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How do you learn to read financial statements?

By Christopher J. Zinski

In the previous edition of Chicago Daily Law Bulletin, I outlined the vital importance of reading client and prospective client financial statements. But what do you do if are not a CPA and a lawyer like me? Good news — there are several ways to learn to read financial statements.

Find a Teacher

Perhaps the easiest way to learn to read financial statements is to have the firm's CFO or executive director use partner meetings as a venue to educate your partners about the firm's financial condition. If this is done well, you will see all kinds of light bulbs flashing in partner minds because it affects them so directly and personally. Ask questions about the firm's key performance indicators, liquidity and financial risks.

There are other options if you cannot persuade the firm's leaders to do this. One is to meet with the smartest financial minds in your network and ask them for some tutoring. If you have three good friends who are CPAs, see if each of them will go through an actual set of client or prospect financial statements with you. Most will be deeply flattered by your request. You may need to meet with them over several months before you begin to gain comfort with reading and understanding financial statements, but I assure you the effort will be well worth it.

Another option is to have the CFO, controller or finance expert in your client organization share with you some of the key drivers (such as ratios and KPI's) of their business. After the shock of being asked wears off, your clients are likely to be flattered. Perhaps you can ask those same people to give a presentation inside the firm and educate your entire team on these key drivers. For example, a consumer products company is likely to be focused on unit sales while a bank will be keenly focused on its net interest margin.

Where to Look

The first step to understanding financial statements is to know what these key performance drivers are before picking up a 40-page set of financial statements and wading through them. Once you have identified the key drivers, skim through the income statement and balance sheet of the company focusing on the line items that represent these key drivers. Admittedly, it will be easier for a CPA to know which line items relate to which key drivers. Again this is where the financial experts in your network can help. Ask them to point out the line items that are most relevant to the business. Importantly, compare current period performance to prior quarter performance and performance in the same quarter for the prior year. This will tell you about the company's trend line relative to those key drivers. The first time you do this it will be cumbersome and probably take quite some time. After you have done it dozens or even hundreds of times it will come to you very quickly.

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The footnotes to financial statements can occupy 20 or more pages and look daunting to most lawyers because they are number intensive. Take it easy on yourself in the beginning and tell yourself you are going to flip through the footnotes and focus on only four that seem most relevant to you. Again you may have to ask someone who is financially literate to help you decide which four footnotes are the most relevant.

In the current economy, focusing on the long-term debt footnote makes sense to see how much debt the company is carrying, the rate paid on the debt, the ratio of debt to equity and whether the debt amount is trending up or down. This can tell you a lot about the company's leverage and its financial health. Many companies are deleveraging in the current environment.

On the asset size of the balance sheet and related footnotes, look for the accounting detail on "allowances." Bad debt allowances – reflecting the company's ability to collect on trade receivables – can tell you a great deal about the financial health of the company. In a bank, the allowance for loan losses, provision for loan losses and charge-offs are often set forth in one large note in the notes to the financial statements; for a bank, those numbers can tell you more than half the story about the bank's financial health and, frankly, whether it will survive long term. Assets subject to impairment risk, like the DTA mentioned in my prior column, or goodwill are also useful data points in the financial statements because management spends considerable time supporting its judgment around those types of assets and impairment charges have material effects on the company's viability. Focus on the items in the financial statements that matter to senior management. If you do not know what they are, ask senior management!

Finding the Financial Statements

In some cases, financial statements are easy to find because they are publicly available. For instance, if your client or prospective client is publicly-traded, the financial statements can be found on the Web page of the Securities and Exchange Commission. In particular highly regulated industries such as banking, financial statements are filed as "call reports" with the FDIC and can be easily found online through a search of the FDIC's institutions directory. But finding financial information on privately-held companies can be more difficult, though you may be interested to find how much presumably private financial information about a company is publicly available on the Internet, so check it.

You might want to take yet another approach if you cannot find the financial statements of your client or a prospective client online: Ask the client if he will send you a copy. Imagine the CEO's pleasant surprise if a lawyer, especially the company's current lawyer, asks to see current financial statements because the lawyer is interested in learning more about her client and ensuring her advice was comprehensive and sensitive to the company's financial issues. Most CEOs will be very impressed. Indeed most business people knock lawyers for being too narrowly focused and not business oriented. Overcome that negative impression and instead knock the CEO's socks off by expressing your craving for detailed financial reports on her company so you can, like the CEO, master them for the purpose of providing better advice and value. Take the same approach with prospective clients.

When you are setting up a lunch meeting with the CEO of a prospective client, ask the CEO to forward you his company's financial statements before the lunch. Most CEOs will be flattered (and shocked) that you are interested in their company to that level of financial detail and you will distinguish yourself from every other lawyer trying to impress that CEO.

In short, CEOs and C-suite executives spend most of their days focused on the financial effects of business decisions and understanding how accounting rules affect their business determinations. Step into their shoes and look at the world through their lens. You will be surprised how much business you generate by focusing, fundamentally, on their business.

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