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A guide to decoding annual accounts

Decoding a company's annual accounts can sometimes feel like struggling to read a foreign language. But the information in an annual account can give you crucial insight into a company's financial health and help you avoid credit risk. Here, we break down the different components of an annual account and explain which ratios you need to master first.

To get the latest incisive information on Credit Risk, visit our download centre, where you can download our guide: Understanding Credit Risk for Dummies.

What's in an annual account?

By law, a company's annual account needs to include the following items:

- Balance sheet
- Profit and loss account (although this isn't always necessary for small and medium sized companies)
- Auditor's report
- Director's report
  Accurately interpreting the implications of this information can inform the amount of credit you're willing to extend. It can also help you predict the future success of a company, particularly in the short term. However, to get the most insight, you'll need to review this information within a wider context to identify trends and analyse performance.

Analysing behavioural trends

A company's year-end figures may look robust as stand-alone data, but it's important to take a holistic view, looking at these figures within the context of previous years as well as wider industry patterns. Reviewing a company's filings from the past three to five years provides a broad enough point of comparison to analyse whether growth, revenue and profit are following an upwards trajectory or whether there has been a slowdown. Make sure to analyse whether sales are trending up or down. How about the company's profits, net worth, and shareholders' funds?

To understand these changes more, compare the figures to similar sized companies operating within the same industry and geography, and also research industry trends to see whether the company is performing on, below or above average for industry expectations. This will give you insight as to the company's financial health, but also the success of its management in terms of operating efficiently and capitalising on opportunities.

Knowing your industry

To help you understand your industry better, here are some key questions you can ask:

- Is it a thriving sector, in general?
- Do earnings fluctuate with the seasons?
- What are typical profit margins for comparable businesses within the industry?
- What are its prospects for growth?
- Is its market share expanding or declining?

- Is it an antiquated industry trying to catch up with technological advancements, or an innovative industry already taking advantage of new opportunities?
- How well is it anticipated to fare in the current economic climate?
- Has it been or will it be affected by any socio, political or economic changes?
- Is its success dependent upon another industry?
- If so, what are the prospects for that industry?

The more you know about an industry, the more equipped you will be to make good decisions about working with businesses in that sector.

Understanding financial ratios

Ratios are an important way for credit managers to assess a company's account – understanding how quickly it turns over stock and collects on invoices as well reviewing performance, liquidity and solvency. Some simple calculations can help you demystify an annual account.

Current ratio

For example, to understand the liquidity of a company, you need to divide its current assets (monies accrued or due to be received within one year) by its current liabilities (monies due to be paid within one year). This helps you assess a company's ability to meet its short-term financial obligations, determining your susceptibility to credit risk when doing business with them. As the ratio increases, so does liquidity. A 2:1 current ratio is ideal and indicates a healthy liquidity position, but a 1:1 ration is also acceptable. It's particularly important to review this figure compared to previous years, as a change from 3:1 to 2:1 is worth investigating.

Quick ratio

Calculated by current assets, minus stock, divided by current liabilities, the quick ratio gives a more accurate measurement of cash flow and liquidity, because you don't need to factor in the sale of stock.

Overall liquidity ratio

This determines a company's ability to cover its liabilities with its assets and is calculated by dividing total assets by the difference between total liabilities and conditional reserves.

Net profit

This is the final gain or loss once you've deducted all expenses, interest expenses, interest income and tax. Which means it's a critical figure when examining a financial statement. Luckily, there's a simple formula for calculating this:
operating income - operating expenses = operating profit (operational gains/losses)
+
interest expenses - interest income = gross gains/losses (gains/losses before tax; gross profit)
– taxes payable
= net profit.

Analysing borrowing

It's also helpful to understand the type of borrowing a company has already taken on, and how this affects its financial stability. There are many types of borrowing, such as a simple loan, an overdraft or asset-based lending, which is similar to a mortgage and becoming increasingly common. Asset-based lending allows borrowing against an underlying security – which could even be money invoiced but not yet collected.

Whatever the form of the loan, borrowing always comes at a cost in the form of interest payments. Check how much a company has borrowed, the scale of its interest payments and how this compares to its financial trends. For example, if you see a decline in sales and profits combined with an increase in borrowing, this should be a red flag.
The more insight and understanding you have about how annual accounts work, the better informed you'll be to make profitable credit lending decisions.

For more information on understanding financial statements, check out our guide here.
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