

# Phase 5

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# Equity Drive



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# Disclosure Document and Equity Drive

## Determining Equity Requirements

By this time the new cooperative venture has gone through a series of stages, including:

- the identification of needs,
- an understanding that the cooperative model can best serve these needs,
- an extensive and comprehensive business plan,
- basic organizational structure, leadership and management are either in place or at least clearly understood, and now the organization faces the challenge of raising capital.

The greatest challenge new cooperatives face is raising the capital necessary to start.

Raising investment from members will provide some of the venture capital required to start a cooperative enterprise, but this is seldom sufficient. In order to generate significant amounts of capital required for start-up, cooperatives can generate Offering Statements outlining investment opportunities for non-member or member investment outside of "membership shares". These are not unlike a prospectus prepared for a private corporation, but are generally less stringent and less expensive. The Offering Statements will require provincial government approval.

The greatest challenge is raising capital from non-members. Investors are most interested in creating wealth, and may not be motivated to make investments that are not linked to control.

## Establishing Capital Requirements of Various Enterprises

Depending on the nature and size of the proposed enterprise, capital must be sufficient to start the business and bring it to a position where retained earnings and profits can become a reality.



All industries or ventures have capital or equity standards (the minimum generally required to get started in a particular industry).

Most lenders will provide equity requirements upon request, but these are commonly in the range of 35% at a minimum for qualifying assets.

Assets such as inventory (raw materials and finished goods) or work in progress are normally discounted entirely, or at the very least they are subject to further discounts depending on their saleability in the event of default. Where a cooperative has finished adding value and has sold the goods or services on credit, creditors may be willing to finance a portion of the current receivables, but discount any accounts that fail to meet the terms and conditions of the trade credit offered by the cooperative. The following chart provides some sample equity guidelines for consideration (credit sources have various policies and special financing requiring reduced equity may be available from government programs):

<b>Item</b>	<b>Standard equity required</b>	<b>Comments and normal limitations</b>
<b>Land &amp; buildings</b>	35%	Depends on marketability and potential for alternate use
<b>Equipment</b>	35 to 50%	Depends on marketability and potential for alternate use
<b>Raw materials</b>	100%	
<b>Work-in-progress</b>	100%	
<b>Completed inventory</b>	50 to 100%	Depends on saleability – market value
<b>Accounts receivable</b>	50%	Generally valued net of accounts payable and discounted for overdue accounts
<b>Expenses to cash-flow</b>	100%	

As you can see, the start-up equity capital required may be far greater than anticipated. The business plan will outline the amount of equity required for start-up, including for periods such as construction, staffing, production and the business cycle, to the point where the enterprise begins to receive incoming cash flow. In many cases the costs of bringing the enterprise to a cash flow position can be greater than the initial construction costs. Delays at any of these stages can be catastrophic, and the equity plans should provide some comfort that at least minor problems can be overcome.

### **Financial Structure and Share Capital**

New generation cooperatives is a term increasingly in use to describe cooperatives whose members produce and deliver something that is then centrally marketed (whether or not it is processed). An example may be a milk marketing cooperative where the members are individual organic milk producers who deliver their milk centrally to be processed, packaged and sold through an operation that they own.

These are increasing in popularity and generally focus on value-added processing or manufacturing. Their financial structure and share capital are quite different from traditional cooperatives. The following describes such ventures:

- A significant equity investment is required by each member, with the total initial equity contribution being a major portion of the gross project costs.
- A two-way contract between the member and the cooperative requires each member to deliver, and the cooperative to accept, an agreed-upon amount of the raw commodity for each delivery right (known as “special investment share” under Manitoba legislation) owned by the member.
- Membership is limited to the number of special investment shares (delivery rights) required to be sold by the cooperative to its members in order to meet its processing capacity.

This is an alternative to seeking membership shares and other non-member investors.

An **Offering Statement** is used where a cooperative is seeking equity investment capital from its members. It is relatively inexpensive, quite popular and can be approved outside of the Securities Commission. A new start-up cooperative can likely get assistance preparing an Offering Statement from a cooperative organization which has gone through the exercise. A **Prospectus** is used where the investments sought include those from non-members. It requires extensive specialized legal and accounting assistance, is very expensive and must have the approval of the Securities Commission.

