

The 'Balance Sheet Illusion': Why Reported Ratios Make Borrowing Harder for Private Manufacturing SMEs in Canada

Eli Konorti

Master of Administrative Science, Fairleigh Dickinson University, Vancouver Campus

210-5968 Cornelia Mews, Vancouver, BC, V5Z 2M9, Canada

Tel: 1-604-341-2398 E-mail: eli.konorti@gmail.com

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Abstract

The analysis illustrates, through case examples, how reported ratios distort profitability, liquidity, solvency, and efficiency measures—particularly through unadjusted customer deposit liabilities and discretionary management-fee distributions. In three firms, lenders asked for the owners' personal assets as additional security. The study proposes a leadership-to-balance-sheet causality model and recommends that lenders supplement covenant tests with qualitative context and adjusted measures.

Keywords: ASPE, Financial diagnostics, Organizational culture, Practitioner inquiry, SME lending

1. Introduction

In all seven firms studied in this paper, the bank tested loan covenants on ratios calculated directly from the firm's financial statements as reported, with no adjustment or allowance of any kind. Each firm reported against its covenants every quarter or half-year, and the principal tests were the current ratio and debt-to-equity. When reported statements diverge from a firm's operating capacity, a viable business can find it harder to borrow or face more onerous terms. This paper examines how that happens in private manufacturing small and medium-sized enterprises (SMEs) in British Columbia (BC), Canada, reporting under Canadian Accounting Standards for Private Enterprises (ASPE). SMEs are defined here as enterprises with 1 to 499 paid employees (Innovation, Science and Economic Development Canada, 2024), and each of the seven firms studied falls below that ceiling.

Reported statements can depart from operating reality in several ways. Unlike IFRS 16 and U.S.

GAAP (ASC 842), which require lessees to recognize most leases on the balance sheet, ASPE Section 3065 retains the distinction between operating and capital leases (CPA Canada, 2020). An operating lease keeps both the equipment and the payment obligation off the balance sheet, which can make leverage look lower than a firm's fixed commitments warrant (Altamuro et al., 2014). Historical-cost depreciation can reduce well-maintained equipment that is still in productive use to a near-zero book value (Kieso et al., 2019), distorting return on assets and the apparent collateral base. Another example is the owner's choice to distribute profit as management fees, which lowers reported income, and with it return on assets and return on equity, without changing the firm's operating capacity. Sophisticated analysts have long adjusted for items like these. In the seven firms studied here, however, the lenders did not.

This paper uses the term 'Balance Sheet Illusion' for the gap between what a firm's reported statements show and its operating capacity and creditworthiness, unlike Vecchi and Hellowell (2013), who use the phrase in the context of public-sector leasing; here it refers to private manufacturing SMEs.

Concern that accounting numbers have lost relevance for decision-making is not new (Johnson & Kaplan, 1987). Lev and Gu (2016) document that decline for investors in public capital markets, particularly where intangible investments are expensed. This paper extends the concern to a different setting, private SMEs in credit markets, where the distortions arise from lease classification, historical-cost depreciation, and owner income extraction.

The study is a qualitative multiple-case study of seven BC manufacturing SMEs. It draws on face-to-face interviews with each firm's senior management team, from the president or CEO down two levels (in one firm, interviews extended to 27 people, including shop-floor supervisors), and on the firms' financial statements as reported. The author's involvement varied by firm, from outside advisor to operating executive. The study illustrates, through case examples, how reported figures diverge from operating reality. It documents the lender responses that followed, including requests for the owners' personal assets as additional security in three firms. It proposes a leadership-to-balance-sheet causality model, in which ownership, leasing, and income-extraction choices reflect leadership philosophy and culture (Hambrick & Mason, 1984). And it recommends how lenders can supplement covenant tests with adjusted measures and qualitative context.

1.1 Background of the Problem

The BC manufacturing sector is dominated by SMEs: in 2025, 7,345 of the 7,363 manufacturing establishments with employees in the province (99.8 per cent) had fewer than 500 employees (Innovation, Science and Economic Development Canada, 2025). Unlike large publicly traded firms, which can explain their strategy to capital markets through investor relations (Healy & Palepu, 2001), private SMEs rely on a small number of regional lenders (Berger & Udell, 2002). For these firms, the lender's covenant tests are the everyday measure of financial health.

Leasing illustrates how the reported figures can mislead. SMEs that lack the cash to buy specialized machinery outright often lease it (Sharpe & Nguyen, 1995). Under ASPE Section

3065, private firms classify leases as operating or capital (CPA Canada, 2020). An operating lease leaves the asset and the payment obligation off the balance sheet; only the future minimum payments for the next five years appear in the notes, so reported leverage can look lower than the firm's commitments justify. Were the same lease capitalized, the added liabilities could weaken working capital and debt-to-equity ratios and put covenant compliance at risk (Duke & Hunt, 1990), even though the equipment is generating cash on the factory floor.

Depreciation works in the other direction. Under historical-cost accounting, equipment is written down over its useful life, and a fully depreciated asset carries a net book value near zero (Kieso et al., 2019). Well-maintained machinery can remain in productive use long after that point. The balance sheet then shows little asset value for equipment that is still producing, which distorts return on assets and can suggest a thin collateral base.

Owner decisions also shape the reported figures. Distributing profit as management fees lowers reported income, and with it return on assets and return on equity, without any change in the firm's operating capacity.

The reported figures matter because lenders act on them. In the seven firms studied here, banks measured covenants on the reported figures without adjusting them. Where firms did well, covenants were not an issue, and in one strong, profitable firm the lender eased covenants to allow room for scale. In three firms with weak reported ratios, the lender demanded the owners' personal assets as additional security, beyond pledged corporate collateral. In two of these firms, thin operating margins left reported metrics below covenant thresholds despite uninterrupted debt service. In the third, accounting treatment for advance operating liabilities and fully depreciated capital equipment created the appearance of structural distress. All three firms remain in operation under ongoing lender monitoring.

