ANALYZING FINANCIAL STATEMENTS

Seventh Edition

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Acknowledgments

The American Bankers Association wants to acknowledge its appreciation of the many contributions George E. Ruth has made towards the education of bankers. Ruth began his banking career in 1965 and is a graduate of the American Bankers Association's Stonier Graduate School of Banking. Currently, he serves as Senior Vice President and Chief Credit Officer for KleinBank, the largest privately held bank in Minnesota. For the ABA, he has authored *Analyzing Financial Statements and Commercial Lending,* and he is the author of *Lending Principles,* published by the Schools of Banking, Lincoln, Nebraska. In addition to writing, Ruth has taught at ABA's National Commercial Lending School and at various graduate schools and state commercial lending schools.

The Risk Management Association (RMA) has provided important data for this text. We are grateful for its cooperation and help. The information and figures used were from the 2005-2006 editions of *Annual Statement Studies—Financial Ratio Benchmarks and Annual Statement Studies—Industry Default Probabilities and Cash Flow Measures.* The RMA qualifies its data as follows:

(i) the Data contained in *Analyzing Financial Statements* was compiled from a sample not necessarily statistically representative and that reliance thereon should be limited accordingly;

(ii) the Data have been obtained from or are based upon sources believed by RMA to be reliable; however, the Data are provided without warranty of any kind, and RMA makes no representations or warranties, express or implied, to licensee (the American Bankers Association) or any other person or entity as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any of the Data; and

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Preface

As the saying goes, "Numbers talk and banker's need to listen." The purpose of *Analyzing Financial Statements* is to provide business bankers with the knowledge and skills they need to analyze and interpret financial information. The goal of this textbook is to emphasize "listening" to the interpretation, not merely calculating the numbers. A number of practical exercises are located at the end of each chapter.

The primary audience of this text includes trainees in credit training programs, small business bankers, loan review staff, and those who need to understand the analysis of business financial statements as part of their job. Although most banks now use computer programs to spread financial information and make calculations, bankers need to understand how the numbers came together and what they mean. To accomplish this, a banker must

- understand the source of the information,
- determine the quality of the financial statement received,
- know the legal structure and type of business organization,
- be able to interpret the data, and
- apply this understanding to make a good credit decision.

Turner Electronic Corporation and Designs by Dezine, Inc., fictitious companies, are used throughout the textbook to help students learn the analysis process. The analysis process begins with an understanding of the types of financial information the business banker may receive, the components of the financial statements, and other management reports. The process continues with an understanding of the various forms of business organization and legal structure, types of loan structures, and competing and complementing sources of financing. Whether a business is a manufacturer, wholesaler, retailer, service company, or agricultural, its business organization and legal structure affect its income statement and balance sheet.

Next in the process is the analysis of the income statement. The income statement is analyzed first because of its impact on the balance sheet. While analyzing an income statement, a business banker must consider sales, cost of goods sold, fixed and variable expenses, and the net profit margin. In addition, a business banker should consider break-even and operating leverage, concepts that are important in income statement analysis.

With an understanding of the income statement, the balance sheet is analyzed next. The various balance sheet accounts are classified as assets, liabilities, or net worth. Accountants and bankers classify these accounts differently. This textbook clarifies how bankers classify each account.

Next ratios are calculated. Ratios are categorized as liquidity, financial leverage, coverage, or profit in nature. The textbook explains how to calculate each ratio and then what the ratio means. Because cash, and only cash, repays loans, several methods of calculating business cash flow are explained: the accountant and bank prepared direct method, the abbreviated method, and the traditional cash flow methods used to analyze business financial statements. One chapter focuses on personal cash flow and financial statements.

The final two chapters explain cash budget and pro forma financial statements. Again, practical application exercises are used to demonstrate these concepts.

The textbook has a companion *Master Case Book* that includes blank forms you may want to use. A summary of business and personal financial statement components, listing accounts as current and noncurrent, is provided to give consistent account classifications. A summary of various ratios, how to calculate them, and what they mean is also provided. Blank forms to calculate a cash budget and personal cash flow are also provided.

Analyzing financial statements is a process in which a systematic procedure must be followed step-by-step in order to assess and monitor credit risk. With this in mind, the seventh edition of *Analyzing Financial Statements* was expanded to include:

- a discussion on lending to construction companies,
- the new cash flow default measures, and
- 2006 income tax forms