

Introduction

- A. Course objectives
1. Understand the meaning and importance of the accounting entries commonly found on balance sheets, income statements and cash flow statements
 2. Calculate and interpret basic ratios commonly used in credit analysis
 3. Identify key issues when working from a business tax return and how to reconcile it to the business financial statement
 4. Differentiate among the various types of accountant-prepared reports
 5. Compile and interpret a statement of cash flows and (as time permits) the Uniform Credit Analysis (UCA) cash flow model
- B. Where “business-only” analysis fits within the typical range underwriting options:

FINANCIAL STATEMENT ANALYSIS OPTIONS AND TOOLS

Situation		Tools	Approach
Consumer Loan		<ul style="list-style-type: none"> • Consumer Loan Calculation Worksheet 	DTI based on <ul style="list-style-type: none"> • Gross monthly income • Monthly debt service
Consumer Loan for Bus. Purpose <ul style="list-style-type: none"> • Primary income – personal • Secondary income – business • Self-employed and/or primary owner of business • Smaller rental properties 		<ul style="list-style-type: none"> • Personal Cash Flow Worksheet (Tax Returns) • CRE Loan Underwriting Worksheet 	DTI based on <ul style="list-style-type: none"> • Monthly income (personal + business) • Monthly debt service (personal + business)
Loan Directly to Business <ul style="list-style-type: none"> • Primary income – business • Secondary income – personal • Self-employed and/or primary owner of business 		<ul style="list-style-type: none"> • Global Cash Flow Worksheet (Tax Returns) 	Global DSC <ul style="list-style-type: none"> • Annual income (personal + business) • Annual debt service (personal + business)
Loan Directly to Business <ul style="list-style-type: none"> • Little or no reliance on personal income • Multiple owners of business 	Small C&I ($\leq \$500M$)		
	Large C&I ($\geq \$500M$) + Owner-Occupied CRE	<ul style="list-style-type: none"> • Bus. Financial Spread (by credit analyst) • Business Loan Underwriting Worksheet 	Various annualized Ratios and cash flow model based on <ul style="list-style-type: none"> • Business financials • Including DSC
	Income-Producing or Investment Real Estate (Non-Owner-Occupied)	<ul style="list-style-type: none"> • Personal Cash Flow Worksheet, or Global Cash Flow Worksheet (Guarantors) • CRE Loan Underwriting Worksheet 	
			DSC based on <ul style="list-style-type: none"> • Annual property net operating income (NOI) • Annual debt service Other ratios/items <ul style="list-style-type: none"> • Supportable loan amount • Breakeven interest rate • Breakeven vacancy

I. Section One: Review of Business Financial Statement “Basics”

- A. What is a financial statement?
A “report card” of the financial effects of decisions made by management.
- B. Three Primary Methods of Accounting
- 1.
 - 2.
 3.
 - a. Transactions will be measured by historical cost
 - b. Revenues will be recognized when earned
 - c. Expenses will be matched with the revenues they produce
- C. What is a “complete” set of financial statements?
1. Accountant cover letter (if applicable)
 2. Balance sheet
 3. Income statement
 4. Reconciliation of owners’ equity
 5. Statement of cash flows
 6. Footnotes
- D. Structure and Purposes of Financial Statements
1. Balance Sheet [*tax return Schedule L*]
 - a. Statement of financial position at a point in time
 - b. Summarizes a company’s resources (assets) and claims (liabilities and owners’ equity) against those resources
 - c. Reflects the basic accounting equation: $A = L + E$
 - d. Assets and Liabilities are classified into current and non-current
 - i. Current = assets to be used or converted to cash within 12 months, or liabilities due within 12 months
 - ii. Non-Current = converted/used or due after 12 months
 2. Income Statement [*first page and Sched. M-1 of Form 1120, 1120S or 1065; plus top portion of Sched. K of Form 1120S or 1065*]
 - a. Profit and Loss Statement, or Statement of Earnings
 - b. In accrual accounting, reports on firm’s economic performance during a period of time
 - c. Reflects that sales or revenues minus expenses equals profit (or loss)
 - d. Generally in a multi-step format
 3. Reconciliation of Retained Earnings [*Schedule M-2*]
 - a.
 - b.
 - c.