Behind the figures are choices made by management. Firms differ in whether they hold capacity as owned assets (a conservative-ownership strategy) or as leased or outsourced capacity (a lean-operational model), and these choices reflect leadership philosophy and organizational culture (Schein, 2010). The executive team's risk tolerance, commitment to local employment, and strategic vision shape the balance sheet (Hambrick & Mason, 1984). Reported statements carry no record of these variables, so a lender reading only the numbers cannot see them. This paper therefore asks how leadership choices show up in reported statements, and what lenders lose by not looking beyond them.

1.2 Problem Statement

The practical problem driving this study is that lenders to private manufacturing SMEs in British Columbia test covenants on reported figures, and those figures can misstate a firm's operating capacity. A single management decision moves many numbers at once, and no set of ratios shows them all. For example, when a firm spends more on training, safety testing, and quality, those costs are typically expensed, so reported margins fall in the period of the spending, while the benefits arrive later and never appear as an asset (Lev & Gu, 2016). Similarly, standard accounting conventions—such as historical-cost asset write-downs, off-balance-sheet commitments, and discretionary owner-remuneration structures—create

mechanical distortions in reported ratios that diverge sharply from underlying productive capability.

The author's experience as CEO of a manufacturer of secondary wooden products illustrates the gap. Choices to use premium materials, enforce rigorous safety testing, and allow factory-floor employees to halt production to protect quality (Spear & Bowen, 1999) reduced margins in the short term. In the author's assessment, they also built a strong reputation for quality and safety. The reported statements recorded the costs and, later, the outcomes, but not the decisions and culture that produced them (Schein, 2010).

When lenders read only the reported figures, viable firms can face tighter terms. Consequently, lenders may demand personal asset guarantees even when operational cash generation remains intact. The problem, then, is that a lender cannot tell from the reported figures alone whether a weak ratio is a fair warning or the product of an invisible reporting mechanism. Unless lenders look beyond reported metrics to the operating realities behind them, viable private manufacturing SMEs will continue to be penalized through tighter credit constraints, personal liability exposure, and restricted access to growth capital.

1.3 Purpose of the Study

The primary purpose of this qualitative multiple-case study (Yin, 2018) is to illustrate how leadership and ownership decisions, such as whether to own or lease equipment, how long to keep it in service, and how to take profit out of the firm, produce different reported financial figures, and how lenders read those figures. Decisions about ownership versus outsourcing and leasing versus purchasing are treated not as isolated financial choices but as expressions of management beliefs about risk, control, and competitive advantage (Williamson, 1985).

Consequently, the study aims to show how reporting rules and management decisions shape the figures lenders rely on, and where those figures diverge from a firm's operating capacity. To do this, it examines seven firms with different asset structures and identifies the specific points at which reported figures can mislead a lender. The study is organized around three research aims:

1. **Leadership choices and reported figures.** To examine how leadership philosophy and organizational culture shape capital allocation, owner decisions on taking profit out of the firm, and operating performance (Hambrick & Mason, 1984; Schein, 2010), and to propose a causality model linking leadership philosophy to the reported figures.
2. **How reporting rules and decisions shape the figures.** How reporting rules and decisions shape the figures. To show, through case examples, how ASPE reporting conventions, balance-sheet liability classifications, and discretionary owner-remuneration practices systematically diverge from operating reality and distort key credit metrics (CPA Canada, 2020).
3. **Lender responses and the way forward.** To document how lenders responded to the reported figures in the seven firms, including a firm whose operations were turned around by a change of leadership while the lender continued to read the figures of a

troubled company, and to propose how lenders can look beyond those figures to the decisions behind them.

1.4 Significance of the Article

This study is significant for three groups: the owners and executives of private manufacturing SMEs, the lenders that serve them, and the research literature on SME finance and financial reporting.

1.4.1 Significance for Owners and Executives

In a private manufacturing SME, the owner or chief executive is usually the person who deals with the bank. For them, the study illustrates how everyday decisions, such as leasing rather than buying equipment, keeping depreciated equipment in service, taking profit out as management fees, and investing in training and quality, show up in the reported figures a lender tests. In the seven firms studied here, covenants were measured on those figures without adjustment, so the study suggests that managing the lender relationship includes explaining what the figures do not show.

1.4.2 Significance for Lenders

For lenders to private manufacturing SMEs, the study documents how covenants set on reported figures treated seven firms and what followed: additional security in the form of owners' personal assets, and close monitoring, in three firms, and eased covenants in a fourth. It illustrates that a weak reported ratio can be a fair warning, the effect of an accounting rule, or the result of a decision the lender cannot see, and it proposes adjustments and questions that may help lenders tell them apart.

1.4.3 Significance for the Literature

Research on SME lending emphasizes information opacity and the role of relationship lending (Berger & Udell, 2002, 2006; Boot, 2000). This study addresses a related question that has received little attention: how covenants set on reported figures treat viable private firms when the leadership decisions behind those figures are invisible to the lender. It extends the argument that financial reports have lost relevance (Johnson & Kaplan, 1987; Lev & Gu, 2016) from public-market investors to private-company credit. It does so in a setting where, unlike under IFRS 16 and ASC 842, operating leases can remain off the balance sheet (CPA Canada, 2020). It also proposes a leadership-to-balance-sheet causality model linking executive philosophy to the reported figures (Hambrick & Mason, 1984).

1.5 Nature of the Study

This study uses a qualitative multiple-case study design (Yin, 2018) to examine how the reported financial figures of private manufacturing SMEs relate to the leadership and ownership decisions behind them, and how lenders respond to those figures. A case-study design suits the question because the connection between management decisions, organizational culture, and reported figures is difficult to capture in isolated metrics (Creswell & Creswell, 2018), and a multiple-case design allows the same question to be examined across

firms (Yin, 2018).

