Financial statements: Take the time to read the entire story

A complete set of financial statements for your business contains three reports. Each serves a different purpose, but ultimately helps stakeholders — including managers, employees, investors and lenders — evaluate a company's performance. Here's an overview of each report and a critical question it answers.

1. Income statement: Is the company growing and profitable?

The income statement (also known as the profit and loss statement) shows revenue, expenses and earnings over a given period. A common term used when discussing income statements is "gross profit," or the income earned after subtracting the cost of goods sold from revenue. Cost of goods sold includes the cost of labor, materials and overhead required to make a product.

Another important term is "net income." This is the income remaining after all expenses (including taxes) have been paid.

It's important to note that growth and profitability aren't the only metrics that matter. For example, high-growth companies that report healthy top and bottom lines may not have enough cash on hand to pay their bills. Though it may be tempting to just review revenue and profit trends, thorough due diligence looks beyond the income statement.

2. Balance sheet: What does the company own (and owe)?

This report provides a snapshot of the company's financial health. It tallies assets, liabilities and "net worth."

Under U.S. Generally Accepted Accounting Principles (GAAP), assets are reported at the *lower* of cost or market value. Current assets (such as accounts receivable or inventory) are reasonably expected to be converted to cash within a year, while long-term assets (such as plant and equipment) have longer lives. Similarly, current liabilities (such as accounts payable) come due within a year, while long-term liabilities are payment obligations that extend beyond the current year or operating cycle.

Intangible assets (such as patents, customer lists and goodwill) can provide significant value to a business. But *internally* developed intangibles aren't reported on the balance sheet. Intangible assets are only reported when they've been acquired *externally*.

Net worth (or owners' equity) is the extent to which the value of assets exceeds liabilities. If the book value of liabilities exceeds the book value of the assets, net worth will be negative. However, *book* value may not necessarily reflect *market* value. Some companies may provide the details of owners' equity in a separate statement called the statement of retained earnings. It details sales or repurchases of stock, dividend payments and changes caused by reported profits or losses.

3. Cash flow statement: Where is cash coming from and going to?

This statement shows all the cash flowing in and out of your company. For example, your company may have cash *inflows* from selling products or services, borrowing money and selling stock. *Outflows* may result from paying expenses, investing in capital equipment and repaying debt.

Typically, cash flows are organized in three categories: operating, investing and financing activities. The bottom of the statement shows the net change in cash during the period. Watch your statement of cash flows closely. To remain in business, companies must continually generate cash to pay creditors, vendors and employees.

Read the fine print

Disclosures at the end of a company's financial statements provide additional details. Together with the three *quantitative* reports, these *qualitative* descriptions can help financial statement users make well-informed business decisions. Contact us for assistance conducting due diligence and benchmarking financial performance.