UNDERSTANDING FINANCIAL STATEMENTS

How to Read Income Statements, Balance Sheets, Cash-Flow Statements and Calculate Financial Ratios

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MAIN IDEA

The ability to understand and analyze financial statements is an essential business skill.

Financial statements reflect the financial health of a company, and can be the sole basis for making investment decisions. For a company's management, how decisions made will be reflected in the company's balance sheet can be a major factor when considering the direction the company may take.

The key financial statements are the Income Statement, the Balance Sheet and the Cash Flow Statement. The information contained in these materials can then be used to calculate a wide array of financial ratios. The financial ratios are an excellent way to compare one company to another, as well as to evaluate the competence and results of one management team by comparison with another.

An Income Statement summarizes a company's sales revenue and level of profitability for a specified period of time. It categorizes:
1. The company's total sales income
2. The costs of the products or services sold
3. The company's expenses
4. Whether the company showed a profit or loss for that period

A Balance Sheet is a snapshot of the financial condition of a company as at a specified date. It states the company's "basic accounting equation":

Assets = Liabilities + Owner's Equity

Assets are anything of value the company owns.
Liabilities are any short- or long-term debts the company has.
Owner's Equity is the owner's stake in the business.

A Cash Flow Statement categorizes what the company's sources of cash were and where that cash has been applied. Broadly speaking, cash flow is deemed to be derived from and applied to:
1. Operations -- the company's day to day business activities
2. Investing activities
3. Financing activities

Once you have a company's financial statements, you can then calculate a number of ratios using the information given. By comparing these ratios with the same ratios for comparable companies in the same industry, you then have a measure of how strong or weak the company is -- and whether or not it would be a good investment.