The study examines seven small and medium-sized manufacturers in British Columbia. The cases were selected for convenience and data availability: they are firms with which the author worked and for which complete financial and interview data were available. The evidence has three sources. The first is face-to-face interviews with each firm's senior management team, from the president or CEO down two levels; in one firm, the interviews extended to 27 people, including shop-floor supervisors. The second is each firm's financial statements as reported, from which the study calculates liquidity, profitability, solvency, and efficiency ratios. The third is information on each firm's loan covenants and its lender's responses, gathered in the course of covenant negotiations, including, in some of the firms, face-to-face meetings with the lenders. The author's involvement varied by firm, from outside advisor to operating executive.

The analysis compares the seven cases to identify how the reported figures relate to management decisions and to lender responses. Because the firms make different products for different markets, the study does not compare ratios across firms; it compares each firm's reported figures with what its interviews reveal. Because the sample is small and not random, the study does not attempt statistical generalization or formal correlations (Creswell & Creswell, 2018); it aims at analytic generalization (Yin, 2018). Pattern matching, the linking of observed figures and organizational behaviors across cases to propositions stated in advance (Miles et al., 2014), is used to assess the fit between what the figures show and what the interviews reveal.

1.6 Research Propositions

To guide the analysis of the seven cases, this study examines three propositions (Yin, 2018). They were formulated before the cases were analyzed and were refined as the evidence was examined; the third, on lender responses, was added after the interviews and covenant information had been reviewed.

1. **Proposition 1 (Leadership and the reported figures):** Leadership philosophy and organizational culture shape capital allocation decisions, such as whether to own or lease equipment, the owner's decisions on taking profit out of the firm, and operating performance, and through them the figures reported in the financial statements (Hambrick & Mason, 1984; Schein, 2010).
2. **Proposition 2 (Reporting rules and decisions):** Reporting rules and management decisions—specifically regarding capital asset depreciation, lease treatment, current liability classification, and discretionary owner distributions—cause reported ratios to misstate a firm's liquidity, profitability, solvency, and efficiency relative to its operating capacity (CPA Canada, 2020).
3. **Proposition 3 (Lender responses):** Lenders who test covenants on reported figures without adjusting them respond to the figures and not to the decisions behind them: firms with weak ratios face tighter terms and firms with strong ratios face looser ones, whether the ratios reflect real weakness or an accounting effect.

1.7 Theoretical and Conceptual Framework

This study rests on three linked ideas, which correspond to the three propositions in Section 1.6.

1.7.1 Leadership, Culture, and Decisions

Upper echelons theory holds that organizational outcomes partly reflect the characteristics and choices of top managers (Hambrick & Mason, 1984), and organizational culture shapes what those managers regard as reasonable choices (Schein, 2010). Everyday management decisions, including where to commit resources, cumulatively shape a firm's strategy and resource allocation (Bower & Gilbert, 2007). In the private SMEs studied here, the owner or chief executive typically makes the decisions that matter most for the balance sheet: whether to own or lease equipment, how long to keep it in service, how to take profit out of the firm, and how much to invest in training and quality.

1.7.2 How Decisions Appear in Reported Figures

Those decisions reach the financial statements through accounting rules. Under ASPE Section 3061, equipment is recorded at historical cost and depreciated over its estimated useful life, so a well-maintained asset that remains in productive use can carry a near-zero book value (CPA Canada, 2020; Kieso et al., 2019). Under ASPE Section 3065, a lease is classified as operating or capital, and an operating lease keeps the asset and the payment obligation off the balance sheet (CPA Canada, 2020). Similarly, mandatory classifications of operational advance receipts and owner withdrawals directly depress reported liquidity and return metrics without reflecting underlying productive capacity. None of this records who made the decision or why. Financial measures also describe results after the fact (Kaplan & Norton, 1992), so a change in leadership or culture appears in the statements only after it has worked through the numbers.

1.7.3 How Lenders Read the Figures: The Balance Sheet Illusion

A lender who tests covenants on the reported figures sees the results of these decisions without seeing the decisions. As defined in Section 1.0, the Balance Sheet Illusion is the gap between what a firm's reported statements show and its operating capacity and creditworthiness. The framework therefore has three steps: leadership and culture shape decisions (Proposition 1); accounting rules turn decisions into reported figures that can misstate a firm's position (Proposition 2); and lenders respond to the figures, not to the decisions behind them (Proposition 3). Figure 1 shows this sequence.

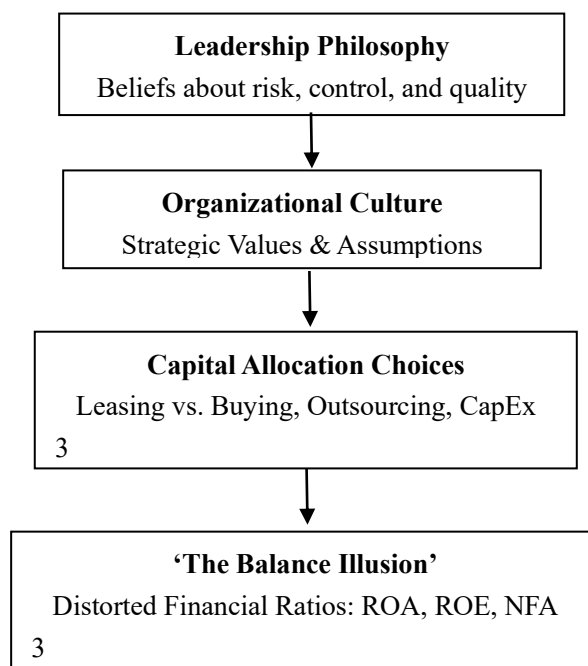


Figure 1. The Domino Effect of The Balance Sheet Illusion

1.8 Limitations and Delimitations

This section sets out the limitations that lie beyond the researcher's control and the boundaries imposed on the study's scope (Creswell & Creswell, 2018; Yin, 2018).

