

READING

FINANCIAL STATEMENT BASICS**Statement Spreading Guidelines**

Before analyzing a company's financial statements, bankers should use the following basic guidelines for preparing a spreadsheet:

- Reverse the order of data columns as presented by an accountant. Accountant prepared financial statements usually present data for the current year in the left-most column, followed by prior years to the right—the reverse of chronological order. The spreadsheet format, however, typically begins with the oldest year on the left and succeeding years on the right, in chronological order. Lenders should be careful to avoid transposing data from the accountant's statements to the bank spreadsheet, to ensure that the dates are in proper order
- Spread and analyze annual and interim statements separately. Compare interim statements only with interim statements of the same date from previous years. If quarterly or monthly statements are available, the lender makes multiple spreadsheets that contain fiscal years, first quarters, second quarters, third quarters, and fourth quarters. Spreadsheets allow the lender to review, simultaneously, several years of financial performance
- Read the accountant's cover letter and disclosures (including footnotes) before spreading the statement and beginning the analysis. Footnotes and other disclosures generally detail basic methods used to construct financial statements. It is essential, therefore, that they be read and understood before spreading the statement. Information in some footnotes does not appear on the balance sheet, income statement, statement of cash flows, or reconciliation of equity. This information may pertain to potential lawsuits, warranties, and events that will take place after the statement date. The footnotes for Dry Supply will be reviewed later in this course
- Round numbers to thousands, with ratio decimal places limited to one or two. This practice makes the spreadsheet easier to read. Additionally, smaller, nonmaterial items that do not evenly round up to at least \$1,000 are eliminated. If financial statement entries are very small, it may make sense not to round

Before spreading the statements, a lender also thinks about the following situations:

- Methods the company uses to recognize revenue and expenses, that is, cash or accruals
- Sales trends, product or service mix, order backlogs, discounts, allowances, returns, large nonrecurring sales, seasons, and cyclical factors
- Cost of goods sold calculations
- Larger changes in expenses in relation to sales
- How bad debt is recognized
- The inventory valuation method used
- The depreciation method used for fixed assets
- Taxation issues

When analyzing spreadsheets, a business banker uses many techniques. One way to assess a company's performance is to look at the trend exhibited by a specific account over several consecutive periods. Examining the net profit after tax posted at the end of four or five consecutive years, for example, reveals whether it declined, increased, remained stable, or fluctuated. After considering the company's operating environment, a business banker may use the trend in net profits to support a prediction of the company's future profits.

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Other Considerations

Financial analysis is more than just adding and subtracting figures, calculating ratios and percentages, and extrapolating numbers based on past trends. For analytical purposes, these numbers have little meaning unless the business banker understands the internal and external factors affecting the company's performance. Later in Level 3, you will learn more about these nonfinancial factors. As a brief overview, the following are some factors to consider:

- **Economic and regulatory issues**—In addition to examining a business and its financial performance, a business banker also pays close attention to general business conditions, including inflation, interest rate forecasts, pending regulations, and taxation policies. All of these factors may influence a company's ability to repay loans
- **The industry**—A business banker determines whether the industry and its products are growing, declining, or stagnant. For example, is the industry highly competitive or controlled by a few companies? What is the customer's position within the company and the industry? Business cycles affect some industries. Cyclical industries include housing, auto, and clothing. Some industries are non-cyclical (not affected by business cycles), such as food, medical care, and education. Still others are counter-cyclical, actually improving when other industries are in declining business cycles. Auto servicing, home repair, and employment agencies tend to be counter-cyclical
- **The market**—Business bankers consider whether the company's market is diversified or restricted, growing, or stagnant. Demographic and consumer preference trends influence sales, expenses, and key balance sheet accounts
- **The business**—The legal structure of the business, management goals and objectives, and operating characteristics affect spreadsheet analysis. A corporation's balance sheet, for example, will indicate an entry for common stock. Because a sole proprietor's net worth is composed of business and personal assets, the balance sheet will not have a common stock entry
- **Other events**—There are other events that affect numbers on a spreadsheet. The poor health or death of an owner or a key manager, for example, influences events. The availability of well-trained, capable employees is important, especially to the growing number of service companies

More on Technical and Interpretive Analysis Revisited

To analyze financial statements effectively, a business banker must possess both the technical skills of an accountant and the interpretive skills of an investigator.

