LISTEN to Your Financial Statement

Those Data From Your Accountant Have a Vital Story to Tell

By Sidney F. Jarrow C.P.A.

Most people believe you read a financial statement.
This is true, but it is also trying to tell you a story—a story that all too often goes unheard and unheeded. Frequently, financial statement users have what I call the HHH syndrome. They open their financial statements to determine:

HOW much do I have in the bank?
HOW much did I make?
HOW much am I worth?

That is the end of the examination when it should be the beginning.

I would imagine that the sequel to the above would be the following oversimplification:

WHY is that amount in the bank?
WHY didn’t I make more (or less)?
WHY wasn’t my net worth greater (or less)?

Let us address ourselves to the financial statements themselves and see if we can learn to “hear” them a little better. Preceding a financial statement should be a letter from your accountant.

DO YOU LISTEN TO YOUR FINANCIAL STATEMENTS?

This letter gives the reader an indication of what the preparer of the statement did, or did not do. It should be read so the statement reader puts them in the proper perspective or frame of reference.

Let us leap to the end of the financial report.

There one will often find a number of foot-notes to the statements which further amplify what the numbers might reflect or the methods used to arrive at those numbers. For a financial statement user who wishes to hear the full story, the words are no less important than the numbers.

The first statement in a report is usually the Balance Sheet. This statement is a photograph of your business at a given instant. The minute any additional transaction occurs, the photograph changes and is no longer true. Another statement is the Statement of Income and Related Earnings. It is more like a motion picture that shows you what happened between two dates—say January 1st through December 31st.

This result is then added to prior results, retained earnings, to update what has been the operating results since you have been in business.

You have probably heard the statement “If I made that much money, where did it go?” The Statement of Changes in financial position is a statement designed to help answer that question and yet it is often ignored by the reader.

You should sit down with your Certified Public Accountant (CPA) or financial consultant and learn how to improve your hearing when it comes to listening to your financial statements.

Many statements are prepared on a comparative basis and this comparison will tell you where the business has been and give you some clue as to where it might be headed. Those “other” statements in financial reports tend to be ignored or overlooked because of lack of familiarity when they are begging you to hear their story for they contain many of the answers you are looking for.

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Percentages are quite frequently reflected by the dollars. They are particularly valuable when compared with those of prior periods and in examining trends. Those percentages can indicate changes in product or service sold, changes in direct costs and be indicative of administrative efficiency—or deficiency.

Let us examine some of the more specific and not too obscure items in the financial statements where a particular story is being told:

1. **How is the company really performing?**
   - This is determined by taking the company’s Working Capital and dividing it by the Sales. Comparing this answer with others in the same industry will tell you whether you see an average, above average or a below average operation.

2. **Are they effective in selling their product?**
   - The Cost of Sales when divided by the Inventory will produce a number that will tell you the average number of times the items in inventory are sold each year. The higher the score the better the operation.

3. **Is the company earning a decent profit as compared to the rest of the industry?**
   - Net Profit divided by Sales will measure the profit margin that can then be measured against the competition to see who the star performers are—or are not.

4. **What about gross profits instead of net profits?**
   - By dividing the Cost of Sales by the Sales you will get a good idea if there appears to be sufficient margin to cover general expense, selling expense and leave something to pay for research and future development.

5. **Can the company pay its bills?**
   - The Current Assets divided by the Current Liabilities will give a good indication of the company’s solvency. If you wish to give the company a “stress test,” deduct the Inventory from the Current Assets and do it all over again.

6. **Is the company “stretched” too far?**
   - Total Debt divided by Net Worth will tell you if there are too many credit grantors standing in line in front of other creditors. Excess debt indicates undercapitalization and that is a very common cause of business demise.

7. **Does management get a good grade for operating the company?**
   - Net profit divided by new worth reflects return on invested capital. The higher the number, the better management’s grades. Would you be willing to leave your money invested here when compared to similar industries and when compared to the money market in general?

The financial statements are a continuing collection of facts and data that are gathered by the CPA for use by management, taxing bodies, creditors and lenders. Some of the stories that these statements are telling are more obscure than others and require acute hearing.

Financial Statements do not tell the entire story, but the intelligent user will be in a position to ask additional necessary questions as he relates to these statements. If you “dig” in the right places, the treasure can convert into money.

For those who need lessons in where and when to dig, their Certified Public Accountants or financial advisors are there to help them locate the treasure.

(Editor’s Note: The author of this article, Sidney F. Jarrow, is a Certified Public Accountant and an administrative partner in the accounting firm of Doty, Jarrow & Co., of Chicago. A speaker and author, he is widely recognized in the accounting/construction area for his expertise in financial statement interpretation.)