1.8.1 Limitations

Several limitations follow from the design. First, the study covers seven firms, chosen for convenience and data availability, so its findings cannot be generalized statistically; they are offered as analytic generalization to the propositions in Section 1.6 (Yin, 2018). Second, all seven are private manufacturers in British Columbia reporting under ASPE, and the lender behavior described is that of these firms' lenders, so the study does not establish how lenders elsewhere, or lenders in general, treat such firms. Lenders were not formally interviewed. Where the author met them, during covenant negotiations, those meetings are the source of the author's understanding of their approach, and such meetings did not take place in every firm. Third, the firms make different products for different markets, so their ratios are not comparable across firms; the study compares each firm's reported figures with what its interviews revealed. Finally, the author gathered the interview data personally, and the author's involvement varied by firm, from outside advisor to operating executive. This gave close access to each firm's decisions and results, but the accounts are those of a single researcher.

1.8.2 Delimitations

The study is limited to private small and medium-sized enterprises (SMEs), defined here as enterprises with 1 to 499 paid employees, in the manufacturing sector, operating in British

Columbia and reporting under Canadian Accounting Standards for Private Enterprises (ASPE). It examines how leadership and ownership decisions appear in reported financial figures and how lenders respond to those figures. It does not examine public companies, other sectors, other reporting frameworks such as IFRS, or the effect of macroeconomic conditions on the firms' results.

2. Method

2.1 Research Design and Case Selection

This study uses a qualitative multiple-case design (Yin, 2018) to examine how the reported financial figures of private manufacturing small and medium-sized enterprises (SMEs) in British Columbia relate to the leadership and ownership decisions behind them, and how lenders respond to those figures. The unit of analysis is the firm, and the study includes seven firms ($N = 7$). The cases were selected for convenience and data availability: they are firms with which the author worked, and for each the author had interview data and the firm's financial statements. All seven are private manufacturers with fewer than 500 employees, and all reported under Canadian Accounting Standards for Private Enterprises (ASPE). Each firm's financial statements were prepared by an external accounting firm; some were audited, and the others were prepared under Notice to Reader engagements. The cases differ in asset structure, leasing practice, and reported financial position. For each firm, the study compares the reported figures with what the interviews revealed about the firm's decisions and results.

2.2 Three-Part Analytical Framework

The author interviewed several people at each firm to corroborate what participants said, covering the senior management team down two levels (in one firm, 27 people including shop-floor supervisors), and compared their accounts across management levels and against the firm's financial statements. The analysis had three parts, shown in Figure 2.

- **Phase One (Interviews):** For each firm, the interview findings were reviewed for the leadership and ownership decisions that shape its reported figures, such as whether to own or lease equipment, how long to keep it in service, how profit is taken out of the firm, and how much to invest in training and quality.
- **Phase Two (Reported ratios):** Liquidity, profitability, solvency, and efficiency ratios and the Altman Z-score were calculated manually from each firm's financial statements as reported, using standard formulas (Altman, 1968; Palepu et al., 2020).
- **Phase Three (Cross-case comparison):** For each firm, the interview findings were compared with the reported figures and with the requirements and responses of its lender, and the patterns were then compared across the seven firms (Yin, 2018).

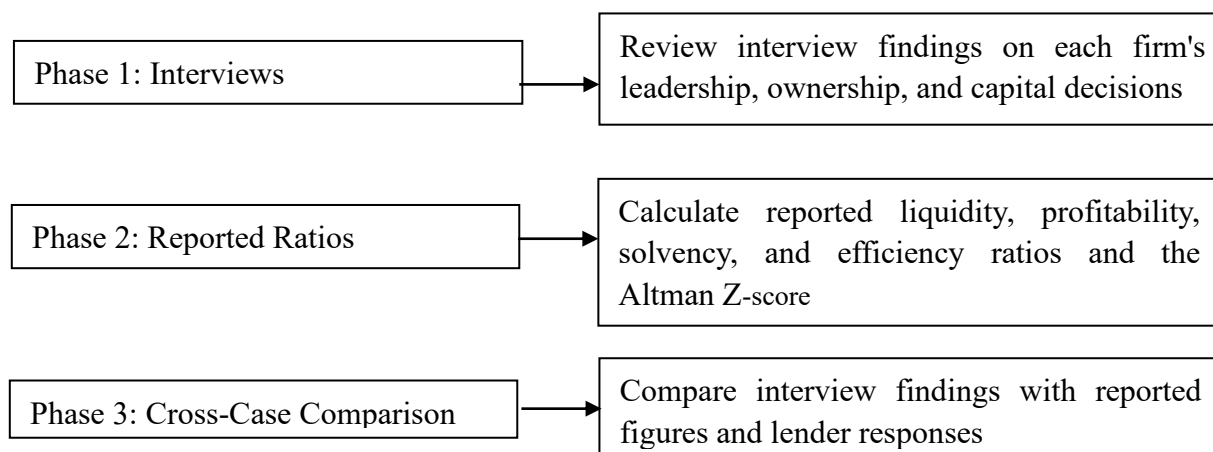


Figure 2. Analysing Patterns Across Companies: A Three-Phase Framework

Figure 3 sets out how the study addresses the four criteria of trustworthiness in qualitative research (Lincoln & Guba, 1985). Credibility is supported by comparing interviews at several management levels with each firm's financial statements (Miles et al., 2014). Transferability is supported by describing the setting, private manufacturing SMEs in British Columbia reporting under ASPE, in enough detail for readers to judge whether the findings apply elsewhere (Lincoln & Guba, 1985). Dependability is supported by documenting the method and by using standard, published ratio formulas that anyone can apply to the same statements (Yin, 2018). Confirmability is supported by an audit trail: the interview notes are retained, and the ratio calculations can be reproduced from the financial statements (Lincoln & Guba, 1985).