### **Start-up and Ongoing Equity Capital Requirements**

All cooperatives require member share capital, and where that share capital is not sufficient for start-up or expansion costs, additional offerings and sources of equity or risk capital are required. Cooperatives have used Offering Statements and other legal means to offer a variety of shares. Examples of this would include Common Shares (beyond membership requirements), Preferred Shares and Surplus Shares. Often plans and provisions are made to redeem start-up shares once the cooperative can build sufficient retained earnings and other generated equity to sustain



Ongoing equity capital, beyond common shares required for membership, is most often held in the form of retained earnings. Theoretically, if the cooperative ceased its enterprise, sold all of its assets, paid its creditors and paid out any preferred shares, the retained earnings would be available for distribution to members equally.

operations.

In order to reward the members who provided success by virtue of greater patronage, cooperatives often create a special share class called "Surplus Shares". These shares are not available for purchase; rather they are based on patronage rewards. Instead of paying patronage cash, the cooperative may provide for the issue of Surplus Shares in lieu of cash. This allows the cooperative to show recognition while retaining equity capital for growth and expansion.

Share dividends are taxed to the individuals rather than the cooperative, which allows the cooperative to grow equity at an increased rate. The benefit to the member-owner of Surplus Shares is that the equity is earmarked for them directly as opposed to distribution at large. Cooperatives have specific redemption policies for shares, including those related to Surplus Shares.

### **Laws Surrounding Getting Permission to Sell Securities**

#### **Overview of Provincial Requirements:**

Cooperatives are largely governed in Manitoba by the Cooperatives Act, the Cooperatives Regulations, the Securities Act and the Securities Regulations with respect to the issuance of securities.

The cooperative must have the ability to sell securities, as authorized through its articles. It also needs to meet the requirements set forth in the Cooperatives Act, the Cooperatives Regulations, the Security Act and Security Regulations.

Articles of Incorporation:

For a cooperative to issue securities, the articles must include provisions for the cooperative to issue investment shares. The articles will specify:

- a. Whether the investment shares can be issued to non-members,
- b. The maximum number of investment shares that can be issued,
- c. The number of classes of investment shares,
- d. (where more than one class of investment shares is created) the differences between classes,
- e. The preferences, rights, conditions, restrictions, limitations and prohibitions attached to the investment shares,
- f. The amounts payable to the holders of any class of investment shares upon redemption of the shares or dissolution of the cooperative, and
- g. The protocol for conducting meetings of the investment shareholders, including the quorum, voting rights, voting methods and impact of votes by the investment shareholders.

If the directors of the cooperative invoke their authority under the articles to issue an offering of investment shares, a certified copy of the resolution of the directors must be provided to the Superintendent of Cooperatives (Financial Institutions Regulation Branch – FIRB) before the investment shares are issued.

Security Issuer:

In order for a cooperative to issue securities to the public, the cooperative must be registered with the Manitoba Securities regulators as a “security Issuer”.

The cooperative must apply to the Director of the Manitoba Securities Commission to become a security Issuer by completing and submitting a Manitoba Securities Commission Form 1: *Application for Registration as a Broker, Investment Dealer, Broker-Dealer, Underwriter, Security Issuer, Investment Counsel, Securities Advisor or Mineral Interest Broker* form, as outlined in the Securities Regulations part 1.

The Director may grant the cooperative unconditional status as a security issuer, or the Director may require a bond be placed with the Securities regulators within a specified period.

The registration will be valid for a period of one (1) year and must be renewed on the anniversary date. The renewal must be submitted no later than thirty (30) days prior to the expiration date using the Manitoba Securities Commission Form 3.

The full details of any changes to the previous registration information must be articulated.

If any changes occur during the year to the following, the director of the Securities regulators must be advised in writing within five (5) days of the change:

- a. Address for service or any business address,
- b. Officers, directors, officials or partners, or
- c. The commencement and termination (including reason) of the sales staff.

### Offering Statement:

An Offering Statement must be prepared and sent to FIRB before the cooperative can issue any shares or other securities, where any of the following applies:

- The par value of membership shares required to be purchased to obtain membership is greater than \$1,000.
- The requirement for membership involves the purchase of membership shares and the making of member loans with a total value greater than \$1,000. If a cooperative undertakes to issue shares or other securities to its members, where the par value of the shares or securities.
- Investment shares are being offered to members only.
- Special investment shares (delivery rights) are being issued.