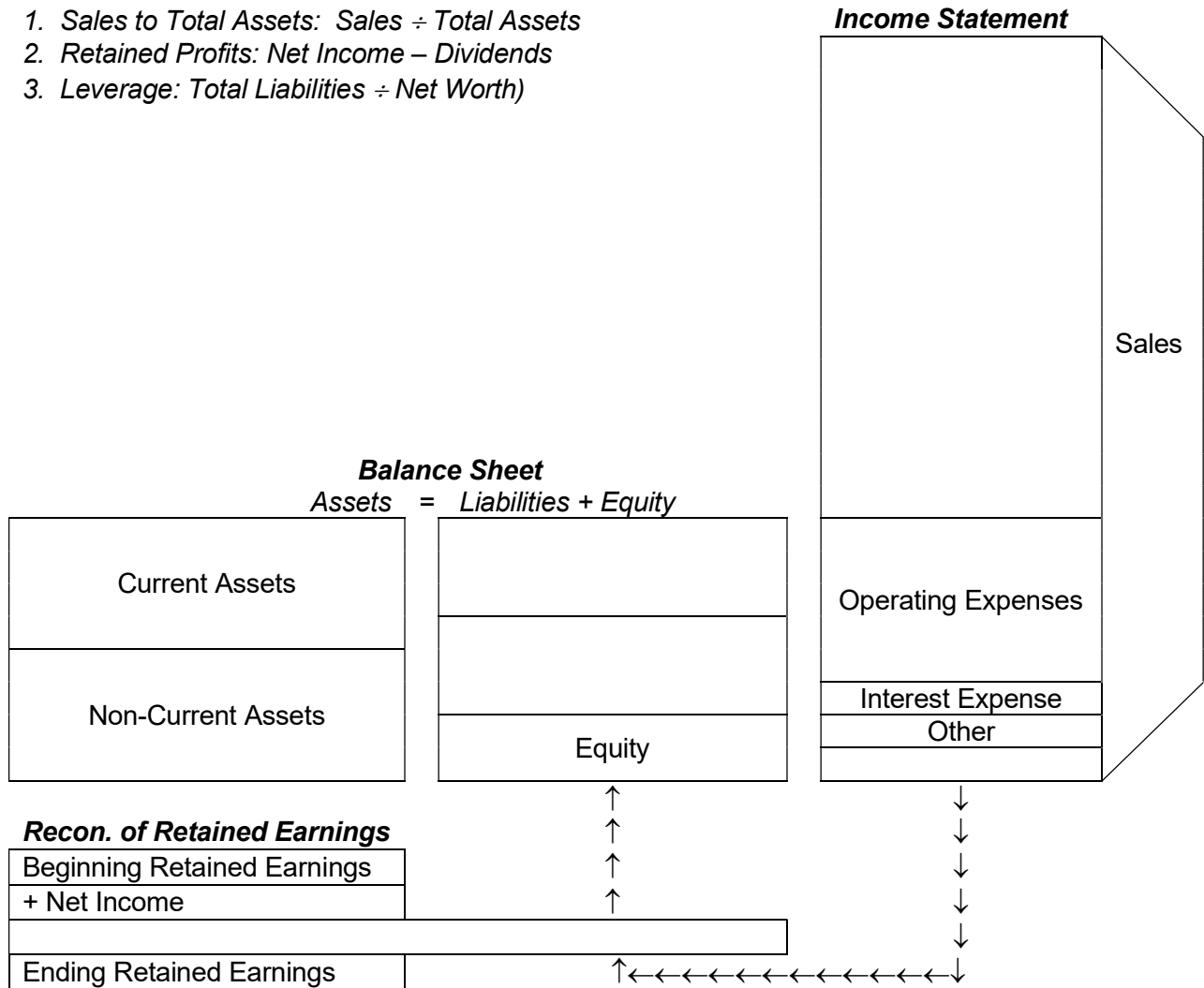
BASIC STRUCTURE OF FINANCIAL STATEMENTS AS A DIAGRAM