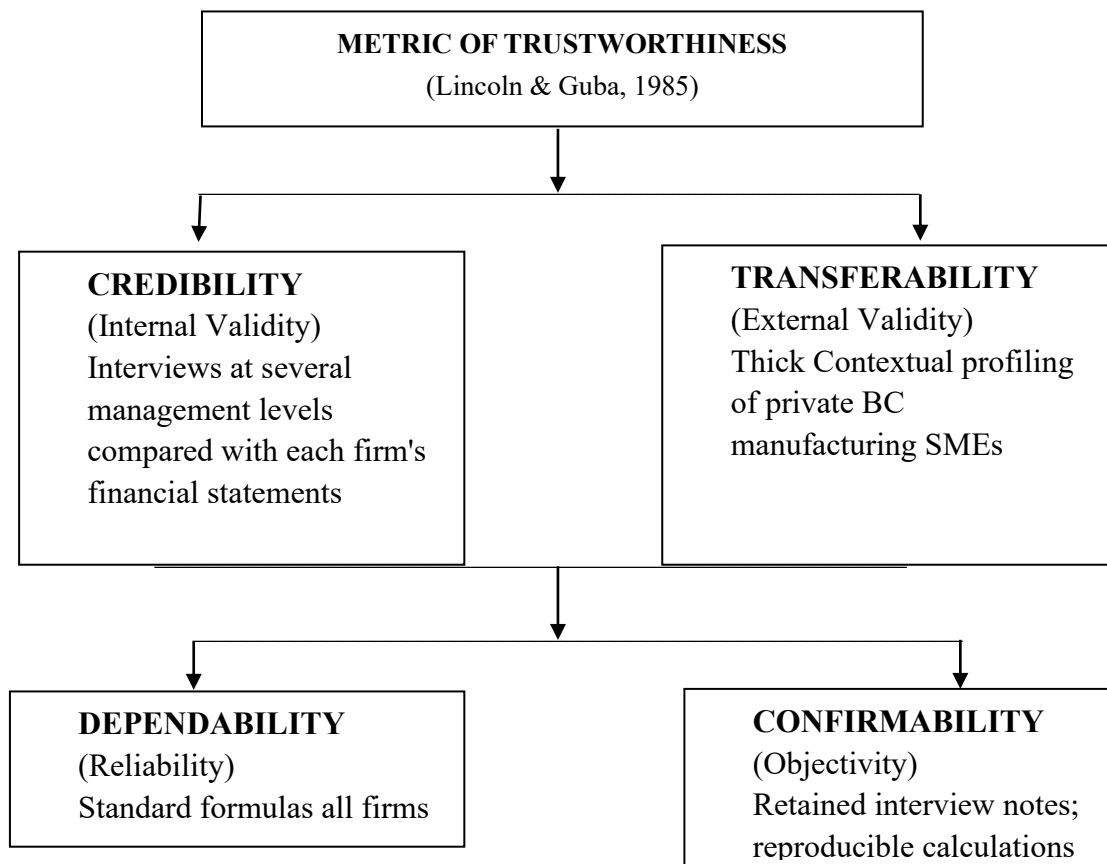


Figure 3. The Qualitative Trustworthiness Matrix Mapping to Empirical Validity and Reliability Standards

3. Empirical Findings and Synthesis

The findings from the seven firms ($N = 7$) are presented in three parts. Part I (3.1) shows how the ratios reported in Table 1 depart from what the firms were doing. Part II (3.2) describes the leadership and ownership decisions behind the reported figures. Part III (3.3) describes the purposes that guided those decisions.

Table 1. Performance Ratio and Solvency Metric Profiles for Companies 1–7

ASSET TYPE	LIGHT	LIGHT	HEAVY	HEAVY	HEAVY	LIGHT	HEAVY
ENTERPRISE	1	2	3	4	5	6	7
RATIO	PERFORMANCE METRICS						
CURRENT RATIO - LIQUIDITY	1.05	0.75	1.26	0.52	6.25	0.24	1.21
WORKING CAPITAL - LIQUIDITY	207,853	-587,348	1,904K	-109,479	4,496K	-1,041K	1,057K
CASH RATIO - LIQUIDITY	-0.04	0.35	0.32	0.00	1.78	-0.03	-0.01
ROA - PROFITABILITY	-9.54	-0.26	10.51	-23.41	3.05	-14.48	-1.43
ROE - PROFITABILITY	-84.74	5.04	39.46	2135.73	11.35	4.45	-4.58
DEBT/EQUITY - SOLVENCY	7.88	-20.63	2.75	-92.23	2.72	-1.31	2.20
FIXED ASSET TURNOVER - EFFICIENCY	5.01	277.96	17.30	2.41	4.69	2.35	5.71
ALTMAN Z-SCORE - BANKRUPTCY/VALUE	1.58	1.38	1.61	0.87	2.82	-1.68	2.7

3.1 Part I: Reported Ratios and Operating Capacity

Table 1 shows how widely the seven firms' reported ratios differ. This part describes three ways in which ratios that are correctly calculated from the reported statements still depart from what the firms were doing: in profitability (Finding 1), liquidity (Finding 2), and solvency and efficiency (Finding 3).

Finding 1: Profitability Ratios Reflect the Asset Base and Owner Decisions

Return on assets (ROA = net income / total assets) and return on equity (ROE = net income / shareholders' equity) each divide income by a balance sheet figure. Equipment is carried at historical cost less depreciation, so total assets can bear little relation to productive capacity, and the ratio moves with that base: a smaller base makes any given income look larger relative to assets, whether the income is a profit or a loss. Owners' decisions about how to take profit out of the firm change the numerator. Across the seven firms, ROA ranges from -23.41 to 10.51 per cent (Table 1).

- **Company 2:** Its ROA is -0.26 per cent. Its production equipment has been amortized to a minor book value under ASPE 3061, so the ratio compares a small loss with a small asset base and says nothing about what the equipment can produce.
- **Company 7:** Its ROA of -1.43 per cent and ROE of -4.58 per cent are negative because the board decided to distribute profit as management fees, which lowered net income. The fee was set each year so that the covenant ratios stayed within the lender's limits.
- **Company 5:** Its ROA is 3.05 per cent. The firm carries its extensive manufacturing

footprint on its balance sheet, so a large asset base is set against a small income.

