Financial Statement Analysis

FEDERATION of CREDIT
and FINANCIAL PROFESSIONALS

EXECUTIVE SUMMARY

While it is sometimes difficult to convince the customer to share their financial information, it must be understood that the financial statement is probably the most important tool available to the credit analyst in allowing him/her the opportunity to get a clear picture of the customer's financial standing.

Financial statement analysis provides an essential tool in the assessment of credit risk as it can provide the analyst valuable information related to trends and relationships to others within its industry, the quality of a company's earnings, and the strengths and weaknesses inherent to its business operations. Typically, financial analysis is used to analyze whether an entity is stable, solvent, liquid, or profitable enough to warrant the extension of open lines of credit.

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Financial Statement Analysis

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It is absolutely essential that financial information be obtained on customers that represent significant exposure in the form of outstanding receivables.

The business customer expects that if they were to apply for a loan from any bank or other type of lending institution they would be required to provide complete and up to date financial information. Likewise, it is important if they are requesting a significant line of credit from your organization that they should be prepared to share the same information.

When conducting the financial analysis of a prospective or existing business customer, the purpose is to extrapolate the company's past performance into an estimate of the company's future performance. In doing so a company's performance and financial position, in relation to others within its industry, can be evaluated and future risks and potential to meet payments in a timely fashion can be estimated. Financial statement analysis provides an essential tool in the assessment of credit risk, as it can provide the analyst valuable information related to trends and relationships to others within its industry, the quality of a company's earnings, and the strengths and weaknesses inherent to its business operations. Typically, financial analysis is used to analyze whether an entity is stable, solvent, liquid, or profitable enough to warrant the extension of open lines of credit.

To effectively conduct a financial analysis, the analyst must:

1) be aware of business practices associated with the customer's industry,
2) understand the purpose, nature, and limitations associated with the financial information being reviewed,
3) be familiar with the terminology appearing in the financial data provided, and
4) be acquainted with the tools available to help interpret the results of a thorough financial statement assessment.

Statement Types

There are three types of statements…

The Balance Sheet which details the business's assets and liabilities. The monetary difference between the value of assets and the value of liabilities is equity. The balance sheet is structured with two columns laid side by side. Assets, both current and long term, appear on the left side of the balance sheet and liabilities, both current and long term, as well as equity appears on the right side of the balance sheet. The total value of the items on the left side (Current Assets + Long Term Assets) always equals the total value of the items on the right side of the balance sheet (Current Liabilities + Long Term Liabilities + Equity).

The Income Statement which shows all items of income and expense realized or incurred by the business for the period specified on the statement. The income statement is generally laid out with line 1 representing gross revenues, line 2 representing cost of goods sold, line 3 representing gross profit which is the difference between line 1 and 2. Line 4 is a compilation of all selling and administrative expenses. Line 5 represents any depreciation and line 6 is net profit before taxes which is arrived at by subtracting selling and administrative expense and depreciation from gross profit. Net profit is arrived at by subtracting taxes due from net profit before taxes.

The Statement of Cash Flows which takes aspects of items from both the Balance Sheet and the Income Statement and expresses sources and uses of cash. Of the three types of statements. This is the one that proves most valuable in assessing the customer's ability to meet its obligations.

It is important to understand that while balance sheet, income and cash flow statement information is essential to financial analysis, equally important are the notes to the financial statements, and the auditor's report.

Financial Statement Forms

Understand that “Financial Statements” take three forms. They include …

Management Prepared Statements which are generally prepared in house, typically by the organization's financial staff.

Unaudited Statements which are generally prepared by outside accountants based on records that are provided by the business.

Audited Statements which are prepared by Independent Certified Public Accountants in accordance with the accounting standards set by GAAP. In the case of an audited statement, the auditor's report will state whether the financial statements have been audited in accordance with generally accepted auditing standards. The report also indicates whether the statements fairly present the company's financial position, results of operations and changes in financial position in accordance with generally accepted accounting principles.

Needless to say, the information in the audited statement is completely reliable, while the information contained in the unaudited statements, as well as the management prepared statements have to be considered based on the expertise of those providing the information and or preparing the statements.

Statement Notes

Notes to the financial statements are often more meaningful than the data found within the body of the statements. The notes explain the accounting policies of the company and usually provide detailed explanations of how those policies were applied, along with supporting details. Analysts often compare the financial statements of one company with other companies in the same industry and with the industry in which the company operates, as well as, with prior year statements of the company being analyzed.

Before all else, it is important to take note of the date on the financial statement. Remember, particularly in the case of the Balance Sheet, the statements reflect a snapshot of the business condition at a particular point in time. Needless to say, the older the information, the less valuable it is in the assessment of the customer’s financial condition. Conversely, the more recent the statement, the more meaningful it becomes as business conditions are constantly in flux. With this in mind, in the case of key customers, the analyst should seek interim financial information if at all possible.

Key Elements to Consider (Ratio Analysis)

The key elements that the analyst should focus on when assessing the financial well-being of the business customer are *Solvency, Liquidity, Efficiency and Profitability.* These factors allow the analyst to determine if the customer has the ability to meet its obligations in a timely manner, sustain ongoing business growth, deal with a temporary downturn in business, or make its creditors whole in the event of a business liquidation.

Let’s examine each of the factors and their relevance to the analysis…

Solvency (Equity)…

A company’s solvency is reflected in the equity position shown on the balance sheet. It represents the difference between Assets and Liabilities. As long as the value of the businesses’ assets exceed the value of its liabilities, creditors can be assured that they will be paid money owed to them.