Upon approval of the Offering Statement, FIRB will issue a receipt to the cooperative, who may then initiate the sale of the investments.

The Offering statement must contain the following information:

1. Name and registered office of the cooperative.
2. The type of securities being offered.
3. A table of contents.
4. Definitions.
5. Brief history of the cooperative, including its purpose, aims and objectives.
6. Information on ownership and control of the cooperative.
7. Full disclosure of business information including:
  - Industry profile.
  - Economic dependence on specific customers/suppliers and effect of loss of those customers/suppliers.
  - Marketing plan.
  - Disclosure of requirements for obtaining licenses, permits or approvals.
  - Environmental compliance.
  - Real estate holdings or requirements.
  - Insurance requirements.
  - Business plan.
8. Details of the cooperative's subsidiaries or affiliations that have a bearing on its operations.
9. Listing of directors and officers of the cooperative and their addresses
10. Listing of the cooperative's senior management, titles, responsibilities and brief profile.
11. Remuneration packages and expenses of directors and senior management.
12. Disclosure of any material interest of directors, officers or employees of the cooperative have with the cooperative through contracts.
13. Full description of the securities being offered.
14. Details of the purpose of the sale proceeds.
15. Details of escrow or trust accounts for proceeds of the sales.
16. Commissions.
17. Risk factors.

18. Capital structure of the cooperative.
19. If applicable, how patronage returns will be applied.
20. Restrictions on transfers of securities.
21. Distribution of surplus on dissolution of the cooperative.
22. Detailed listing of all mortgages, loans or other liabilities.
23. Details of any actions, suits or other legal proceedings in which the cooperative is involved
24. Reporting of any other material facts.
25. Financial reporting and auditor's reports.
26. Other relevant supporting documentation.
27. Subscription procedure.
28. Contractual rights of action for purchasers.
29. Declaration statement.
30. Signatures of all directors.

Amendments:

If any material changes occur in any of the information reported in the offering statement, the cooperative has thirty (30) days to provide notice to FIRB with an amending statement, or if required by FIRB, a revised offering statement. The cooperative will cease issuing any new shares until the Superintendent's receipt for the amendment or new offering statement is received.

Issuance of a Receipt:

FIRB may determine a submission for an offering statement or amendment will not be approved and a receipt not issued if FIRB believes:

- o The application or documentation:
  - o Does not comply with the requirements of the Cooperatives Act.
  - o Contains statements, information, projections or forecasts that are false or misleading.
  - o Contains information that is misleading, false or deceptive.
- o The projected funds raised from the sale of the security do not appear to be sufficient to meet the requirements of the objective of the offering statement.
- o An unconscionable consideration has been made for promotional purposes or for the purchase of property.
- o An escrow or pooling agreement deemed to be necessary has not been completed.
- o An agreement has not been completed to hold funds raised from the sale of the shares or securities in trust until the shares or securities are issued to the purchasers.

Obligation to Provide the Offering Statement:

The offering statement, plus any amendments to the offering statement, must be provided to any prospective purchaser of the share or security before the sale can be completed.

If a sale is made, the purchaser has until midnight of the second day, excluding Saturdays, Sundays and holidays, following receipt of the offering statement and any amending statements, to cancel a purchase.

### Fees:

At the time of publication of this material:

Filing an offering statement: \$200.

Filing an amendment to an offering statement: \$100.

### **Disclosure Document Requirements:**

When a cooperative obtains an exemption from filing an Offering Statement from FIRB, or from filing a Prospectus from the Securities Commission for the issuance of shares, investments or securities, a disclosure document, or Offering Memorandum, must still be submitted to FIRB or the Securities Commission. Exemptions are contained in National Instrument 45-106.

An Offering Memorandum is a less formal document than an Offering Statement or Prospectus, but still must identify the risks and conditions associated with the shares, investments or securities being offered. It can also be used to market and promote the issue to potential shareholders.

The most common exemptions are granted for issuance of securities sold to the following:

- An accredited investor.
- A private issuer.
- Family, friends and business associates.
- A specific group of purchasers, in particular for a new or developing enterprise where the exemption can only be used one time; this group includes those:
  - Who have special knowledge of the particular business.
  - Who have received professional advice about the specific investment.
- A specified type of purchaser; this exemption is generally used by an existing business that would not be in a position to issue a prospectus for whatever reason, but has a business and financial history.