These cases show that ROA and ROE reflect the asset base and the owner's decisions on taking profit as well as operating performance, so the ratios cannot be compared across the firms as measures of performance.

Finding 2: Liquidity Ratios Have Different Causes in Different Firms

Current ratios range from 0.24 (Company 6) to 6.25 (Company 5), and the low readings have different causes. In Company 2, for example, customer deposits received in advance are carried as a current liability, as accounting rules require. This lowers the current ratio although the firm holds cash, because the deposits are settled by delivering product and not by repaying cash. This lowers the current ratio although the firm holds cash, because the deposits are settled by delivering product and not by repaying cash. In Companies 4 and 6, by contrast, thin sales and low margins left the ratios below covenant levels, although cash flow was sufficient to service the debt and payments were always made on time.

Finding 3: Solvency and Efficiency Ratios

The lenders' critical covenants were the current ratio and debt-to-equity, measured on the reported figures. In Company 7, the lender eased its covenants from a current ratio of 1.5 to 1.2 and from a debt-to-equity ratio of 2.0:1 to 3.0:1. The firm was strong and profitable, and its reported ratios of 1.21 and 2.20 sit inside the eased limits.

Companies 2, 4, and 6 report negative shareholders' equity, so their debt-to-equity ratios are negative (-20.63, -92.23, and -1.31). A negative ratio shows that reported liabilities exceed reported assets. It cannot be compared with a covenant limit such as 2.0:1, and it changes the sign of ROE: these three firms report net losses (ROA of -0.26, -23.41, and -14.48) but positive ROE (5.04, 2135.73, and 4.45), because a negative income is divided by negative equity. Company 2 also holds a significant amount of cash, and its liabilities include the customer deposits described in Finding 2.

Company 2's fixed asset turnover is 277.96x. Because its production equipment has been amortized to near-zero book value, there are almost no net fixed assets to divide revenue by. The other six firms range from 2.35x to 17.30x. A ratio of this size measures the depreciation record and not the firm's throughput.

Company 1 manufactured building products for the construction and renovation industry. It was led by an experienced president with a financial background, and it was a well-run firm in a period of growth, with a solid asset base. Its covenants were a current ratio no lower than 1.5 and debt-to-equity no higher than 2.0:1. In the year shown in Table 1, its ratios were outside those limits (a current ratio of 1.05 and debt-to-equity of 7.88), and the lender put the firm on warning. Before any further action was taken, the firm was sold to a company in its value chain.

Company 3 was a long-established industrial manufacturer, and it was highly profitable, with the highest return on assets of the seven (10.51 per cent, Table 1). Its covenants were not an issue. The owners closed the firm voluntarily when they retired, because no suitable person could be found to run it. The reported figures gave no sign of this outcome: they record profit

but not who will lead the firm next.

3.2 Part II: The Human Element Behind the Numbers

Part I described how the reported ratios depart from what the firms were doing. The ratios cannot show why the figures look as they do. Financial statements record the results of decisions made by a firm's leaders (Hambrick & Mason, 1984), and they record those results after the fact (Kaplan & Norton, 1992). Firms in the same province, reporting under the same accounting standard, reported very different figures. To understand why, the analysis looks beyond the statements to the leadership and ownership decisions, and the culture, behind them. Figure 4 shows the sequence.

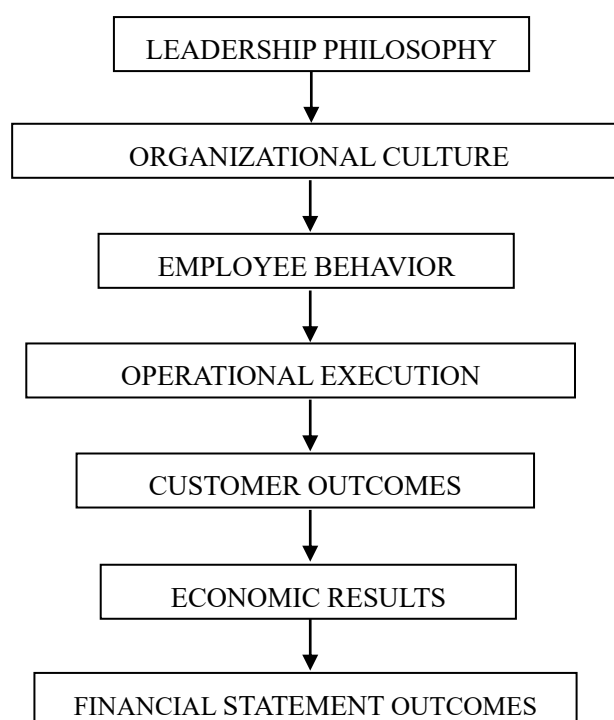


Figure 4. The Leadership-to-Balance-Sheet Causality Model

Note. Authored by the researcher (2026) specifically for this study to map the upstream behavioral drivers of lagging ledger endpoints.

Figure 4 shows why a change at the top is invisible to a lender who starts from the financial statements. Leadership philosophy shapes culture (Schein, 2010), culture shapes employee behavior, behavior shapes operational execution, and operations shape customer outcomes and economic results, and only then do the results reach the statements. A lender testing covenants on the reported figures starts at the last link and works backward. It sees the outcome and not the causes above it, and it cannot see a change at the top until that change has worked its way down the chain.

Companies 2 and 7 show this. Under their previous leadership, both firms were run for short-term margins, and their operations had eroded. In Company 2, the previous president

produced losses, and the previous owner returned to lead the firm. In both firms, the new leader is described here in terms of the author's 3D Transformational Leadership Model, which identifies courage, wisdom, and vision as the traits of transformational leaders (Konorti, 2008). The model is the author's own earlier work, and the two cases are used to illustrate it. Each leader brought experience and informed judgment, a clear direction for the firm, and a willingness to take risk. Each replaced the pursuit of short-term profit with a purpose anchored in core values: customer focus, safety, zero-defect quality, and lean manufacturing.