The company’s equity represents the money a business can afford to lose before it begins to lose money that creditors have invested in the business in the form of open receivables.

Two factors have to be considered when assessing the business customer’s equity position.

- Are the assets properly valued?
- Is the information you are looking at relatively current? *(this is particularly important if you suspect that a business might be incurring recent losses)*

Needless to say, the larger the equity position the more protection afforded to creditors.

Efficiency (Asset Turnover)

This measure reflects how effectively the enterprise is using its assets.

In general, a low asset turnover ratios suggests problems with excess production capacity, poor inventory management, or lax collection methods. Increases in the asset turnover ratio over time may indicate a company is "growing into" its capacity (while a decreasing ratio may indicate the opposite), but remember that asset purchases made in anticipation of coming growth (or the sale of unnecessary assets in anticipation of declining growth) can suddenly and somewhat artificially change a company's asset turnover ratio.

Low-margin industries tend to have higher asset turnover ratios than high-margin industries because low-margin industries must offset lower per-unit profits with higher unit-sales volume. Additionally, capital-intensive companies will typically have lower asset turnover ratios than companies using fewer assets. This is why comparison of asset turnover ratios is generally most meaningful among companies within the same industry, and the definition of a "high" or "low" ratio should be made within this context.

Liquidity (Working Capital)…

Liquidity or Working Capital represents the financial cushion that businesses have to assure that short term obligations are retired as they come due.

Because exposure in accounts receivable is by nature relatively short term, this is a component of the review process that the analyst should pay particular attention to. The analyst should question…Does the customer have sufficient working capital to meet its obligations within the period in which I have exposure?

If it is apparent that the customers internal working capital is limited, then the analyst should question if sufficient working capital lines of credit are in place with the customers lending institution that could be drawn on to meet current obligations.

Profitability…

If a business is sustaining an ongoing profitable stature, analysts can overlook weaknesses in the balance sheet as continued profitability on the part of the business will eventually remedy these weaknesses.

When analyzing the business, the credit person should assure that sufficient amounts of profits are being retained by the business, thus bolstering net worth. The analyst should view, as a red flag, a situation where profits are being drawn down significantly in the form of dividends being paid out of profits to stockholders. If most of the profits are withdrawn in the form of dividends to stockholders there is no tangible increase in protection to creditors.

Horizontal & Vertical Analysis

Horizontal analysis and vertical analysis of financial statements are additional techniques that can be used effectively when evaluating a company. Horizontal analysis spotlights trends and establishes relationships between items that appear on the same row of a comparative statement, thereby disclosing changes on items in financial statements over time. Vertical analysis involves the conversion of items appearing in statement columns into terms of percentages of a base figure to show the relative significance of the items and to facilitate comparisons. For example, individual items appearing on the income statement can be expressed as percentages of sales. On the balance sheet, individual assets can be expressed as a percentage of total assets. Liabilities and owner’s equity accounts can be expressed in terms of their relationship to total liabilities and owner’s equity.

Final Considerations

Financial statement analysis has its limitations. Statements represent the past and do not necessarily predict the future. However, financial statement analysis can provide clues or suggest a need for further investigation. What is found on financial statements is the product of accounting conventions and procedures (LIFO or FIFO inventory; straight-line or accelerated depreciation) that sometimes distort the economic reality or substance or the underlying situation. Financial statements say little directly about changes in markets, the business cycle, technological developments, laws and regulations, management personnel, price-level changes, and other critical analytical concerns.

The FCFP Financial Statement Worksheet Template

*Included with this paper is an Excel based Financial Statement Worksheet developed by the Federation of Credit & Financial Professionals. The worksheet contains four tabs. The first tab of the worksheet **(Balance Sheet-Income Statement Tab)** is a page that allows you to enter the data found in the balance sheet and income section of your customer's financial statement. On this worksheet simply replace the information that appears in (red) with the information that corresponds to that on the balance sheet and income statement being analyzed. In that the template does not contain all categories of assets, liabilities and equity items, there are cells in each category labeled,* Other (Describe), *that allow you to insert these items with a brief description as it appears on the financial statement that you are analyzing. Information appearing in the remaining worksheet tabs is automatically tabulated based on the information that is inputted on the initial worksheet.*

*You will note that when you open the **(Ratio Tab)** that each of the ratios has a red mark in the upper right hand corner of the ratio described. By placing your cursor on the red mark a definition of the ratio will appear describing its relevance to the financial information being reviewed.*

*Particular attention should be paid to the worksheet that corresponds to the **(Cash Flow Tab)** as the information on this worksheet reflects the customer's cash positions and its ability to meet short term obligations.*

*The **(Altman Z Tab)** opens a worksheet that examines the information entered and calculates, utilizing statistical analysis, the customer's ability to maintain ongoing profitable operations.*

Benefits of Membership in
The Federation of Credit & Financial Professionals

You can transform your Credit, Collections and Accounts Receivable operations by staying up to date with best practices used by industry leaders, building a peer network, and collaborating with experts when you have a problem. The FCFP is your partner to simplify and reduce costs of the credit and collection resources you use every day, with automation that can streamline operations and reduce costs. You can engage with General or Industry Specific credit groups, depending on your interest, and over time build a significant personal network of industry professionals. The benefits can be profound to your company and career.

■ Industry Credit Groups – Collaborate to make a more informed credit decision

■ Networking Sessions – Credit & A/R Professional Retreat Days

■ Training by experts in billing, treasury, credit, collections, payment processing and deduction management

■ Trusted peer network when help is needed – Reach out to other FCFP members via survey

■ FCFP Help desk - On-call expert advice

■ Information on all components of the Order-to-Cash process

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for

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