The Offering Memorandum (Form 26, Securities Regulations) should contain the information detailed in [http://www.msc.gov.mb.ca/securities/forms/forms\\_links/form26.pdf](http://www.msc.gov.mb.ca/securities/forms/forms_links/form26.pdf) Form 26 Fees:

At the time of publication of these materials:

Filing an Offering Memorandum: \$650.

Filing a Notice of Intention to Trade in Securities (form 23): \$650.

### **Prospectus Requirements:**

If a cooperative wishes to undertake the sale of securities to the public, including non members, a prospectus must be submitted and approved by the Director of the Securities Commission. Securities cannot be sold until the prospectus is approved by the Director of the Securities Commission and a receipt issued to the cooperative.



A prospectus will provide a potential investor with a full description of the security being offered and the purpose for the funds being raised. It will be used both as a disclosure document and marketing tool for the security.

The cooperative will file a preliminary prospectus and prospectus for the security with the Securities Commission, unless an exemption is granted by the commission, as described above under Disclosure Document Requirements. (A detailed summary of exemptions are contained in the National Instrument 45-106 Prospectus and Registration Exemptions document). The preliminary prospectus will contain the same information as the prospectus, except the price to the underwriter and the sale price to the public, in addition to other factors directly dependent on these two items, may not yet be available.

The Director of the Securities Commission will review the preliminary prospectus and prospectus. If they are found to be satisfactory, a receipt will be issued for the preliminary prospectus and prospectus, authorizing the issuance of the security by the cooperative.

If the Director of the Securities Commission has issued a receipt for the preliminary prospectus, but not yet issued a receipt for the prospectus, the cooperative may initiate the solicitation of sales for the security and distribute the preliminary prospectus to potential investors to solicit expressions of interest in the security.

Contents of the Prospectus:

The prospectus must include the information listed below. Specific details and requirements are found in the Manitoba Securities Commission MSC Rule 2007-15F1: Form 41-101F1 Information Required in a Prospectus, and the Manitoba Securities Regulations.

The Director may determine a receipt, and therefore approval, of a prospectus will not be issued if the Director believes that:

- The application and documentation:
  - Do not comply with the requirements of the Securities Act.
  - Contain statements, information, projections or forecasts that are false or misleading.
  - Contain a misrepresentation.
- Unreasonable consideration will or shall be given in the solicitation or procuring of investors.
- The projected funds raised from the sale of the security do not appear to be sufficient to meet the requirements of the objective of the prospectus.
- The financial condition of the parties directly involved in the execution of the prospectus suggests it would not be financially prudent to undertake it.
- Past conduct of the issuer, its directors, officers, promoters or control persons or its investment fund manager or officers, directors or control persons is of concern
- Individuals or organizations involved in the certification of the prospectus are not acceptable to the Director.
- An acceptable escrow or pooling agreement has not been arranged.
- An acceptable arrangement has not been made for maintaining the proceeds of the sale in trust for the cooperative pending distribution of the securities.

### Fees:

At time of publication of this material:

Registration or renewal of registration as a security Issuer: \$ 750.

Filing a prospectus with the Securities Commission:

- For the sale of one class of security or unit offering (a unit offering being 2 or more classes of securities sold as one unit) \$1,000.
- For each additional class of security or unit offering - \$ 350.

### **Holding Funds in Escrow until Terms of Disclosure Document are Met**

If a cooperative is issuing a prospectus for its first or initial public offering (IPO) of a security, the Manitoba Securities Commission will usually require that the cooperative enter into an escrow agreement with its principals and an Escrow Agent.

An escrow agreement requires the principals to sign an escrow agreement and deposit their securities with the Escrow Agent. The principals are limited from selling or entering into any transactions with the securities until they are released from escrow in accordance with the terms of the escrow agreement.

### **Escrow Requirements: Legal and Practical:**

#### Issuers:

Issuers of securities are categorized into three (3) groups:

#### 1. Exempt Issuers:

The securities regulators may exempt Issuers from escrow for security offerings after their very first offering if they have:

- Securities listed on the Toronto stock exchange (TSX) and are classified by the TSX as an exempt Issuer.
- Market capitalization of \$100 million or more.