First, financial analysis involves an understanding of the structure, organization, and contents of financial statements. An experienced business banker, for example, knows what "cost of goods sold" means, where it can be found on a financial statement, the accounts that make up its structure, how it is calculated, and how the choice of inventory valuation methods affects it. In short, a business banker must have an accountant's familiarity with the terminology of financial statements.

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Second, mathematical proficiency is essential. Data are calculated in specific, sometimes complex, ways. During technical analysis, the applications used include statement spreading, comparing ratios, preparing cash flow calculations, and projecting future operating results. The business banker must be knowledgeable about the following approaches to calculations:

- Know how to calculate the numerical and percentage changes in an account over time
- Understand how the calculations were made
- Make comparisons with data from other statements
- Know how to calculate ratios and a cash flow statement
- Be comfortable working with numbers
- Know how to interpret the results

In financial analysis, an inability to look beyond the numbers is a serious failing. One of the first duties of a business banker is to get behind the numbers and not take them at face value. This is equally important whether the numbers are good or bad. A major objective of interpretive analysis, therefore, is to help a business banker understand a firm's financial strengths and weaknesses better through technical calculation and data interpretation.

Limitations of Financial Analysis

The financial condition of a business is not always accurately portrayed by calculating and interpreting financial data, because the raw data may be misleading, inconsistent, or erroneous. Before analyzing statements, therefore, a business banker must be familiar with limitations, especially accuracy, involving the quality of information, accounting methods used, external environment, unlisted information, distortion in numbers, and aggregate accounts.

The bankruptcy filings of Enron, World-Com and Adelphia within the last decade are good examples of limitations to financial analysis. The financial failures of these firms illustrate the importance of being able to draw independent conclusions and to not rely solely on the accounting experts. While these firms were very large and seemingly irrelevant to community banks, many small, related businesses were caught up in the financial difficulties and ultimately failed or had operating losses that affected loans at community banks.

Quality of information

Financial analysis is only as good as the information upon which it is based. Lenders often borrow a phrase from the computer industry ("garbage in, garbage out") when referring to the quality of financial information and its effect on the quality of the related financial analysis.

For example, if accounts receivable are erroneously reported on a balance sheet, the resulting calculation of the current ratio or accounts receivable turnover will be faulty. Statements prepared and attested to by a reputable accounting firm are more likely to be complete and accurate than those prepared by an inexperienced internal controller. Business bankers must be wary of any statement that appears to have been drawn up at the last minute or in an unprofessional manner.

Accounting methods

In preparing financial statements, many different accounting alternatives are available and acceptable. For instance, three inventory valuation methods commonly used are first-in, first out (FIFO); last-in, first-out (LIFO), and weighted average cost. When production costs are rising, the FIFO method of valuing inventory can result in higher gross profits relative to current costs. Comparing a company that uses the FIFO method to a company that uses LIFO can result in erroneous conclusions. The accounting methods used are described usually in the footnotes to the financial statement.

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Economic, competitive and regulatory conditions influence the environment in which a business operates. What may appear as a weakness on an income statement, such as a small decline in profits from one year to the next, may actually be strength, if the economy took a sharp downturn during that period. The constantly changing external environment can limit conclusions drawn from comparing statements from different periods.

Unlisted information

Honesty, willingness to repay debts, and other measures of character cannot be quantified and listed on a financial statement. This information is obtained primarily through loan interviews and credit investigation. Financial statements also do not include other information that may be relevant, such as a list of order backlogs, unfunded pension liabilities, proposed capital expenditures, pending lawsuits, or assets used by the business that may belong to the owner. For example, Dry Supply's financial statements do not reflect that the company has a \$150,000 backlog in orders, is approaching shipping capacity, and is projecting an increase in capital expenditures for the next year.

Distortion in numbers

A firm's management may decide to distort the picture portrayed in its financial statements. For example, an owner may write off the accumulated bad debts (unpaid accounts receivable) of the business over a single accounting period or obsolete inventory may not be written off quickly. Such actions make it difficult for the business banker to accurately assess historical profitability, accounts receivable turnover rates, and inventory value.

Aggregate accounts

Much of the data in financial statements is aggregated. Sales generated for each product are combined and listed as one account (net sales) on the income statement. Aggregation may limit a business banker's observations when assessing the financial condition and prospects of a company. Dry Supply's statements, for example, do not break out sales by dry cleaning and laundry products. Most businesses can provide breakdowns of accounts and items shown in the financial statement, including product mix of sales, if needed.