Deciphering financial statements for non-financial professionals

6 Things Every Director Needs to Know About Financial Statements

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This eighth post in my *Deciphering Financial Statements for Non-financial Professionals* series discusses financial statement concerns for directors and questions they should ask to assist in discharging them of their fiduciary duty as a director. In this series of posts, I provide insight into financial reporting and related topics geared toward non-financial professionals who are required to understand financial statements as part of their professional roles. I encourage you to also read the other installments in the series, both past and future, particularly the introduction as that post establishes the series and includes a number of resources you may find useful.

If you're a director of a corporation in Canada, in exercising your powers and discharging your duties as a director you must, among other things, exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances in adherence to the requirements of the Canada Business Corporations Act. Fiscal responsibility plays a significant part in the role of a director and knowledge is key in discharging one's responsibilities. Understanding financial statements is a foundational skill essential to any board member. Depending on the nature of the organization the financial statement issues may vary widely. That said, there are a number of commonalities across financial statements, the understanding of which can assist you in monitoring your organization's ongoing financial reporting.

1. The presence of an auditor's report does not ensure a company is free of fraud

Fraud can take many forms including misappropriation of assets, corruption and financial statement fraud. An audit involves certain considerations with respect to identifying indications of fraud; however it is important to understand that a standard financial statement audit is not designed specifically to identify fraud. Should the auditor identify fraud or indicators of fraud during their audit, they are obligated to take appropriate action, which ranges from informing an appropriate level of management of their findings to resigning altogether from the audit engagement. However, a well-orchestrated fraud, particularly one involving collusion, may not be identified by standard audit procedures.

The best tool to prevent and detect fraud is having anti-fraud policies and procedures. An important aspect of this is a well designed and executed internal control structure. The design of such internal controls should take into account specific fraud risks to which the company may be exposed and the cost vs. benefit of mitigating such risks. Proactive companies will take such issues into consideration when entering into new lines of business or branching out into new geographical areas, particularly where business practices differ from home.

If you do suspect that a fraud has occurred within your company, it may be necessary to bring in a specialist to assist in identifying and quantifying the fraud and suggesting measures to prevent similar frauds from occurring again. In addition, the specialist can assist is dealing with recovery options (insurance, civil or criminal), preserving evidence and employee termination options. The involvement of a third party is key given that there is a very high cost of fraud including reputation risk. A swift and professional approach to managing a fraud investigation will provide much-needed assurance to stake holders.

2. Most audits do not ensure that internal controls are well designed or carried out effectively

A standard financial statement audit does involve an assessment of a company's internal controls, largely for two purposes (1) where internal controls may be tested to improve efficiency of the audit; and (2) to determine whether weaknesses in the internal control structure may give rise to audit risks. Further, when the auditor is considering internal control issues, they do so in the context of materiality, which often leaves smaller, yet operationally significant, weaknesses undetected. It is important that management and the Board not rely on a clean auditor's report as an indication that internal controls are functioning effectively. Management should periodically review the company's internal controls to ensure they remain appropriate and perform periodic tests of their effectiveness to ensure they're being carried out effectively.

An important caveat to the above is that there are specific audits carried out to test the design and effectiveness of internal controls, such as those performed for the issuance of a Service Auditor Report. Such audits are carried out only in certain circumstances and typically only for organizations providing third party services, such as payroll providers. The resulting reports will clearly identify that they were for the purpose of testing internal controls.

The key here is to read the auditor's report and be sure you understand what they are expressing an opinion on.

3. An organization's management is responsible for the financial statements and the many decisions that factor into their preparation

The preparation of financial statements involves a combination of science and art - a matrix of management judgments and estimates, selection of accounting policies, and interpretations of accounting standards. An auditor performs procedures to ensure that the position management has taken is appropriate within the relevant accounting standards, but it is management who makes the decisions and the picture that is presented through the financial statements reflects their position.

As the Board oversees the company's management, they should be asking management what alternatives have been considered in the selection of the company's accounting policies, in the determination of judgments and estimates and interpretation of accounting standards as significant items such as these can have a significant impact on the overall picture presented by the financial statements. This is especially true where the outcome appears illogical or counterintuitive. There are many cases where it simply isn't possible to present as pretty a picture as may be desired, but it's always good to ask what the alternatives are and what the results of those alternatives may look like.

At the end of the day, the goal is to provide transparent financial statement disclosure that demonstrates the spirit of the transactions the company has been a party to during the periods presented.

4. Financial statements' reliability can vary widely

In a previous post, I discussed the various levels of assurance that may be provided on a set of financial statements, with that level of assurance indicating how reliable those financial statements may be. In the context of audited, reviewed or non-audited financial statements it is important for the Board, or any reader for that matter, to take into consideration the company's internal controls affecting financial reporting. Such internal controls include the standard 'checks and balances' but also include items such as the qualifications and experience of the individuals involved and their respective workloads.

As a company grows in complexity, it is important to ensure that staff supporting the financial reporting function are adequately trained, offered the opportunity to update their knowledge and, when necessary, are supplemented through the addition of consultants or other technical resources. Workload issues can also present a challenge, in both a growing and a shrinking company, in the preparation of accurate and timely financial information. Management should query such items to ensure the financial reporting personnel have the resources they require to produce a consistent, quality product. Should there be concerns about lack of such resources, the Board should dig deeper into the financial reporting to ensure its quality has been maintained and establish measures to remediate the issue.

5. An audit does not ensure a company's operations are run efficiently

By their nature, financial statements tell you what has happened in the past, information that may help form expectations of future results. This information is valuable from a big picture perspective, but reveals little about whether the company is well managed, has the right strategic direction, or is operating to its full potential. These finer details are vital to a company's ongoing health and require close attention from the Board and management.

To gain the necessary insight to evaluate these finer details, additional reviews (beyond those into the company's financial statements) may be advisable. The type and depth of these reviews will vary depending on scope and complexity and will need to be customized with the input of the Board and management. Depending on the internal resources available, a consultant may be a good alternative to assist in designing and/or delivering such reviews and analysis.

6. Financial statements require interpretation in order to evaluate a company's performance

A company's financial statements present a wealth of information on which to evaluate its performance. However, it is up to the reader to evaluate and interpret that information. Such evaluation may include the review of supplementary information such as an aged payables listing; discussion with the company's finance personnel and management; or the application of financial analysis tools such as ratios. In a previous post I provided a number of ratios and similar tools that can be applied in the evaluation of a set of financial statements.

Many finance teams will prepare a monthly or quarterly report for the board's consideration that will include such information and analysis, the content of which should serve to assist the directors to evaluate performance and thus fulfill their fiduciary duty of oversight.

Thank you for reading my post. I hope that you've found it to be useful and informative. Don't forget to follow me and join my LinkedIn group, BDO Global Mining, so you don't miss my future posts. If you would prefer to receive a PDF copy of this and past/future posts in the series, please message me to receive a copy. Please do reach out to me (or better yet, comment below) if you have specific questions or comments that go beyond the depth I've provided.

About Bryndon Kydd:

As the National Leader of BDO Canada's Mining Sector Group, Bryndon provides practical, customized solutions tailored to fit the needs of each company he works with. His core practice focuses on Canadian and US-listed mining companies with either international or domestic operations. Bryndon currently serves as BDO Canada's representative on the CPA Canada Mining Industry Task Force on IFRS and as Vice-Chair of the Canadian Institute of Mining, Metallurgy and Petroleum's Vancouver Branch.

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