Three Vertical Bars

1. In proportion
2. Balance sheet on left side as equal vertical bars ($A = L + E$), and
3. Income statement as larger bar on right side

Three Key Relationships Illustrated

1. *Sales to Total Assets: Sales ÷ Total Assets*
2. *Retained Profits: Net Income – Dividends*
3. *Leverage: Total Liabilities ÷ Net Worth*



4. Statement of Cash Flows (in certain accountant prepared statements, and available printout in most analytical or “spreading” software) *[not in tax return]*
 - a. Classifies sources and uses of cash into
 - i.
 - ii.
 - iii.
 - b. Starts with net income, adds back depreciation, then includes sources and uses of cash generated by balance sheet accounts

5. Additional disclosures
 - a. Footnotes (in certain accountant prepared statements)
 - b. Example footnotes
 - i. Identify entity, time period and legal status (LLC, S corp., etc)
 - ii. Identify accounting method and any changes from previous period
 - iii. Summarize any significant accounting policies
 - iv. Additional information not provided directly in the financial statements, generally following the sequence of the balance sheet, starting with cash, then accounts receivable and so on, then moving to the income statement, with bad debt expense, interest paid on loans and so on
 - c. *Schedules and attachments to the tax return*
 - d. Format and location of footnotes is optional within financial statements – example for disclosing the three primary components of inventory in a financial statement:

Directly in the balance sheet, the breakdown of inventory can be provided

Cash	\$ 90,123
Accounts Receivable	\$ 1,808,690
Inventories (see note 1) <i>note 1 discusses method, such as LIFO or FIFO</i>	
Raw Materials	\$ 701,611
Work in Progress	\$ 377,391
Finished Goods	<u>\$ 230,578</u>
Total Inventories	\$ 1,309,580
Prepaid Expenses	\$ 88,409

Or, the balance sheet can reference a footnote that provides the breakdown

Cash	\$ 90,123
Accounts Receivable	\$ 1,808,690
Inventories (see notes 1 and 3)	\$ 1,309,580
Prepaid Expenses	\$ 88,409

NOTE 3:

A summary of inventories at December 31, 2019 is as follows:

Raw Materials	\$ 701,611
Work in Progress	\$ 377,391
Finished Goods	<u>\$ 230,578</u>
Total Inventories	\$ 1,309,580

II. **Section Two: Review of Accounting Basics – Example Case – How Financial Statements are Compiled and Example **Accrual vs. Cash Accounting Results****

Introduction – We will be using accounting “t-accounts” where

- Balance sheet accounts will have a beginning balance at the top and an ending balance at the bottom
- **Asset** accounts will have a running **debit** balance, shown on the left-hand side
- **Liability** and **equity** accounts will have running **credit** balances, shown on right-hand side
- In lieu of t-accounts, income statement items will be shown in a financial statement format

The Case

- A. On July 1, 2024, **Cam Connor** started a retail business specializing in the sale of women's clothing by investing \$10,000 (cash) into an S corporation **Cam's Clothing**

The following is a summary of all of the business transactions for the first fiscal year ending June 30, 2025:

B.	Purchases of store fixtures (paid with cash)	\$ 8,000
C.	Purchases of merchandise for resale (all on account)	\$ 45,000
D.	Sales of merchandise (all on account)	\$ 53,000
E.	Cash collected on account (from customers)	\$ 38,000
F.	Cash interest income on money market checking account	\$ 100
G.	Cash proceeds from secured operating line of credit	\$ 10,000

Cash disbursements

H.	To creditors (on account)	\$ 31,000
I.	To employees (for wages)	\$ 9,000
J.	For rent of store facilities	\$ 2,600
K.	For miscellaneous operating expenses (including \$200 of interest expense and \$400 of meals and entertainment exp.)	\$ 4,000
L.	For distribution to owner (tax reimb.)	\$ 800

No other transactions occurred during the fiscal year ending June 30, 2025.

