

READING

BASIC ANALYTICAL TECHNIQUES

Strengths — Weaknesses > Uncertainties

Financial analysis is not a crystal ball that allows a business banker to peer into the future and predict, with absolute certainty, how a business will fare in the coming years. Uncertainty is ever present. Examples are the chance the economy will take a turn for the worse, that a well-financed competitor will set up shop down the street, or that a business's customers may stop paying their bills.

Financial analysis requires a constant process of inquiry to identify and evaluate a borrower's financial strengths and weaknesses. When done properly, the business banker will understand all of the risks involved in extending credit and how to minimize those risks through proper credit underwriting and loan structuring. If all the strengths outweigh the accumulated weaknesses by a margin sufficient to cover for uncertainties, the loan represents an acceptable credit risk. This conclusion is written as follows:

Strengths —Weaknesses > Uncertainties

For example, consider a loan request for a line of credit by Dry Supply. The most recent balance sheet submitted by the customer shows current assets of \$201,000 and current liabilities of \$109,000. The \$92,000 differential is generally favorable. If demand for the product surges unexpectedly or, conversely, if demand falls off, the company has a margin of funds available to purchase inventory or to sustain short-term operating losses.

However, of the \$201,000 in current assets, \$67,000 is inventory—primarily liquid dry cleaning products purchased by the company. Inventory is not as easily converted to cash as other forms of current assets, and cash is needed to repay loans. The concentration of current assets in inventory should raise the following questions:

- What is the demand for the product?
- Will dry cleaning prices be rising?
- When will the inventory be sold and the accounts receivable collected?

Next, uncertainties are considered. A prime uncertainty is the future demand for various types of dry cleaning products. If, for example, due to environmental reasons, many dry cleaners switch from using liquid to using powder in dry cleaning, then the inventory will not be sold and the cash the business needs to repay and meet operating costs will not be generated.

Of course, financial analysis involves more than looking at the amount of current assets, current liabilities, inventory, and the characteristics of a particular industry. For efficiency, a bank may even **credit score** certain business loans. Every financial statement should draw out numerous questions about every aspect of a business's financial performance. Applying specific analytical techniques to this task begins with a look at the types of financial statements and the quality of information they contain.

Credit Scoring Versus Financial Analysis

For efficiency, a bank may credit score certain commercial loans. Credit scoring is the process of giving points for a variety of factors, such as length of time in business, number of years of consecutive profits, amount of debt versus equity, type of collateral and loan term. The total of the points helps a business banker estimate repayment probability based the financial statements. An applicant who scores high enough is granted the loan. A full financial analysis is completed on the larger loan requests only.

When credit scoring is used, one or more senior lenders may have authority to override the credit score and approve loans on an exception basis. Approval may be warranted based on other factors not considered in the credit score, such as a financially strong guarantor.

Community banks normally perform a complete credit analysis on all commercial loans, including nonfinancial considerations such as character, number of jobs in the community, and length of time in business. Full financial analysis involves investigating the business to understand the "story" behind the numbers.