# Finding opportunities in financial statements

Fact finding is a crucial process that advisors use to identify client needs. When it comes to a corporate client, fact finding allows you to determine its financial health and help you better identify insurance needs and/or opportunities. Financial statements offer a window into the health of a company. While accountants are trained to read and understand these documents, many advisors are not.

## What are financial statements?

Financial statements are reports that summarize important financial accounting information about a business. There are two main components of financial statements: the balance sheet and income statement.

Together, they give you a picture of a company's financial position and health.

We'll look at each of these two main components of a financial statement and examine how they work together to give you a picture of a company's financial health.

### The Balance Sheet

A balance sheet is essentially a snapshot of a company's finances on a particular date. The balance sheet shows what the company owns (assets) and what the company owes (liabilities). Any remaining difference between these two amounts (assets less liabilities) shows what belongs to the shareholder as their equity (shareholder's equity).

Assets are any items of value, and include:

- Current assets (e.g. cash, accounts receivable or inventory), and
- Non-current assets (e.g. investments, equipment, or real estate)

Liabilities are debts, and include:

- Current liabilities (e.g. accounts payable), and
- Non-current liabilities (e.g. operating loans or mortgages)

A main component of shareholder's equity is retained earnings. Retained earnings is a measure of the assets of a corporation that have been generated through profitable activity, retained in the business, and not paid out to the shareholder.

Generally, a large amount of retained earnings is regarded as a sign that the company has done well and is reinvesting its profits. That said, retained earnings does not translate to liquidity (cash) in the business as it does not tell you where such profits were reinvested. For example, a company could have reinvested all its profits in real estate, in which case the company may have large retained earnings but little cash or liquidity, as is common for real estate developers.

### The Income Statement

While the balance sheet is a snapshot of a business's finances at a point in time, the income statement shows you how profitable the business was over a time period, typically a year. It shows you how much a business made (revenue) and how much it spent (expenses). Combined, these numbers produce the net income (or loss) from the business.

Revenue encompasses all income generated by the business, and includes:

- income from sales of products/services, and
- secondary income (e.g. interest income or rental income)

Expenses encompass costs incurred in the business, and includes:

- cost of goods sold/cost of sales (how much was paid to produce or provide a product or service), and
- operating expenses (e.g. rent, interest, or insurance)

## How can financial statements be used?

Reviewing and understanding a client's financial statements can provide you with valuable insights about a client, and help you identify insurance needs or opportunities, for example:

- Significant liquidity on the balance sheet in the form of cash or short-term investments (i.e. GICs) may indicate the corporation's ability to fund a life insurance policy that would facilitate a tax-efficient transfer of wealth.
- Bank loans or mortgages may indicate a need for life insurance to pay off debts.
- Salaries and wages may lead to a discussion about key person life insurance.
- Sizable retained earnings or significant profits could suggest a valuable business and, as a result, looming tax liability upon the shareholder's death. This liability could be funded with life insurance.
- Substantial investment income may provide an opportunity to use permanent insurance as a tax-effective strategy to reduce passive corporate income – which is subject to tax at high rates and may reduce or eliminate the corporation's access to the small business deduction.

## An example

Let's look at an example of a balance sheet and income statement for XYZ Corporation located in this article's Appendix.

What potential insurance needs or opportunities can we identify from these financial statements?

A review of the financial statements for XYZ Corporation can provide the advisor with valuable insights including:

- The company has liquidity – in particular, $750,000 of cash and cash equivalents plus $1,000,000 of marketable securities.[1]
- Mortgages of $500,000 remain outstanding on corporate properties.
- Net income after taxes of $250,850 in 2020 and retained earnings of $2,000,000 indicate that the company is profitable and has been profitable in the past.
- Significant passive income is earned (i.e. $22,500 interest income plus $55,000 dividend income) annually on its investments (cash/cash equivalents and marketable securities).

Based on the above, the following insurance needs or opportunities may exist:

- Insurance for debt retirement in respect to outstanding mortgage.[2]

[1] As a profitable business evolves, a holding company is normally introduced to hold excess cash or marketable securities to protect such investments from the creditors of the operating company.

[2] If the shareholder is vital to the business, the corporation may have issues servicing the outstanding mortgage if the shareholder dies. Insurance on the shareholder's life to cover the mortgage may alleviate this issue.

- Insurance for taxes on death - the company has been profitable (i.e. significant retained earnings and profit) and as such the value of the company is likely significant and will continue to grow.[3]
- A permanent insurance solution could be used to minimize corporate taxes on passive investments and facilitate a tax-efficient transfer of wealth to the next generation. The company appears to have the liquidity to fund a permanent life insurance policy for this purpose.

## Conclusion

Fact finding is an important step in identifying life insurance opportunities with your clients. For corporate clients, financial statements are a crucial piece of the fact finding process that can provide an indication of a client's financial health and be used to identify insurance needs and/or opportunities. Canada Life has the resources available to help you through this process.

[3] Upon the death of the shareholder, the shares of XYZ Corporation are deemed to be disposed of at fair market value (assuming the spousal rollover is not available). This could trigger a significant tax obligation on the deceased shareholder's terminal tax return.

# Appendix

**XYZ Corporation**
**Balance Sheet**
**December 31, 2020**

| | |
|---|---|
| **Assets** | |
| Current assets | |
| Cash and cash equivalents | $ 750,000 |
| Marketable securities | 1,000,000 |
| Accounts receivable | 50,000 |
| Inventory | 100,000 |
| Prepaid expenses | 3,000 |
| Non-current assets | |
| Property, plant and equipment, net | 750,000 |
| Other assets | 65,000 |
| Total assets | $ 2,718,000 |
| **Liabilities and Shareholders' Equity** | |
| Current liabilities | |
| Accounts payable | $ 125,000 |
| Accrued expenses and other | 92,900 |
| Non-current liabilities | |
| Mortgage payable | 500,000 |
| Shareholders' Equity | |
| Capital stock | 100 |
| Retained earnings | 2,000,000 |
| Total liabilities and shareholders' equity | $ 2,718,000 |

**XYZ Corporation**
**Income Statement**
**For the year ended December 31, 2020**

| | |
|---|---|
| Revenue | $ 500,000 |
| Cost of Goods Sold | 150,000 |
| Gross Profit | 350,000 |
| | |
| Operating expenses: | |
| Depreciation | 50,000 |
| Selling, admin & general expenses | 65,000 |
| Total operating expenses | 115,000 |
| | |
| Net operating Income | 235,000 |
| | |
| Other Income: | |
| Interest income | 22,250 |
| Dividend income | 55,000 |
| Total other income | 77,250 |
| | |
| Income before taxes | 312,250 |
| Income taxes | 61,400 |
| Net Income after taxes | $ 250,850 |