Financial training for non financial staff

ATTAINMENT TRAINING

The financial training specialists

Company accounts: what are we looking for?

When we're looking at company accounts, we're trying to assess the health of the company.

A healthy company has several financial characteristics:

- its sales are growing rather than shrinking
- profitability (not much use growing the business simply to make bigger losses!)
- positive cashflow (poor cashflow will kill a company more quickly than poor profitability). This usually requires…
- good working capital management
- investment in new equipment to enable further growth

So when we're analysing a company it's useful to get about 4 years of accounts, and try and get an idea of the trends in these five areas.

Let's look at each bullet point in turn.

Growing or shrinking?
The *sales* (or *turnover* or *revenue*) figure at the top of the P&L account answers this question. Are sales increasing or decreasing?

It's also worth looking at the *Cost of sales* figure (the cost of producing the goods or services that the company sells). If cost of sales is rising more quickly than sales, the company may be driving sales by giving bigger and bigger discounts, which will damage profitability.

Profitability
"We don't want to make sales, we want to make profitable sales." So look near the bottom of the P&L account for the *PBT* (*profit before tax*).

Is the company making money or losing money?

If the company is growing, is PBT growing in line with sales, or more slowly? It can be illuminating to compare the trend in sales with the trend in PBT over a few years.

How well is the company managing its *overheads* (the HR; IT Finance; sales and marketing; etc departments)? You will find overheads as a line in the P&L, or as a line in the note to PBT. If overheads are growing faster than sales, there may be a cost management problem.

Cashflow
"Cash is king" they say. So how much cash has the company got, and is it increasing or dwindling away?

Cash is more complicated to get a grip on than the earlier figures, so be patient! Start with *current assets* in the Balance Sheet, and look for the value of *Cash and bank balances*. If the company has no positive bank balances, this figure won't be there. It's all the bank accounts that are in the black.

Next, find the note for *Creditors due within less than 12 months*. There may be an overdraft here; and some bank loans; and some finance leases. These are the accounts in the red!

Finally, look for the note *Creditors due within more than 12 months*. Look for any long term bank loans and finance leases here as well.

Now we can get a picture of the overall cash situation.

What's the trend with net cash (bank balances minus overdrafts)? Is it getting better, or getting worse?

And what about longer term borrowing (loans and finance leases)? Are they paying off their loans, or are the loans increasing? If loans are growing, what are they using the extra money for?

Think about your own personal financial situation when you're doing this. Just as we may have a savings account; an occasional overdraft; car finance and a mortgage; it's just as complicated for companies! But we'd like our savings to grow and our overdraft to shrink from year to year. We want to gradually pay off our mortgage and car loans, although they may grow if we've changed cars or moved house. If we've had to take out a loan to cover general living expenses, that's bad news!

Working capital
This is often the cause of cashflow problems. Working capital is the cash tied up in the production process. It's like a sponge that wants to soaks up all the cash. How well is the company succeeding in squeezing the cash out of the sponge and back into the bank account?

Look for *Stock and WIP* (or *Inventories*) under *Current assets* in the Balance Sheet. This is the cash tied up in raw materials, finished goods and WIP (work in progress: the unbilled or half finished work). If sales are growing, stocks and WIP will probably be growing. But if they're growing faster than sales the company is taking longer to turn its supplies back into a product or service that they have invoiced.

Next find the note for *Debtors and Prepayments*, and look for *Trade debtors* (or *trade receivables*). These are the customers who haven't paid their bills. If they're rising faster than sales, customers are taking longer to pay. Slow paying customers are the biggest cause of cashflow problems and business failure.

Finally look for *Trade Creditors* (or *trade payables*) in the note *Creditors due within less than 12 months*. These are the suppliers who haven't been paid yet. If this figure is growing faster than sales, the company is taking longer to pay its suppliers. This may indicate that the company is having cashflow problems and is unable to pay its suppliers on time (especially if trade creditors and sales have recently moved dramatically out of synch).

Investment
Look for *Tangible fixed assets* at the top of the Balance Sheet, and its accompanying note. Is the company investing in new equipment (look under *additions* to cost in the note)?

If there is a trend of not investing, why is this? What will happen when the equipment eventually needs replacing (as it inevitably will)? If it is investing, how is it paying for the new equipment? Out of its profits, or is it borrowing to pay for the equipment?

Overall summary
With many companies you'll come up with a mixed picture, with some of these five areas doing well, but concerns about others.

The trends are important: are things getting better or getting worse?

Your gut feel is probably more important than assessing "this number should be more than x." If at this preliminary stage your gut feel is warning you about the company, hang onto that warning until you can articulate exactly what the problem is.

Dig deeper
By assessing these five measures we have built a basic overall picture of the company's financial health. There's a lot more that we can (and will) look at, but – as you dig into the detail – don't lose sight of this overall picture. It's this context that the detail will help illuminate.