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How to Read a Financial Statement

10 TIPS

HOW TO READ A FINANCIAL STATEMENT

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The financial statements tell a story

The financial statements tell the story of a company. You have to know how to read the financial statements to find the story. Here are 10 tips to help you find the story.

Every company has three parts in its financial statement:

1. Income Statement
2. Balance Sheet
3. Cash Flow Statement

Income Statement
The income statement shows if the company is earning a profit or if it has a loss. The income statement starts with revenue and subtracts expenses. The final number or "bottom line" is net income or net loss. The income statement is also called statement of operations, a profit & loss statement, or a P&L.

Alpha, Inc.
Income Statement
Year Ended 12/31/2017

Revenue	$ 50,000
Cost of goods sold	22,500
Gross profit	27,500
Selling, general & administrative expenses	18,400
Operating income	9,100
Interest expense	900
Income before income tax	8,200
Income taxes	2,500
Net income	$ 5,700

Simplified Income Statement

Balance Sheet

The balance sheet lists the company's assets, liabilities, and equity. Assets are everything that the company owns. Liabilities are debts that the company owes. The equity is the net worth of the company. The equity always equals assets minus debts. The balance sheet is also called the statement of financial position.

The balance sheet shows the accounting equation where assets = liabilities + equity. The assets are what the company own. The liabilities and equity are claims on the assets by the creditors and the owners. The balance sheet is always in balance because the accounting equation is always in balance.

> *Accounting Equation: Assets = Liabilities + Equity*

Alpha, Inc.
Balance Sheet
December 31, 2017

Assets	
Cash	$ 11,200
Accounts Receivable	9,400
Inventory	13,900
Short-term investments	4,500
Total current assets	39,000
Property, plant & equipment, net	45,200
Long-term investments	8,700
Other assets	1,600
Total assets	$ 94,500
Liabilities	
Accounts payable	$ 19,300
Accrued expenses	18,900
Notes payable	11,000
Total current liabilities	49,200
Total long-term liabilities	34,500
Total liabilities	83,700
Stockholders' Equity	
Common stock	1,200
Additiional paid-in capital	4,300
Retained earnings	5,300
Total stockholders' equity	10,800
Total liabilities and stockholders' equity	$ 94,500

Simplified Balance Sheet

Cash Flow Statement

Cash is so important that it has its own financial statement. The cash flow statement shows cash coming in and cash going out of the company. The cash flow statement has three sections of cash activities: operating, investing, and financing.

Operating activities are cash transactions from operating the business. Payments to suppliers, payments to employees, and receipts from customers are all operating activities.

Investing activities are buying and selling long-term assets. Buying or selling land, equipment, machines, legal rights, cars, buildings, and securities all count as investing activities.

Financing activities include borrowing and repaying long-term debts, paying cash dividends, and selling or repurchasing company stock. These transactions help to finance the activities of the company.

Alpha, Inc.
Cash Flow Statement
Year Ended 12/31/2017

Cash Flows From Operating Activities		
Net income	$	6,550
Depreciation expense		1,787
Deferred income taxes		(856)
Accounts receivable		(28)
Inventory		(142)
Prepaid expenses		286
Accrued liabilities		750
Net cash provided by operating activities		8,347
Cash Flows From Investing Activities		
Investments in property, plant, and equipm		(2,262)
Sale of investments, net		1,154
Net cash used for investing activities		(1,108)
Cash Flows From Financing Activities		
Debt issued, net		2,584
Common stock repurchased, net		(2,180)
Dividend paid		(6,043)
Net cash provided by (used for) financing a		(5,639)
Net change in cash	$	1,600
Cash at beginning of period	$	9,600
Cash at end of period	$	11,200

Simplified Cash Flow Statement

For each of the 10 tips, use the Alpha Inc. financial statements to find the answers.

1. Revenue, net income, and cash

Revenue
Look at the income statement and find the top line which is total revenue or sales. Revenue is where it all starts for the company. How much revenue did the company earn?

> *Alpha's revenue is $50,000. If the numbers were shown in millions, the $50,000 would be $50,000,000,000. That's $50 billion!*

Net Income
Next, look for the bottom line on the income statement which is net income. Net income is when revenue is higher than expenses. If the expenses are higher then there is a net loss. Net income is also called net profit or net earnings.

Companies have to be profitable to continue to exist. Profit means growth for the company. What is the profit or loss of the company?

> *Alpha's net income is $5,700. After all the revenue comes in and the expenses go out, Alpha earned $5,700.*

Cash
Finally, find the cash balance. It is usually the first line on the balance sheet. Cash is king, so we always want to see how much cash the company has. Too little cash could be fatal for the company!

> *Alpha's cash balance is $11,200.*

2. Gross profit margin

Revenue is when the company sells its goods or services. Revenue is when money comes in to the company. Expenses are money that goes out of the company or when assets are used by the company. The biggest expense for most companies is cost of goods sold (COGS), or cost of sales, which is directly below the revenue number. Revenue minus cost of goods sold is an important number called gross profit or gross margin. This shows what profit the company is making just from selling its products.

The actual gross profit number is hard to analyze, so lets convert it to a percentage. The gross profit formula is **Gross profit / Revenue = Gross margin %**

> *Gross profit is $27,500 and revenue is $50,000, so 27,500 / 50,000 = 55.0%. For every $1 of revenue, it costs Alpha about 45 cents and it makes 55 cents in gross profit. Cool, huh?*

A company has to have gross profit before it can achieve a net profit, so this is an important calculation to make!