The operating results followed quickly. Company 2 was turned around in a short time. In Company 7, within twelve months of the change in culture, defective warranty returns fell from 6 per cent of sales to 1 per cent, direct labour hours per unit fell by 62 per cent, from an index of 1.00 to 0.38, and delivery lead times and administrative overhead fell by more than 80 per cent and 50 per cent respectively.

The lenders' responses did not reflect the change. In Company 2, the lender read the reported figures of a firm that had recently lost heavily, saw a financially troubled company, and asked for the owner's personal assets as additional security. In Company 7, the lender applied standard covenants, a current ratio of no lower than 1.5 and debt-to-equity of no higher than 2.0:1, to the reported figures, and eased them to 1.2 and 3.0:1 only when the firm was strong and profitable. In neither case did the covenants take account of who was leading the firm. The improvements appeared first in behavior and operations, and the statements recorded them later, so covenants measured on the statements could respond only to what had already reached the bottom of the chain.

3.3 Part III: The Corporate Raison d'Être

Part II described how leadership shapes what a firm does. This part describes the purpose behind those decisions. A firm's *raison d'être*, its reason for being, is more than the pursuit of profit (Collins & Porras, 1994), in contrast with the view that a firm exists to maximize shareholder wealth (Friedman, 1970). In the two turnarounds described in Section 3.2, the new leaders anchored their firms in core values (customer focus, safety, zero-defect quality, and lean manufacturing) and ran operations and capital decisions accordingly, so that profit followed from execution and was not the direct target (Kay, 2010).

Decisions that serve such a purpose, such as investing in training, safety, and quality, are expensed as they are made, so they lower reported margins in the period of the spending, while their benefits reach the statements later. A lender reading only the reported figures sees the lower margins and not the purpose behind them.

3.4 Case Application: The Strategic Value of Safety

One example from the author's experience shows how a company's purpose affects the numbers in its financial statements. The company defined its purpose as making products its customers could trust to be safe. To serve that purpose, it chose premium materials, rigorous safety testing, and a rule that factory-floor employees could stop production to protect quality (Spear & Bowen, 1999). These choices cost money. Because such costs are expensed as they are incurred, they lowered reported margins in the period of the spending. They also built a

strong reputation for quality and safety, and profits followed. The statements never recorded that reputation as an asset; its effect appeared only afterward, in the firm's profits. Table 2 sets each decision beside how it appears in the reported figures.

Company 2 shows the same lag between leadership and the statements. Its new leadership brought a new culture and a transformational leadership style (Konorti, 2008), and the firm turned around in a short time. The reported figures did not follow. Company 2's balance sheet continued to show negative shareholders' equity and an Altman Z-score of 1.38 (Table 1), because the statements record results only after they have worked through the numbers.

Table 2. How a Purpose of Safety and Quality Appears in the Reported Figures

Decision	How it appears in the reported figures	What the statements do not show
Use premium materials	Higher cost of goods sold and a lower gross margin in the period.	The benefit to the customer and to the brand.
Employ rigorous safety testing	Cost of quality costs are expensed as incurred lowering reported gross margin in the period.	Satisfied customers and lower customer complaints.
Employees empowered to stop production to protect quality	Higher operating costs lowering reported gross margin in the period.	Reduced product defects and improved customer satisfaction.
Execute a quality management program	Higher cost of quality costs lowering reported gross margin in the period.	The long-term financial benefits.

Table 2 above shows that decisions serving a purpose of safety and quality appear in the reported figures first as costs, and their benefits reach the statements later, as profit. Profit followed from execution and was not the direct target (Collins & Porras, 1994; Kay, 2010). The statements record the costs and, later, the profit, but not the purpose that connects them.

Company 7 illustrates how owner-level governance choices uncouple reported margins from productive capability. As documented in Finding 1, discretionary distribution choices directly managed covenant compliance while artificially depressing reported profitability metrics. The accounting record captured the mechanical cost deduction, while completely obscuring the governance rationale and underlying commercial solvency.

4. Discussion

The seven cases show a consistent pattern in how lenders treated private manufacturing SMEs. In every firm, the lender tested covenants on the figures in the financial statements as reported, without adjusting them. This section interprets what that meant for the firms, why the lender could not see what lay behind the figures, and how the findings relate to earlier research.

4.1 What the Cases Show

The critical covenants were the current ratio and debt-to-equity, and each firm reported against them every quarter or half-year. Where firms did well, the covenants were not an issue. In one strong, profitable firm, the lender eased them, from a current ratio of 1.5 to 1.2 and from debt-to-equity of 2.0:1 to 3.0:1, to give the firm room to scale. Three firms (Companies 2, 4, and 6) had weak reported ratios, and in each the lender asked for the owners' personal assets as additional security, beyond the company assets already pledged. All three remain in business, under continued close monitoring, and their debt payments were always made on time.

The reasons for the weak ratios differ. In Companies 4 and 6, thin sales and low margins left the ratios below covenant levels. The ratios described the balance sheet fairly, but they did not measure the firms' ability to repay, and cash flow was enough to service the debt. In Company 2, accounting mechanics converted strong customer demand and fully amortized operating assets into the appearance of a severe working-capital deficiency. In the lender meetings the author attended, the lenders applied the same covenant tests whatever a firm made or sold, so a weak ratio caused by thin sales and one caused by an accounting effect looked the same to them.

4.2 Why the Lender Could Not See the Decisions

Figure 4 shows why. A financial statement is the last link in a chain that begins with leadership philosophy and passes through culture, employee behavior, operations, customer outcomes, and economic results. A lender that starts from the statements reads what has already reached the last link and cannot see a change higher up until it has worked its way down (Kaplan & Norton, 1992; Hambrick & Mason, 1984). In Companies 2 and 7, a change of leadership improved operations before the statements could record it, and the covenants took no account of who was leading the firm (Section 3.2). This does not show carelessness by the lenders. The reported figures do not record the causes of the results they report.