#### 2. Established Issuers:

The securities regulators will normally require escrow from Issuers where they have:

- Securities listed on the TSX but are not classified by the TSX as an exempt Issuer.
- Securities listed on the TSX Venture and is a TSX Venture Tier 1 Issuer.

#### 3. Emerging Issuers:

The securities regulators will normally require escrow from these Issuers who, subsequent to their first security offering, cannot be classified as an exempt Issuer or an established Issuer.

#### Escrow Agent:

The person or company acting as the Escrow Agent, can be an agent that has been approved by a Canadian exchange to act as a transfer agent.

#### Securities Subject to Escrow:

The following type of securities would be encompassed by an escrow agreement if the principal owns them immediately before the IPO and is not exempt:

- a. Share, including common, restricted voting, subordinate voting, multiple voting and non-voting shares.
- b. Convertible securities.

In addition, if a principal owns shares or convertible shares in escrow, and receives additional shares or securities as a result of their being issued:

- o As a dividend or other distribution,
- o As a result of the exercise of a right of purchase, conversion or exchange,
- o As a result of a subdivision or conversion or exchange,
- o From a successor Issuer in a business combination, then they, too, must be placed in escrow.

If a securities holder of escrow securities acquires additional escrow securities, they will also become part of the escrow agreement and be included in the escrow holdings.

Release from Escrow:

National Policy 46-201 Escrow for Initial Public Offerings details the time frames in which securities may be released from escrow under several scenarios.

The timeframes for release will depend on the classification of the security Issuer. Under normal circumstances, the escrow securities of an established Issuer will be released from escrow over an eighteen (18) month period, while an emerging Issuer will be over a three (3) year period. The timing may also be impacted by death of a security holder, conversion of an emerging Issuer to an established Issuer, or an Issuer becoming involved in a business combination.

- a. Established Issuer:

Under normal circumstances, the release of escrow securities from an established Issuer would be under the following schedule:

<b>Relevant date</b>	<b>Portion of escrow securities that can be released</b>
Listing date (on which the Issuer's securities are listed on a Canadian exchange).	1/4 of the escrow securities.
6 months after the listing date.	1/3 of the remaining escrow securities.
12 months after the listing date.	1/2 of the remaining escrow securities.
18 months after the listing date.	Remaining escrow securities.

- b. Emerging Issuer:

Under normal circumstances, the release of escrow securities from an emerging Issuer would be under the following schedule:

<b>Relevant date</b>	<b>Portion of escrow securities that can be released</b>
Listing date (on which the Issuer's securities are listed on a Canadian exchange).	1/10 of the escrow securities.
6 months after the listing date.	1/6 of the remaining escrow securities.
12 months after the listing date.	1/5 of the remaining escrow securities.
18 months after the listing date.	1/4 of the remaining escrow securities.
24 months after the listing date.	1/3 of the remaining escrow securities.
30 months after the listing date.	1/2 of the remaining escrow securities.
36 months after the listing date.	Remaining escrow securities.

Please see National Policy 46-201 Escrow for Initial Public Offerings or the Escrow Agreement for additional scenarios.

**Escrow Account Administration Responsibilities:**

The Escrow Agent is appointed by the cooperative. The Escrow Agent is responsible for maintaining the portfolio of escrow securities through the variety of circumstances where the portfolio may change.

Escrow Securities:

When a security holder subject to escrow signs the escrow agreement, Form 46-201F1, the holder's securities certificates or other evidence of those securities, which will be listed in Appendix A, must be delivered to the Escrow Agent.

If additional securities are received by the security holder based on these holdings as a result of any of the following, the security holder must also deliver them to the Escrow Agent:

- o As a dividend or other distribution,
- o As a result of the exercise of a right of purchase, conversion or exchange,
- o As a result of a subdivision or conversion or exchange,
- o From a successor Issuer in a business combination,

If any dividend payments or other distributions are issued on the escrow securities and received by the Escrow Agent, the Escrow Agent will pay the dividend or other distribution to the security holder.

Escrow securities may be pledged as security for a loan. However, the security certificates or other evidence of the escrow securities will not be released to the financial institution. There must be a provision made in the loan agreement to confirm that the financial institution is aware that the securities will remain in escrow, even if the lender realizes on the loan.

The security holder is restricted from completing a transfer of securities held in escrow, unless it is specified in the National Policy 46-201 and the escrow agreement.