> *A company should have at least 30% gross profit if it wants to have net profit.*

3. Operating profit margin

Gross profit is the profit from selling the products or services. Below gross profit are the operating expenses. These operating expenses are what it takes to run the business. The largest of these are selling, general, and administrative expenses. These three categories are usually combined into one SG&A number. These would include all the salaries, wages, utilities, and any other costs of running the business.

Gross profit minus operating expenses gives operating income, operating profit, or earnings before interest and taxes (EBIT). Operating profit is the profit of running the business before interest and taxes. Once again we want to convert this number to a percentage to interpret it. The operating margin is **Operating profit / Revenue = Operating Profit Margin**

> *Operating profit is $9,100 and revenue is $50,000, so 9,100 / 50,000 = 18.2%. For every $1 of revenue, it costs Alpha about 82 cents for product costs and administrative costs. So, it makes 18 cents in operating profit on each $1 in revenue.*

4. Pretax margin

Pretax profit is the operating profit minus the interest expense. If the company has zero debt, the operating profit and the pretax profit will be the same. Pretax profit is also called earnings before taxes or EBT. Again, this needs to be in a percentage so **Pretax margin = EBT / Revenue.**

> *Pretax profit is $8,200 and revenue is $50,000, so 8,200 / 50,000 = 16.4%. For every $1 of revenue, it costs Alpha about 84 cents for product costs, administrative costs, and interest costs. Alpha makes 16 cents in pretax profit on each $1 in revenue.*

You have noticed that on the income statement, the terms income, profit, and earnings all mean the same. So pretax profit = pretax income = pretax earnings = EBT = income before tax. Accounting is the language of business and it is not always so precise!

5. Net profit margin or return on sales (ROS)

Since you know that profit = income, this tip is looking at net income. Again, we need to make it a percentage. So, **Net Income / Revenue = Net Profit Margin.** Net profit margin is also called return on sales (ROS).

> *Net income is $5,700 and revenue is $50,000, so 5,700 / 50,000 = 11.4%. For every $1 of revenue, it costs Alpha about 89 cents for all costs. Alpha makes 11 cents in net earnings on each $1 in revenue.*

6. Current ratio

Companies are so concerned about being able to pay bills on time, they calculate the current ratio to measure this ability. **Current ratio = Current assets / Current liabilities.**

This number compares the current debt that the company owes this year to the current assets that will be used to pay. Current means short-term assets and debts. The current ratio shows the ability of the company to pay its short-term debts.

> *Current assets are $39,000 and current liabilities are $49,200, so the current ratio is 39,000 / 49,200 = 0.79. Alpha has 79 cents in current assets to pay off $1 of current liabilities. Usually companies would like to have a number higher than 1.0.*

7. Debt ratio

Another area of concern is the company's debts. If you look on the company balance sheet, the assets are financed by either debt or equity. If debt levels get to high, it can be very damaging to the company. So, **Total liabilities / Total Assets = Debt ratio.** Remember, liabilities are debts that are owed to others outside the company.

> *Liabilities are $83,700 and assets are $94,500, so the debt ratio is 83,700 / 94,500 = 88.57%. Alpha has 89 cents in debt for every $1 in assets. Equity only finances about 11 cents of each $1 of assets. This is a high percentage of debt.*

8. Return on assets

Net profit margin or return on sales is how profitable the company is based on each dollar of revenue. But what is the return on investment? There are two ways to think of this return: Return on assets and return on equity.

This tip is ROA and the next one calculates ROE. Return on assets (ROA) is **Net Income / Total Assets = ROA**. ROA measures the profitability based on the assets used by the company to generate the profits.

> *Alpha net income is $5,700 and total assets are $94,500. ROA is 5,700 / 94,500 = 6.03%.*

ROA shows how effective the company uses its assets to generate a profit. Remember for this company, the debt ratio is high. So, one concern is that the company has a sufficient return on assets to pay off the interest expense on its loans.

9. Return on equity

Return on equity measures the profitability based on the equity or net worth of the company. Equity is what the stockholders own so ROE is the return for the owners of the company. Return on equity (ROE) is **Net Income / Total Equity = ROE**.

> *Alpha net income is $5,700 and total equity is $10,800. ROE for Alpha is 5,700 / 10,800 = 52.78%.*

If Alpha has zero debt, ROA and ROE would be the same. Since Alpha has lots of debt, the equity is very small and the ROE is much higher than ROA. Return on equity shows how profitable the company is based only on the owners' equity.

10. Find "total cash"

This seems like a simple question, but in the financial world many people add cash plus investments to equal "total cash." The idea is to calculate cash and all the investments that could be converted to cash quickly to find what the total would be. So, **Total cash** = **Cash + Short-term investments + long-term investments.**

> *Alpha has cash of $11,200, short-term investments $4,500 and long-term investments $8,700. So total cash is $24,400.*

The company has taken the excess cash and invested it in securities to earn a higher return.

We finished! Now we know a lot more about our company. You can use your new skills to find financial statements of a company that you know and you can start to find the story. Good luck!

Recommended resources

> *Full disclosure: These are books that I personally recommend for reading financial statements. The following are affiliate links.*

Warren Buffet and the Interpretation of Financial Statements by Mary Buffett

Financial Statements: A Step-by-Step Guid to Understanding and Creating Financial Reports by Thomas Ittelson

How to Read a Financial Report: Wringing Vital Signs Out of the Numbers by John A. Tracy

Final thoughts

You now have some tips on how to start to analyze a financial statement! I hope you learned something that was useful and that you won't be afraid to dig in to financial statements from now on. You can do it!

Jeff Mankin

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