4.3 Owner Decisions and Covenants

Company 7 demonstrates how owner-governance choices actively decouple reported return metrics from underlying cash generation. By calibrating owner remuneration precisely to satisfy debt covenants, management preserved borrowing compliance while deliberately depressing reported profitability. A credit analyst relying exclusively on reported return metrics would interpret calculated losses as operating distress rather than strategic balance-sheet optimization..

4.4 Relation to Earlier Research

Research on SME lending emphasizes information opacity and the role of relationship lending (Berger & Udell, 2002, 2006; Boot, 2000). These cases add a description of what covenants set on reported figures did in practice for seven private firms, including firms whose figures reflected an accounting rule and not their operations. The findings also extend the argument that financial reports have lost relevance (Johnson & Kaplan, 1987; Lev & Gu, 2016), which has concentrated on investors in public markets, to lenders in private-company credit. In Canada the reported figures of a private firm differ from those of a firm under IFRS 16 or U.S.

GAAP (ASC 842), because ASPE allows operating leases to stay off the balance sheet (CPA Canada, 2020), so a firm that leases and one that owns equipment of the same capacity can report different ratios. Because the seven firms were chosen for convenience, the findings illustrate what can happen and do not show how often it does (Section 1.8.1).

5. Implications for Practice and Policy

The seven cases suggest several changes in how lenders and borrowers handle covenants in private manufacturing SMEs. They come from a small, convenience-selected set of firms (Section 1.8.1), so they are offered as suggestions for practice and not as findings about lenders generally.

5.1 For Lenders

First, when reported ratios fall below covenant levels, ask management what it is doing to fix the financial position or strengthen the balance sheet before asking for additional security, and weigh the answer. This is a top-down question. The reported figures record what has happened, and management's plan and its early results show where the firm is heading. The relationship-lending literature describes lenders using such information (Berger & Udell, 2002, 2006). Read the quarterly and half-yearly figures, and monthly figures where needed, as a trend, and read that trend alongside what management is doing.

Second, adjust reported figures for mechanical distortions that can be identified and quantified (Palepu et al., 2020). Lenders should normalize working capital for deferred customer advance receipts, add back discretionary owner distributions when evaluating operating return capacity, and utilize gross or appraised asset values rather than historical amortized book values when evaluating the collateral base.

Third, where cash flow is sufficient and payments have always been made on time, as in Companies 4 and 6, debt-service capacity is direct evidence that the ratios alone do not provide.

Fourth, allow time. A change in leadership reaches the statements only after it has worked through culture, behavior, operations, and other change management programs (Figure 4), so a lender reading the statements alone will see a turnaround late. Companies 2 and 7 both turned around while their reported figures were still weak or the standard covenants still applied. Lenders who are willing, at times, to give a credible new leader room to carry out the plan can back a recovery the reported figures cannot yet show. This takes courage as well as patience, because the figures will continue to look weak in the meantime.

5.2 For Owners and Executives

Owners and executives can bring the lender what the statements omit. In the cases, the operating improvements that preceded the financial results were warranty returns, labour hours per unit, lead times, and overhead (Section 3.2). Reported to the lender as they happen, these show a change that will reach the statements only later. Owners should also explain the decisions behind unusual figures, such as management-fee distributions, and how they relate to covenant compliance.

6. Conclusions

This study examined how the reported figures of seven private manufacturing SMEs in British Columbia related to the decisions behind them, and how their lenders responded. In every firm, the lender tested covenants, chiefly the current ratio and debt-to-equity, on the figures in the financial statements as reported, without adjusting them. The weak ratios had different causes. In two firms they came from thin sales and low margins, and they described the balance sheet fairly without measuring the firms' ability to repay. In other firms, weak metrics stemmed from accounting conventions—including deferred revenue treatment, legacy asset amortization schedules, and discretionary owner distributions—that bore no relation to underlying operating health. Three firms with weak ratios were asked for their owners' personal assets as additional security, and one strong firm had its covenants eased.

The main conclusion is that financial statements record the results of decisions and not the decisions themselves. Because a change in leadership works through culture, behavior, and operations before it reaches the statements (Figure 4), the covenants in Companies 2 and 7 responded to the reported figures and took no account of a leadership change that was already improving operations (Hambrick & Mason, 1984; Kaplan & Norton, 1992). This gap between what a firm's reported statements show and its operating capacity and creditworthiness is what this paper calls the 'Balance Sheet Illusion'. In Canada, the gap can be wider for private firms because ASPE allows operating leases to remain off the balance sheet (CPA Canada, 2020).

Because the seven firms were chosen for convenience, the findings show what can happen and not how often it does (Section 1.8.1).

The balance sheet remains one of the most powerful tools in business analysis, but it should not be mistaken for the business itself (Johnson & Kaplan, 1987). Financial statements record the consequences of decisions; they do not reveal the philosophies that created them.

6.1 Moving Forward

For standard setters, the cases raise one specific question. ASPE retains the distinction between operating and capital leases, while IFRS 16 and ASC 842 do not (CPA Canada, 2020), so an operating lease can keep an obligation off the balance sheet, where covenant ratios are measured. Standard setters and lenders could consider whether that distinction serves those who rely on private-company statements, and lenders could read the commitments disclosed in the notes alongside the reported ratios.

Future research could build on this study in several ways. Larger or random samples could show how often the patterns in these cases occur. Formal interviews with lenders would add the lender's side. In this study, the author's understanding of lenders' approach comes from face-to-face meetings during covenant negotiations in some of the firms, not from structured interviews. Studies in other provinces or under other reporting frameworks would show whether the findings hold elsewhere. Researchers could also examine the Leadership-to-Balance-Sheet Causality Model (Figure 4) by comparing observable outcomes, such as operating performance, customer outcomes, and employee behavior, with later financial reporting patterns (Hambrick & Mason, 1984; Nanni et al., 1992).

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