At June 30, 2025, adjusting entries need to be made to close the books:

- M. The inventory on hand amounted to \$13,000
- N. Earned but unpaid wages amounted to \$400
- O. Prepaid rent amounted to \$200 (one month's rent was prepaid; that is, the \$2,600 of rent payments covered a period of 13 months from July 1, 2024 to July 31, 2025)
- P. Depreciation (recorded on books on straight-line basis over ten years) of store fixtures amounted to \$800
- Q. Uncollectible accounts were estimated to be \$300, and none had been written off during the fiscal year; instead of charging this amount directly against revenue, it will be recorded as a bad debt expense

Part 1: Based on the **accrual basis/method of accounting**, on the next page (page 6) we will create a balance sheet and income statement for this first fiscal year of operations.

Part 2: On page 7 we will recast the balance sheet and income statement using **cash basis/method of accounting**.

CAM'S CLOTHING EXERCISE - PART 1

FINANCIAL STATEMENTS USING ACCRUAL ACCOUNTING

BALANCE SHEET			
ASSETS		=	LIABILITIES + EQUITY
Cash			Accounts Payable
\$0			\$0
A \$10,000			C \$45,000
F \$100			
			Sh-Term Notes Payable
			\$0
Accounts Receivable			
\$0			Accrued Expenses
			\$0
Inventory			
\$0			
C \$45,000			TOTAL LIABILITIES
M \$13,000			
Prepaid Assets			Capital Stock
\$0			\$0
			A \$10,000
Net Fixed Assets			Retained Earnings
\$0			\$0
TOTAL ASSETS			TOTAL STCKHLDRS EQ
\$37,800			
			TOT LIABS & STKH EQ
			\$37,800

INCOME STATEMENT			
Sales			
Cost of Sales			
Beg. Inventory			
+ Purchases			
- Ending Inventory	M \$13,000		
Cost of Sales			
Gross Profit			
Operating Expenses			
Wages			
Rent			
Bad Debt			
Depreciation			
Other			
Total Operating Expenses			
Operating Profit			
Interest Expense			
Interest Income		F (\$100)	
Pretax Profit			
Income Tax Expense			
Net Profit			

CAM'S CLOTHING EXERCISE - PART 2

FINANCIAL STATEMENTS USING CASH ACCOUNTING

BALANCE SHEET			
ASSETS		=	LIABILITIES + EQUITY
Cash			Accounts Payable
\$0			\$0
A \$10,000			
F \$100			
			Sh-Term Notes Payable
			\$0
Accounts Receivable			Accrued Expenses
\$0			\$0
Inventory			
\$0			
M \$13,000			TOTAL LIABILITIES
Prepaid Assets			Capital Stock
			\$0
			A \$10,000
Net Fixed Assets			Retained Earnings
\$0			\$0
TOTAL ASSETS			TOTAL STCKHLDRS EQ
\$22,900			
			TOT LIABS & STKH EQ
			\$22,900

INCOME STATEMENT			
Sales			
Cost of Sales			
Beg. Inventory			
+ Purchases			
- Ending Inventory	M \$13,000		
Cost of Sales			
Gross Profit			
Operating Expenses			
Wages			
Rent			
Bad Debt			
Depreciation			
Other			
Total Operating Expenses			
Operating Profit			
Interest Expense			
Interest Income		F (\$ 100)	
Pretax Profit			
Income Tax Expense			
Net Profit			

Cam's Clothing – Summary Financial Statements

Accrual Method

Balance Sheet as of June 30, 2025	
Cash	\$2,700
Accounts Receivable	\$14,700
Inventory	\$13,000
Prepaid Expenses	\$200
Current Assets	\$30,600
Net Fixed Assets	\$7,200
TOTAL ASSETS	\$37,800
Short-Term Notes Pay.	\$10,000
Accounts Payable	\$14,000
Accrued Expenses	\$400
Total Liabilities	\$24,400
Capital Stock	\$10,000
Retained Earnings	\$3,400
Total Sthldrs. Eq.	\$13,400
TOT LIAB + SH EQ	\$37,800

