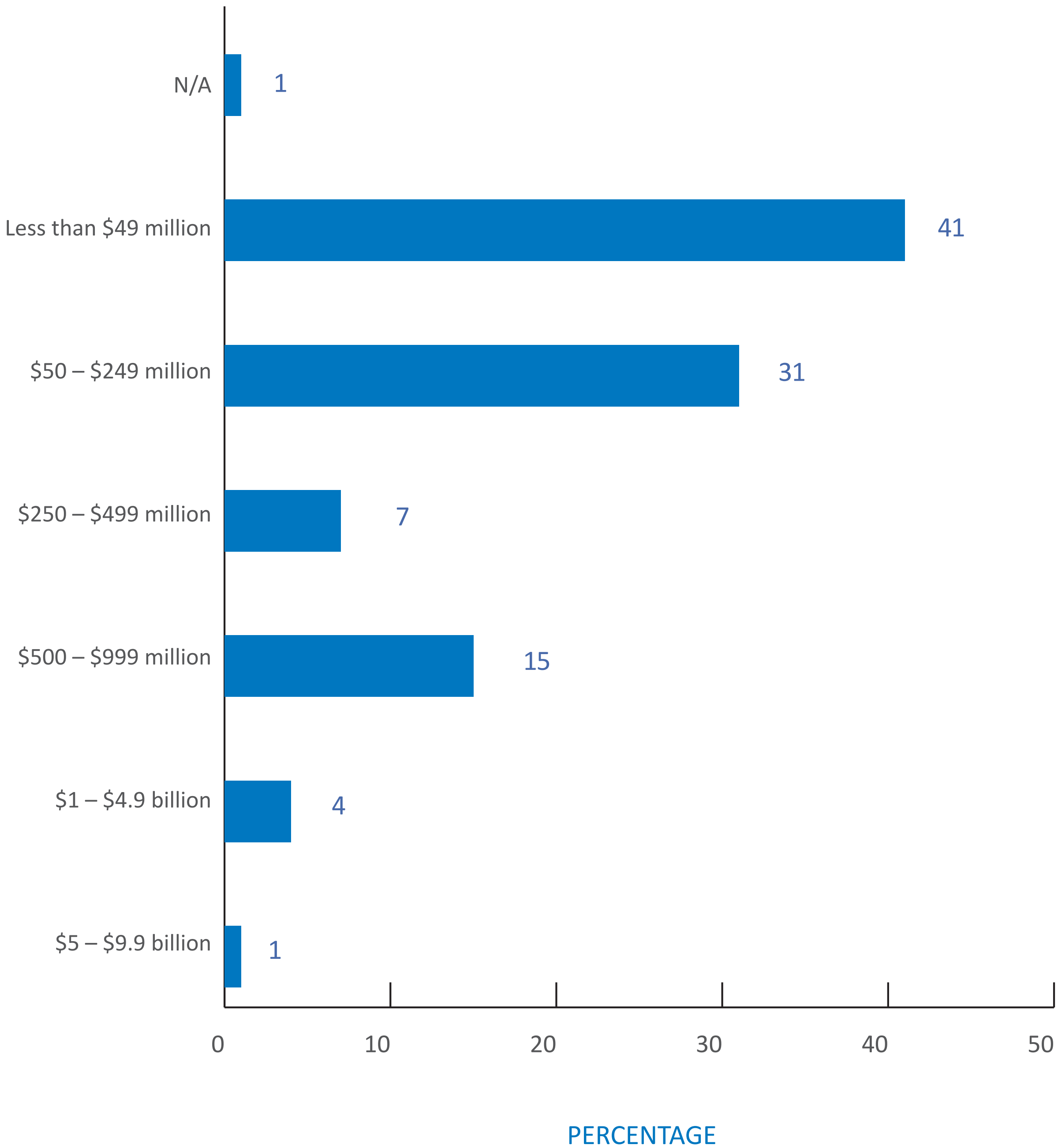
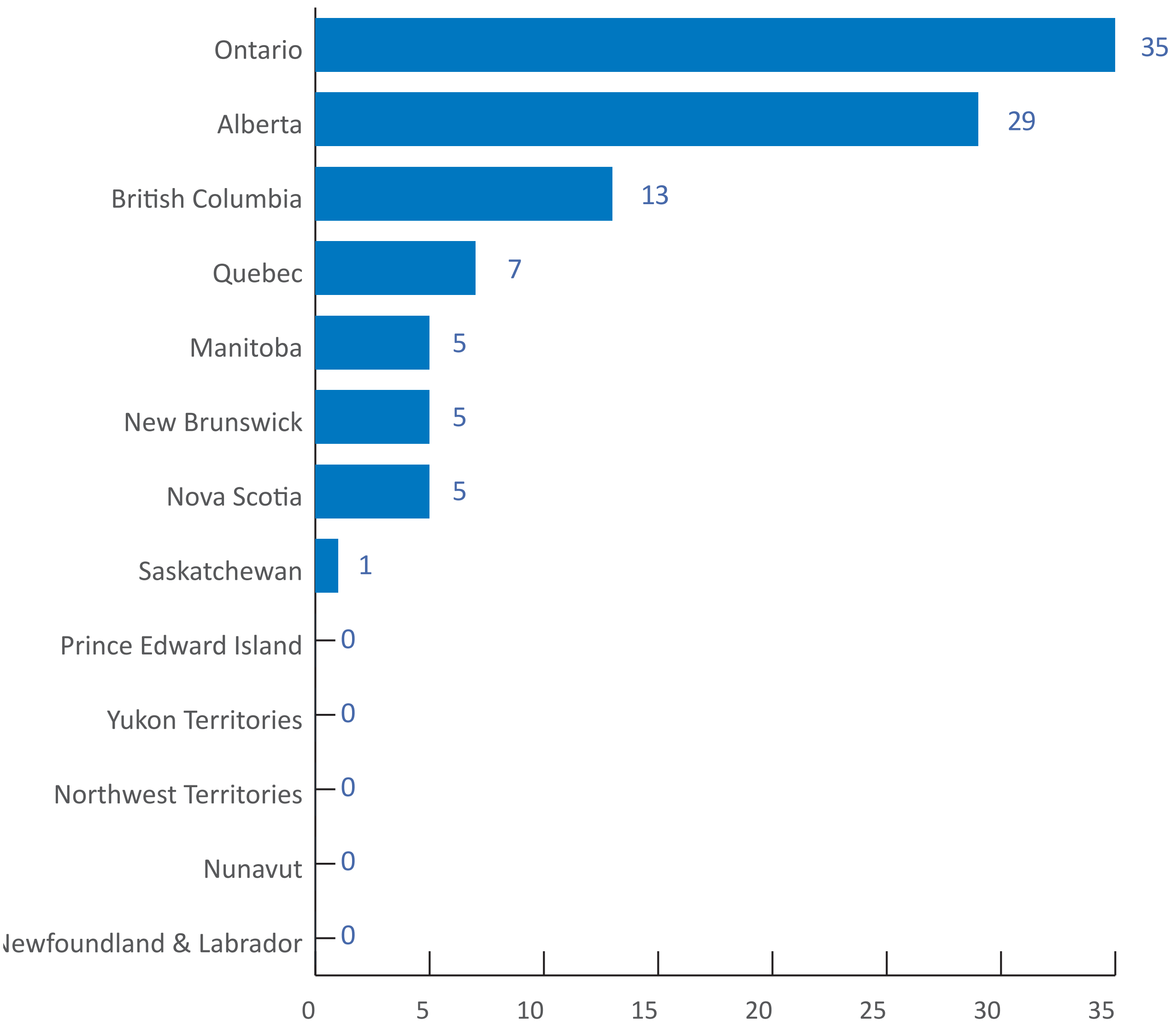
25
30
PERCENTAGE

