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Understanding Financial Statements

The following strategies can help you understand a company's financial statements and financial health.

SEE WHO PREPARED THE TAX RETURNS OR FINANCIAL STATEMENTS YOU ARE REVIEWING. The quality of tax return and financial information varies considerably depending on the sophistication of the client. Any financial statements not reviewed or audited by independent accountants should be closely scrutinized.

MAKE SURE ALL OF THE COMPANY'S ASSETS ARE REFLECTED ON THE BALANCE SHEET. Companies preparing their own financial statements on the cash basis of accounting may not include certain assets, such as accounts receivables and work in progress, on the balance sheet. This is especially true of construction and contracting companies.

DETERMINE THE CURRENT VALUE OF THE COMPANY'S ASSETS. For accounting purposes, most items on a balance sheet are shown at their original purchase price. Accordingly, the current value of a company's long-term assets, such as equipment and real estate, may be higher or lower than their balance sheet value.

SCRUTINIZE ANY TRANSACTIONS WITH RELATED PARTIES. Often transactions between related parties are not at arms-length and may unfairly benefit one of the parties. Therefore, be skeptical of revenues, expenses, assets and liabilities that result from related party transactions.

DETERMINE THE ROUGH VALUE OF A COMPANY UNDER THE COST APPROACH. Total the current value of a company's assets and subtract its debts for its

SEE IF THE COMPANY IS GROWING MORE PROFITABLE. Add the company's net income (the sum of the company's revenues less its expenses) to the owners' compensation. If the company's net income plus owners' compensation is increasing the company is likely to be healthy and increasing in value.

ASK THE OWNERS ABOUT SIGNIFICANT CUSTOMERS OR SUPPLIERS. Transactions with one party representing over 10% of a company's total revenues or expenses are considered significant. Companies relying on significant customer and supplier relationships for their profitability may be at risk because such relationships may become less favorable.

ANALYZE SHORT-TERM ASSETS AND LIABILITIES. The current health of a company can be indicated by changes in its short-term assets and liabilities. Increasing accounts receivable and inventory levels can indicate a growing business but may also indicate the company is having difficultly collecting on its receivables or selling its merchandise. A company is more likely to be struggling if its accounts receivable or inventory levels are growing faster than its sales. Similarly, a company with growing accounts payable may have a cash flow problem.

QUESTIONS OR COMMENTS

Please call me with your comments at 916.756.5622.

— Thomas Collins, CPA / ABV, CFA