Cash Method

Balance Sheet as of June 30, 2025	
Cash	\$2,700
Inventory	\$13,000
Current Assets	\$15,700
Net Fixed Assets	\$7,200
TOTAL ASSETS	\$22,900

Short-Term Notes Pay.	\$10,000
Total Liabilities	\$10,000
Capital Stock	\$10,000
Retained Earnings	\$2,900
Total Sthldrs. Eq.	\$12,900
TOT LIAB + SH EQ	\$22,900

Income Statement for FY 2025	
Sales	\$53,000
Cost of Sales	\$32,000
Gross Profit	\$21,000
Operating Expenses	\$16,700
Operating Profit	\$ 4,300
Interest Expense	\$ 200
Interest Income	(\$ 100)
Pretax Profit	\$ 4,200
Income Taxes	\$0
Net Income	\$ 4,200

Reconciliation of Retained Earnings	
Beginning RE	\$0
+ Net Income for Year	\$ 4,200
– Dividends Paid	(\$ 800)
Ending RE	\$ 3,400

Income Statement for FY 2025	
Sales	\$38,000
Cost of Sales	\$18,000
Gross Profit	\$20,000
Operating Expenses	\$16,200
Operating Profit	\$ 3,800
Interest Expense	\$ 200
Interest Income	(\$ 100)
Pretax Profit	\$ 3,700
Income Taxes	\$0
Net Income	\$ 3,700

Reconciliation of Retained Earnings	
Beginning RE	\$0
+ Net Income for Year	\$ 3,700
– Dividends Paid	(\$ 800)
Ending RE	\$ 2,900

Accrual Method

Statement of Cash Flows for FY 2025*	
Net Income	\$ 4,200
+ Depreciation	\$ <u>800</u>
= Gross Cash Flow	\$
(Incr.) Decr. in Acc. Rec.	\$
(Incr.) Decr. in Inventory	(\$ 13,000)
(Incr.) Decr. in Prepaid Exp.	\$
Incr. (Decr.) in Acc. Pay	\$
Incr. (Decr.) in Accred. Exp.	\$
OPERATING CASH FLOW	\$
Change in Net Fixed Assets	\$
– Depreciation	(\$)
INVESTING CASH FLOW	\$
Change in ST Debt	\$ 10,000
Capital Stock Issue	\$ 10,000
Dividends Paid	(\$)
FINANCING CASH FLOW	\$
NET CHANGE IN CASH	\$

Cash Method

Statement of Cash Flows for FY 2025*	
Net Income	\$ 3,700
+ Depreciation	\$ <u>800</u>
= Gross Cash Flow	\$
(Incr.) Decr. in Inventory	(\$ 13,000)
OPERATING CASH FLOW	\$
Change in Net Fixed Assets	\$
– Depreciation	(\$)
INVESTING CASH FLOW	\$
Change in ST Debt	\$ 10,000
Capital Stock Issue	\$ 10,000
Dividends Paid	(\$)
FINANCING CASH FLOW	\$
NET CHANGE IN CASH	\$

* Sources	*Uses of Cash	
		in assets other than cash
		in liabilities
		in equity (other than retained earnings)
		in retained earnings

II. Section Two (continued): Accrual Method or Generally Accepted Accounting Principles (GAAP) Compared to Others

A. Three broad GAAP standards

1. Conservatism

- a. When cost/benefit analysis or industry practice can't resolve an issue or accounting method choice . . .
- b.

2. Consistency and comparability

- a. Principles will be applied consistently from period to period
- b.

3. Materiality
 - a. Any item (included or omitted) that would have effect on decision maker
 - b.

C. Limitations of GAAP

1. The use of historical cost can make it difficult to use the balance sheet for current values of some assets. Bankers need to obtain or make their own appraisals of significant assets and liabilities, instead of relying solely on the financial statement.
2. The matching principle can obscure the receipt and payment of cash. Lenders must also identify the actual cash inflows and outflows.
3. GAAP permits several alternatives to account for some kinds of transactions, which makes it more difficult for the analyst or lender to compare financial statements and increases the importance of footnotes and disclosures.
4. GAAP permits certain industries to use accounting methods not consistent for companies that may have similar transactions but are in other industries. Lenders need to learn the accounting methods used in a particular industry in order to properly analyze the financial statements of such businesses.
5. Chart: Alternatives within GAAP that can reduce comparability

Revenue Recognition		
Expense or Cost Recognition		
Inventory		
Fixed Asset Depreciation		
Writing Off Uncollectible Accounts		

III. Section Three: Building a Financial Statement & Tax Return

Using Cam's Clothing and cash method, we will create a tax return on the following pages.