ANNUAL REVENUE



HEADQUARTER LOCATION



PERCENTAGE

Appendix B – Forum Participants

Forum Chair:	Michael Conway – Chief Executive & National President, FEI Canada
Moderators:	Ramona Dzinkowski – Executive Director, CFERF Bob Young – Partner, KPMG Enterprise
Participants:	John Barraclough – AVP Credit, Maxium Financial Services/Desante Financial Services Steven Bryce – Vice President, Finance, Metro Retail Supply Chain Solutions Anne Burpee – Chief Financial Officer, South Western Group John Cole – Chief Financial Officer, Loewen Stephen Cummings – Chief Financial Officer, Lumira Capital Corp. Elda Fares – Partner, KPMG Enterprise John Forester – Chief Financial Officer, NUCAP Industries Inc.. Dennis Fortnum – National Leader, KPMG Enterprise Patrick Leung – Chief Financial Officer, Tristan Capital Inc. Mike McAloon – Chief Financial Officer, Flakeboard Company Limited Florian Meyer – Finance Practice Leader, Newhouse Partners Inc.. Ian Robinson – Vice President and Chief Financial Officer, Avant Garde Energy Corp. Siva Sivarajah – Secretary & Treasurer, International Custom Products Inc.. Mark Walsh – Principal, Accounting Standards Board of Canada Tim Zahavich – Chief Financial Officer, St. Joseph Communications
FEI Canada:	Laura Bobak – Senior Writer, CFERF Melissa Gibson – Communications & Research Coordinator, FEI Canada
Observers:	Tracy A. Holotuk – National Marketing Director, KPMG Enterprise

Appendix C –
Selected disclosures required under ASPE

ACCOUNTS RECEIVABLE

- The carrying amount of impaired accounts receivable and the amount of any allowance for impairment
- The exposures of accounts receivable to risk and how they arise, including concentrations of risk (credit risk, currency risk, interest rate risk, liquidity risk, market risk, other price risk)

INVENTORIES

- The amount of inventories recognized as an expense during the period, i.e. cost of goods sold

PROPERTY, PLANT & EQUIPMENT

- A description of impaired long-lived assts, i.e. long-lived assets whose cost is not recoverable, including the facts and circumstances leading to the impairment
- The amount of impairment loss on property, plant & equipment included in income

TRADE ACCOUNTS PAYABLE

- The amounts payable at the end of the period in respect of government remittances

LONG-TERM DEBT

- Any debt instrument in default or breach of any term or covenant that would permit a lender to demand accelerated repayment
- Whether any default was remedied or the terms of the liability were renegotiated before the financial statements were completed
- The exposures of long-term debt to risk and how they arise (credit risk, currency risk, interest rate risk, liquidity risk, market risk, other price risk)

CASH FLOWS

- Investing and financing transactions that do not require the use of cash or cash equivalents, including all relevant information

Appendix D – Possible additional disclosures

ACCOUNTS RECEIVABLE

- The ageing of accounts receivable, i.e. a maturity analysis

INVENTORIES

- The amount of inventories whose cost exceeds net realizable value
- The circumstances resulting in a provision for impairment or the subsequent reversal of a write-down of inventories

PROPERTY, PLANT & EQUIPMENT

- The fair value of property, plant & equipment
- The estimated salvage value or disposal value of plant and equipment at the end of its estimated useful life

TRADE ACCOUNTS PAYABLE

- The ageing of accounts payable, i.e. a maturity analysis

LONG-TERM DEBT

- The priority of security positions on collateral
- The fair value of debt instruments
- A sensitivity analysis for each type of market risk to which the entity is exposed

CASH FLOWS

- Cash flows for interest and dividends received and paid
- Cash flows arising from income taxes

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