#### Release of Escrow Securities:

Securities held in escrow may be released from escrow prior to the regulatory time frames provided above in the following circumstances:

#### Death of the Security Holder:

Upon death of the security holder, the escrow securities will be released from escrow to the security holder's legal representative upon receipt of the following:

- o Certified copy of the death certificate.
- o Evidence of the party's status as the legal representative of the deceased.

#### Change in Issuer Status:

If an emerging Issuer in an escrow arrangement becomes an established Issuer eighteen (18) months or more after the listing date, all escrow securities will be released immediately.

If the status changes within eighteen (18) months, any escrow securities that would have been scheduled to be released at the date the status changed, will be released immediately. The remaining escrow securities will be released in equal batches at the six (6) month, twelve (12) and eighteen (18) month dates from the listing date.

The new release schedule will take effect ten (10) days after the Issuer provides the Escrow Agent with a certificate signed by a director or officer advising:

- That the Issuer has become an established Issuer.
- That the release schedule for the Issuer's escrow securities has been changed.
- That the Issuer has issued a news release at least ten (10) days before of the release of escrow securities.
- The new release schedule.

To initiate the release of the securities under this situation, the Issuer will:

- File with the securities regulator, at least twenty (20) days before the date of the first scheduled release under the new release schedule, the following:
  - A certificate, signed by a director or officer, confirming the change in status.
  - A copy of a letter or other evidence from the securities exchange, confirming the change in status.
- Prepare a news release providing details of the first release of escrow securities and the change in the release schedule. Provide a copy of the release to the securities regulators at least ten (10) days before the release date.
- Provide a copy of the news release to the Escrow Agent.

#### Replacement Certificates:

Where a portion of a security holder's escrow securities are due to be released, but a security certificate represents more than what can be released, the Escrow Agent will

return the certificate to the Issuer and request a replacement certificate for the balance beyond the amount to be released.

Resignation of Escrow Agent:

Where the Escrow Agent resigns or is terminated by the Issuer, the following will be undertaken:

- The Escrow Agent will provide written notice of their resignation to the Issuer.
- The Issuer will provide written notice to the Escrow Agent of their termination.
- The Issuer must ensure the Escrow Agent is replaced by the designated date by someone acceptable to the securities regulator.
- The designated date will be sixty (60) days from the date notice is provided or at a mutually agreed upon date between the parties, but not less than ten (10) business days before the designated date.
- If a replacement is not in place within the sixty (60) days, the Escrow Agent can apply to a court for an appointment of a replacement.
- The successor will have the same powers, duties, rights and responsibilities as the former Escrow Agent, who is obligated to turn over all securities, records, documentation or other property held in accordance with their duties.

Reporting:

Financial Statements:

The Issuer is required to file its annual comparative financial statements and auditor's report with the securities regulators. The documentation provided will include:

- Income statement.
- Cash flow statement.
- Statement of retained earnings.
- Balance sheet.
- Auditor's report.

The annual return must be filed within ninety (90) days of the cooperative's financial year end.

Annual Information Form:

The Issuer is also required to file an *Annual Information Form (AIF)* Form 51-102F1, as outlined in National Instrument 51-102.

It must be filed within ninety (90) days of the issuer's financial year end.

Certification of Annual Filings:

In addition to the above, a *Certification of Annual Filings*, form 52-109F1, described in National Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings, is required.

A separate annual certificate is required for each person who is a certifying officer and must be signed by the certifying officer. The certificate states that the certifying officer has reviewed the Issuer's AIF and finds it to be a true representation of the facts.

## Basics of Finance, including Accounting and Financial Reporting

This section is intended to provide a general understanding of financial processes and the use of accounting information for cooperative boards. The concepts and principles that guide the preparation of accounting information will be applicable to a variety of situations.

### Types of Accounting Systems and Reporting Financial Transactions

Accounting provides a system to record, verify, and report financial change in the value of the assets and liabilities through the transactions of business. Put another way, it is a process to provide a historical view of business decisions (reflected in financial transactions) and their effect on the business. It explains the past, but does not predict the future. Historical financial information, however, based on reporting, can be used by boards and management to view trends and use as a basis for future planning. Accounting records the information and reports what has been done historically. Financial reporting (discussed later) helps businesses to interpret the results.