Department of the Treasury
Internal Revenue ServiceDo not file this form unless the corporation has filed or
is attaching Form 2553 to elect to be an S corporation.
Go to www.irs.gov/Form1120S for instructions and the latest information.

2024

For calendar year 2024 or tax year beginning , 2024, ending , 20

A S election effective date July 1, 2024	TYPE OR PRINT	Name Cam's Clothing, Inc.	D Employer identification number 63-1234567
B Business activity code number (see instructions) 1234		Number, street, and room or suite no. If a P.O. box, see instructions. 1201 Main Street	E Date incorporated July 1, 2024
C Check if Sch. M-3 attached <input type="checkbox"/>		City or town, state or province, country, and ZIP or foreign postal code Huntsville, AL 35801	F Total assets (see instructions) \$ 22,900

- G** Is the corporation electing to be an S corporation beginning with this tax year? See instructions. ☐ Yes ☐ No
- H** Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return (5) ☐ S election termination
- I** Enter the number of shareholders who were shareholders during any part of the tax year
- J** Check if corporation: (1) ☐ Aggregated activities for section 465 at-risk purposes (2) ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 22. See the instructions for more information.

Income	1a Gross receipts or sales	b Less returns and allowances	c Balance	1c
	2 Cost of goods sold (attach Form 1125-A)			2
	3 Gross profit. Subtract line 2 from line 1c			3
	4 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			4
	5 Other income (loss) (see instructions—attach statement)			5
	6 Total income (loss). Add lines 3 through 5			6
Deductions (see instructions for limitations)	7 Compensation of officers (see instructions—attach Form 1125-E)			7
	8 Salaries and wages (less employment credits)			8
	9 Repairs and maintenance			9
	10 Bad debts			10
	11 Rents			11
	12 Taxes and licenses			12
	13 Interest (see instructions)			13
	14 Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14
	15 Depletion (do not deduct oil and gas depletion)			15
	16 Advertising			16
	17 Pension, profit-sharing, etc., plans			17
	18 Employee benefit programs			18
	19 Energy efficient commercial buildings deduction (attach Form 7205)			19
	20 Other deductions (attach statement)			20
	21 Total deductions. Add lines 7 through 20			21
	22 Ordinary business income (loss). Subtract line 21 from line 6			22
Tax and Payments	23a Excess net passive income or LIFO recapture tax (see instructions)	23a		
	b Tax from Schedule D (Form 1120-S)	23b		
	c Add lines 23a and 23b (see instructions for additional taxes)			23c
	24a Current year's estimated tax payments and preceding year's overpayment credited to the current year	24a		
	b Tax deposited with Form 7004	24b		
	c Credit for federal tax paid on fuels (attach Form 4136)	24c		
	d Elective payment election amount from Form 3800	24d		
	z Add lines 24a through 24d			24z
	25 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>			25
	26 Amount owed. If line 24z is smaller than the total of lines 23c and 25, enter amount owed			26
	27 Overpayment. If line 24z is larger than the total of lines 23c and 25, enter amount overpaid			27
	28 Enter amount from line 27: Credited to 2025 estimated tax Refunded			28

**Sign
Here**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer

Date

Title

May the IRS discuss this return
with the preparer shown below?
See instructions. ☐ Yes ☐ No**Paid
Preparer
Use Only**

Print/Type preparer's name

Preparer's signature

Date

Check ☐ if
self-employed

PTIN

Firm's name

Firm's EIN

Firm's address

Phone no.

