

READING

OTHER COMPONENT ANALYSIS**Management Plans and Reports**

Information from business and personal financial statements is, by itself, insufficient to measure performance because the information may not be adequately detailed. Management plans and reports can provide additional insight, but the usefulness of these reports varies among businesses.

- **Business and strategic plan**—many businesses prepare an annual business and strategic plan that summarizes the company’s goals in the market, types of products, management structure and projected sales growth and financial results for the coming year. The level of detail of a business and strategic plan vary by the size of the business and the organizational ability of the owner
- **Operations and capital budgets**—most well-run businesses develop operational and capital budgets that specify how funds are to be spent in the coming year. Operations budgets show a company’s plans for allocating personnel and other sales support resources. Capital budgets provide insight into future financing needs for fixed-asset purchases
- **Accounts receivable aged listing**—this report lists individual customer accounts and the related amounts due by billing dates in aged categories. A single account may have invoices or portions of invoices that are current or 30, 60, or 90 days past due. This report also identifies amounts that may be uncollectible
- **Inventory analysis**—businesses often analyze inventory from a number of different perspectives, such as age (time on hand), type, location, and quantity. A schedule with an aged listing of inventory often identifies slow-moving products. Depending on the type of industry, inventory may be raw material, work-in-process and/or finished goods. Many businesses have multiple locations, and the quantity of inventory needed will vary by location

Analyzing the Financial Statements**Income statement analysis**

The income statement (also called a profit and loss statement, “P & L” statement or earnings statement) is one of the most important sources of information about a business. One reason is that the income statement influences most balance sheet accounts. The following chart shows the components of a balance sheet that are taken from the income statement:

Income Statement	Balance Sheet
Cash sales	Cash
Credit sales	Accounts receivable
Cost of goods sold	Inventory, accounts payable
Depreciation	Fixed assets
Net profit (loss)	Retained earnings

Over a period of time, the income statement reflects how total sales (or revenues) and expenses lead to the net profit (or loss) for that period. The terms “sales” and “revenues” often are used interchangeably, although sales generally are derived from a tangible product being sold, while revenues generally are derived from services being provided.

READING

The analysis of an income statement starts with the quality and consistency of sales/revenues and accuracy of the expenses. The income statement identifies a company's growth as evidenced by the increases in sales/revenues and also reveals the firm's viability through profitable operations. A consistently unprofitable company would not be considered viable. Income statement analysis also includes analyzing the break-even point of the business, which is the level of sales where fixed costs are covered such that the business has a net profit of \$0. You will learn more about specific techniques and examples of income statement analysis in Level 2 of this curriculum.

Balance sheet analysis

The balance sheet is a point-in-time financial picture of the business, usually as of the last day of a month, quarter or fiscal year. The basic structure of the balance sheet can be stated in the following simple equation:

$$\text{Assets} - \text{Liabilities} = \text{Net Worth}$$

Balance sheet analysis entails a line-by-line evaluation of the firm's assets and liabilities (or debt) and the difference between the two—its net worth (or equity). Net worth and equity are often used interchangeably.

The purpose of balance sheet analysis is to determine the liquidity and solvency of the business. Liquidity is the ability of the company to convert its assets to cash in time to pay its liabilities as they become due. Solvency is the ability of the company to sell its assets for sufficient cash to pay all of its liabilities. You will learn more about specific techniques and examples of balance sheet analysis in Level 2.

Ratio analysis

Ratios are not only the best known and most widely used of all financial statement analysis tools, but also they are the most overrated and most widely misused. Ratios allow the business banker to study the relationship and trends over time between various components of financial statements, such as assets and liabilities or expenses and revenues. Although ratios are easily calculated, their correct interpretation is problematic. The primary classes of ratios are liquidity, financial leverage, profitability, efficiency and coverage, which will be covered in Level 2.

Cash flow analysis

The remaining primary component of a financial statement to be analyzed is the statement of cash flows. As its name implies, this statement of a firm's operations shows how it obtains and uses its cash resources. The data to construct a statement of cash flows come from the income statement and the balance sheet.

Because debt is repaid with cash, the statement of cash flows helps the business banker assess both the funding needs of the business and its potential sources of repayment. The statement of cash flows shows inflows and outflows of cash categorized as operating, investing and financing activities. If the financial statement is audited or reviewed, the accountant includes a statement of cash flows. In compiled statements, the cash flow statement may or may not be included.

If possible, borrowers should be required to submit a statement of cash flows that conforms to Statement of Financial Accounting Standards (SFAS) number 95. Some borrowers, especially those submitting statements that have not been prepared by outside auditors, may not be able to prepare a statement of cash flows. In such cases, the business banker can create similar information in the spreading process, particularly if a computerized statement spreading model is used. Cash flow analysis, the statement of cash flows, and related models will be covered in Level 2 of this curriculum.

READING**Preparing Forecasts**

Forecasts, basic to loan analysis, are presented in numerical form and help determine what conditions are needed for the borrower to be able to repay the principal and interest. Two tools used in this analysis are cash budgets and pro-formas.

Cash budget

A cash budget projects the cash position of a company during a short period of time (usually less than one year). Presented in a monthly format, a cash budget forecasts a company's cash receipts and payments for each period. This enables the business banker to gauge a firm's peak credit needs and its ability to generate sufficient cash to repay short-term loans during the term of its operating cycle.

The cash budget also helps a business banker determine whether a company's borrowing needs are long- or short-term. Cash budgets are particularly useful in determining the financial needs of borrowers with seasonal operating cycles (such as a toy store that rings up half of its total sales in the last two months of each year). Because management controls the outflows of cash, a company's management should prepare cash budgets.

Pro-formas

Using revenues/sales as its primary basis, a pro-forma statement forecasts what the income statement and balance sheet of a business will look like after any new debt is added. Creating one- to three-year forecasts (referred to as pro forma statements) forces the lender to apply information gathered from historical financial statements to estimate future levels of sales. Examining a company-provided forecast involves evaluating the company's underlying assumptions as well as the expected economic, competitive and regulatory environments in which the company will operate. For example, if the business is forecasting sales growth of 10 percent per year and the expected economic and industry growth is 4 percent, the business banker clearly will want to understand why the company expects to grow faster.

Normally, the type of projections needed by the banker depend on the size and term of the requested loan. Because management-submitted pro-formas tend to be optimistic, business borrowers often create their own prognosis for a company, based on what they consider to be more likely assumptions (such as lower profit margins).

Limitations of Analysis

Although financial statement analysis is a critical tool in business lending activities, it has some important limitations. First, its success depends on the reliability and completeness of the information being analyzed. Second, the financial statements may have amounts that were estimated, many accounts are aggregated, and different accounting methods may be used by different businesses. Even with unqualified audit opinions, financial statement analysis is not an exact science providing absolute conclusions. Because analysis deals with future uncertainties, it is better at formulating questions and projecting possibilities than it is at providing definitive answers. You will learn more about these limitations in Level 2 of this curriculum.

Beyond the limitations, technical analysis alone cannot provide a complete understanding of the borrower. Banks do not base loan decisions solely on financial statement analysis; a borrower's nonfinancial strengths and weaknesses must be considered. Nonfinancial issues include the management, company's plant capacity, pending lawsuits, technology changes and industry trends. These concerns are not always apparent in the financial statements. In addition, pricing, negotiation of specific terms, the bank's willingness to assume risk, and the availability of funds are important aspects of the decision to extend or deny credit.