The accounting system records the transactions within a ledger, as credits or debits.

Bookkeeping is the act of recording the financial transactions.

Accounting Statements are the end result of the accounting process. They are used to provide a clear picture of the profitability and financial position of the business.

#### Some accounting concepts defined:

**Business Entity Concept:** this concept outlines that every business is treated as a separate entity. The financial information of a business should not include the financial information of any other business or personal assets of its owners.

**Cost Principle:** this holds that all goods and services purchased are recorded at cost. The cost principle measures items on a cash basis.

**Objectivity Principle:** this holds that all transactions are recorded at cost. The cost is an objective measure because the price has been established by the market.

**On Going Concern:** this concept holds that the assets on the balance sheet do not change in value to reflect market conditions.

#### Single Entry System

Single entry bookkeeping records income and expenses similar to a checkbook, where all transaction are recorded on a single line for each transaction. Only the difference between revenues and expenses are totaled. The single entry system can be as simple balancing a check book and is used primarily in very small (cash-based) businesses.

#### Double Entry Accounting:

Double entry accounting specifies that every transaction is recorded in two or more accounts, resulting in equal total debits and credits. From the perspective of the organization as a whole, the equation to balance all the entries is as follows:

Assets = Liabilities + Owners' Equity

To facilitate the equation the following rules apply:

- 1.) Increases in assets are debited to asset accounts; consequently, decreases must be credited.

- 2.) Increases in liability and owners' equity items are credited to liabilities and owners' equity; consequently decreases must be debited.

### Trial Balance

The total of the accounts on the credit side of the ledger and the debits side of the ledger is called the trial balance. The trial balance serves as a tool to detect errors, when the amount of the credits and debits are not equal. The trial balance is not absolute proof of accuracy. Errors can occur that offset each other and therefore do not affect the quality of its columns. Consequently, a trial balance is only presumptive proof of recording accuracy.

### Journal Entries

To link together the debits and credits of each transaction, and to provide in one place a complete record of each transaction, all transactions are recorded in a journal. The journal provides a place to record; 1.) the transaction date, 2.) the names of the accounts involved, 3.) an explanation of the transaction, 4.) the account numbers, 5.) the transaction's debit and credit information.

### Petty Cash

Almost all businesses have small payments for items such as postage, courier charges and small supply items. To avoid writing cheques or having the items billed directly, a petty cash fund is established. When a petty cash fund is established, an estimate is made of the total small payments likely to be dispersed during a short period of time.

### Internal Controls

Internal controls are required to increase operational efficiencies; protect the business from waste, fraud and theft; and ensure accurate accounting information. Important internal control principles are as follows:

- 1.) Internal control processes should be clearly defined and understood. Employees require training and orientation in this area.
- 2.) Accurate records must be maintained to protect the assets of the company.
- 3.) Assets should be covered by adequate insurance and employees handling cash may have to be bonded.
- 4.) Record keeping and asset control should be kept separate.
- 5.) Responsibility for related transactions should be divided, and they should be checked by separate individuals

### Auditing

An audit is a critical exploratory review of the business's methods and accounting records, made to enable the accountant to express an opinion as to whether the financial statements fairly reflect its financial position and operating results.

### Financial Reporting

The process of preparing and issuing financial information is called financial reporting. There are several objectives of financial reporting:

- 1.) Assessment of performance; assessment of financial performance over periods in the recent past, or against expectations

- 2.) Assessment of management quality: financial statements over time provide indicators of management's ability to maintain and improve financial performance
- 3.) As an input to estimating projected income: Past financial results can identify trends in financial performance. In combination with known market information, management can use this information to forecast future profits
- 4.) Assessing financial strength and stability: the financial statements provide an indication of the financial strength of the company to withstand possible downturns in the economy, additional competition, loss of a major supplier or customer.
- 5.) Assessing Liquidity: Liquidity is the life-blood of a company. Without liquidity the company would fail to meet its short term commitments.
- 6.) Assessing Risk and Uncertainty: The financial statements can provide an indication of the variability of the company's past record, and identify problems with cash flow.
- 7.) Comparative Analysis: Financial reporting can be used to compare results to prior years, or can be used to compare the company against other companies in the same industry.
- 8.) Assessing Adaptability: Financial results can be used to assess the ability of the company to adapt to a new technology or economic condition.