		Yes	No																									
1	Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) _____																											
2	See the instructions and enter the: a Business activity _____ b Product or service _____																											
3	At any time during the tax year, was any shareholder of the corporation a disregarded entity, a trust, an estate, or a nominee or similar person? If "Yes," attach Schedule B-1, Information on Certain Shareholders of an S Corporation . . .																											
4	At the end of the tax year, did the corporation:																											
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total stock issued and outstanding of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below																											
	<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 25%;">(i) Name of Corporation</th> <th style="width: 15%;">(ii) Employer Identification Number (if any)</th> <th style="width: 15%;">(iii) Country of Incorporation</th> <th style="width: 15%;">(iv) Percentage of Stock Owned</th> <th style="width: 30%;">(v) If Percentage in (iv) Is 100%, Enter the Date (if applicable) a Qualified Subchapter S Subsidiary Election Was Made</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td> </td></tr> </tbody> </table>	(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage of Stock Owned	(v) If Percentage in (iv) Is 100%, Enter the Date (if applicable) a Qualified Subchapter S Subsidiary Election Was Made																						
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b	Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below																											
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5a	At the end of the tax year, did the corporation have any outstanding shares of restricted stock? If "Yes," complete lines (i) and (ii) below. (i) Total shares of restricted stock (ii) Total shares of non-restricted stock																											
b	At the end of the tax year, did the corporation have any outstanding stock options, warrants, or similar instruments? If "Yes," complete lines (i) and (ii) below. (i) Total shares of stock outstanding at the end of the tax year (ii) Total shares of stock outstanding if all instruments were executed																											
6	Has this corporation filed, or is it required to file, Form 8918 , Material Advisor Disclosure Statement, to provide information on any reportable transaction?																											
7	Check this box if the corporation issued publicly offered debt instruments with original issue discount <input type="checkbox"/> If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.																											
8	If the corporation (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation, and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years. See instructions \$ _____																											
9	Did the corporation have an election under section 163(j) for any real property trade or business or any farming business in effect during the tax year? See instructions																											
10	Does the corporation satisfy one or more of the following? See instructions																											
a	The corporation owns a pass-through entity with current, or prior year carryover, excess business interest expense.																											
b	The corporation's aggregate average annual gross receipts (determined under section 448(c)) for the 3 tax years preceding the current tax year are more than \$30 million and the corporation has business interest expense.																											
c	The corporation is a tax shelter and the corporation has business interest expense. If "Yes," complete and attach Form 8990 , Limitation on Business Interest Expense Under Section 163(j).																											
11	Does the corporation satisfy both of the following conditions?																											
a	The corporation's total receipts (see instructions) for the tax year were less than \$250,000.																											
b	The corporation's total assets at the end of the tax year were less than \$250,000. If "Yes," the corporation is not required to complete Schedules L and M-1.																											

Schedule B Other Information (see instructions) <i>(continued)</i>		Yes	No
12	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		
	If "Yes," enter the amount of principal reduction \$		
13	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		
14a	Did the corporation make any payments that would require it to file Form(s) 1099?		
b	If "Yes," did or will the corporation file required Form(s) 1099?		
15	Is the corporation attaching Form 8996 to certify as a Qualified Opportunity Fund?		
	If "Yes," enter the amount from Form 8996, line 15 \$		
16	At any time during the tax year, did the corporation: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? See instructions		

