Talking Company Accounts

CICM Trainer, Tony Skone shares his experience on working with company accounts.

I ESTABLISHED Management and Training Associates Limited back in 2002. Working with colleagues in the credit industry, we developed innovative techniques for establishing credit worthiness, credit scoring and the setting of credit levels (I prefer this term over limits). These methods combined both financial and non-financial factors, for a holistic approach. My specialism is using accounts, both financial and management, to make informed decisions, mainly in the credit management area but also for making better investment choices.

How important is an understanding of finance and accounts?

Of prime importance, particularly these days with so much political and economic uncertainty. Anyone involved in credit risk assessment must appreciate the essential basics of risk assessment. Whatever the outcome of the current European negotiations, the basics will still apply.

Do I need an accountancy qualification or degree to make use of the numbers?

No, although any prior knowledge is a good thing. We are not looking at how the financial statements are produced but more how to interpret the numbers. Anyone with a logical mind will be able to benefit.

Can you give some real life examples of how an understanding of the figures produces positive results?

I was giving a lecture on using accounts to value a company. One of the participants was in the process of selling a subsidiary company. At the coffee break he rang his team and using what he had just learnt secured an additional £150k. Drinks all round!

Using insolvency prediction models, I have been able to help a large organisation avoid a very substantial bad debt.

We also use financial analysis to make investment decisions. We can identify undervalued shares as well as those shares that should be sold or shorted. Two of my contacts in the US were able to retire early using their analysis based on algorithmic data.

Of the three main financial statements, which would you say was the most important?

They are all vital in risk assessment but I recommend paying particular attention to the Cash Flow Statement. In 1998, the directors of Enron were asked by a journalist from the Wall Street Journal why they hadn't produced a Cash Flow Statement. The Profit & Loss Account looked great (by using some financial engineering), the Balance Sheet also looked wonderful but a Cash Flow Statement would have shown the true dire situation. The directors' response cannot be printed here!

What about Management Accounts?

The main drawback with financial accounts is that they are probably a year old at least. Small and medium sized companies only have to lodge modified accounts at Companies House.

Asking your debtors for management accounts which show the up-to-date situation as well as cashflow forecasts which show the budgeted cash receipts and payments is to be recommended.

Management accounts can also identify break-even points, margins of safety and operational gearing, which are all indicators of risk.

In granting credit, the profit margin on the sale will also be an important factor in the risk/reward scenario.

What are the key factors to be aware of?

In the Profit and Loss Account (Income Statement) there are at least five different profits. The most important is the profit before interest, tax, depreciation and amortisation (EBITDA). As Paulie Walnuts says in the Sopranos 'it's the true measure of a company's profitability'.

The Balance Sheet is the main measure of risk. It shows the ratio between debt and equity, the gearing or leverage. It also shows long and short term sources and long and short term uses of finance.

A key measure is the current ratio showing the ratio between current assets and current liabilities. A balance sheet can be arranged to show where the money originated on the left and where it was invested on the right. I once had to make a recommendation as to the financial stability of a debtor. I finished off by saying 'there's nothing left on the right and nothing right on the left'!

In the Cash Flow Statement, which is subdivided into operating, investment and financing, a key figure is the free cash flow. This is the amount available to pay dividends and make loan repayments.

To summarise, sales are vanity, profit is sanity and cash is reality.

Tell us an accountant's joke

A client of mine, a farmer, asked me to help round up 19 cows. I said 'sure, that's 20 cows.'