Review Financial Statements Critically

Corporate financial statements should not necessarily be taken at face value. While the financial statements of public companies must be stated in accordance with generally accepted accounting principles (GAAP), these principles are not rigid rules, allowing much leeway and discretion.

A company's earnings can vary significantly depending on how certain items are reported, such as:

- **How revenue is recognized.** The accounting principle is that revenue should be recognized when most of the company's obligations are fulfilled and the company is reasonably sure that it will be paid. While the concept seems simple enough, there are a number of situations where revenue recognition would seem questionable. For an indication of aggressive revenue recognition, see if accounts receivable are increasing faster than revenue or if there are large increases in finished goods inventory. Also make sure that net income is roughly in line with cash flow.

- **How depreciation is calculated.** Since major assets are used in a business for several years, their cost is usually spread over their useful life instead of charging the entire cost against income when purchased. Depreciation is calculated by dividing the cost by the estimated useful life. Management has broad discretion in estimating useful lives and can change those estimates whenever they decide new estimates are more accurate. Longer lives result in less depreciation being charged against income, thus increasing earnings. The notes to the financial statements will indicate whether changes have been made to the depreciation schedules that year.

- **How reserves are estimated.** Companies are required to set up reserve accounts to cover potential future expenses related to current-year sales. For instance, reserves are set up against accounts receivable to cover accounts that won't be paid or for potential payouts for lawsuits currently in litigation. Those reserves can be changed based on management's judgment. Examine the financial statements for any allowances or reserves and review whether those balances are increasing or decreasing over time.

- **How pension liabilities are calculated.** Companies record liabilities for pension benefits that will be paid to current and future retirees. Those liabilities are significantly impacted by the rate of return assumed to be earned on pension investments. Higher returns result in lower current liabilities, since future investment earnings will be higher and thus will pay more of the obligation. The rate of return is disclosed in the notes to the financial statements.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com