Schedule K Shareholders' Pro Rata Share Items		Total amount	
Income (Loss)	1 Ordinary business income (loss) (page 1, line 22)	1	
	2 Net rental real estate income (loss) (attach Form 8825)	2	
	3a Other gross rental income (loss) 3a		
	b Expenses from other rental activities (attach statement) 3b		
	c Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4 Interest income	4	
	5 Dividends: a Ordinary dividends 5a		
	b Qualified dividends 5b		
	6 Royalties	6	
	7 Net short-term capital gain (loss) (attach Schedule D (Form 1120-S))	7	
8a Net long-term capital gain (loss) (attach Schedule D (Form 1120-S))	8a		
b Collectibles (28%) gain (loss) 8b			
c Unrecaptured section 1250 gain (attach statement) 8c			
9 Net section 1231 gain (loss) (attach Form 4797)	9		
10 Other income (loss) (see instructions) Type:	10		
Deductions	11 Section 179 deduction (attach Form 4562)	11	
	12a Cash charitable contributions	12a	
	b Noncash charitable contributions	12b	
	c Investment interest expense	12c	
	d Section 59(e)(2) expenditures Type:	12d	
e Other deductions (see instructions) Type:	12e		
Credits	13a Low-income housing credit (section 42(j)(5))	13a	
	b Low-income housing credit (other)	13b	
	c Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	13c	
	d Other rental real estate credits (see instructions) Type:	13d	
	e Other rental credits (see instructions) Type:	13e	
	f Biofuel producer credit (attach Form 6478)	13f	
	g Other credits (see instructions) Type:	13g	
Inter-national	14 Attach Schedule K-2 (Form 1120-S), Shareholders' Pro Rata Share Items—International, and check this box to indicate you are reporting items of international tax relevance <input type="checkbox"/>		
Alternative Minimum Tax (AMT) Items	15a Post-1986 depreciation adjustment	15a	
	b Adjusted gain or loss	15b	
	c Depletion (other than oil and gas)	15c	
	d Oil, gas, and geothermal properties—gross income	15d	
	e Oil, gas, and geothermal properties—deductions	15e	
	f Other AMT items (attach statement)	15f	
Items Affecting Shareholder Basis	16a Tax-exempt interest income	16a	
	b Other tax-exempt income	16b	
	c Nondeductible expenses	16c	
	d Distributions (attach statement if required) (see instructions)	16d	
	e Repayment of loans from shareholders	16e	
	f Foreign taxes paid or accrued	16f	

Schedule K		Shareholders' Pro Rata Share Items (continued)	Total amount	
Other Information	17a	Investment income	17a	
	b	Investment expenses	17b	
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	Income (loss) reconciliation. Combine the total amounts on lines 1 through 10. From the result, subtract the sum of the amounts on lines 11 through 12e and 16f	18	

Schedule L		Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)		
Assets							
1	Cash						
2a	Trade notes and accounts receivable						
b	Less allowance for bad debts	()		()			
3	Inventories						
4	U.S. government obligations						
5	Tax-exempt securities (see instructions)						
6	Other current assets (attach statement)						
7	Loans to shareholders						
8	Mortgage and real estate loans						
9	Other investments (attach statement)						
10a	Buildings and other depreciable assets						
b	Less accumulated depreciation	()		()			
11a	Depletable assets						
b	Less accumulated depletion	()		()			
12	Land (net of any amortization)						
13a	Intangible assets (amortizable only)						
b	Less accumulated amortization	()		()			
14	Other assets (attach statement)						
15	Total assets						
Liabilities and Shareholders' Equity							
16	Accounts payable						
17	Mortgages, notes, bonds payable in less than 1 year						
18	Other current liabilities (attach statement)						
19	Loans from shareholders						
20	Mortgages, notes, bonds payable in 1 year or more						
21	Other liabilities (attach statement)						
22	Capital stock						
23	Additional paid-in capital						
24	Retained earnings						
25	Adjustments to shareholders' equity (attach statement)						
26	Less cost of treasury stock		()		()		
27	Total liabilities and shareholders' equity						

Schedule M-1

Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: The corporation may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books		5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize): _____		a	Tax-exempt interest \$ _____	
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12e, and 16f (itemize):		6	Deductions included on Schedule K, lines 1 through 12e, and 16f, not charged against book income this year (itemize):	
a	Depreciation \$ _____		a	Depreciation \$ _____	
b	Travel and entertainment \$ _____		7	Add lines 5 and 6	
4	Add lines 1 through 3		8	Income (loss) (Schedule K, line 18). Subtract line 7 from line 4	

Schedule M-2

Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account

(see instructions)

	(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1	Balance at beginning of tax year			
2	Ordinary income from page 1, line 22			
3	Other additions			
4	Loss from page 1, line 22	()		
5	Other reductions	()		()
6	Combine lines 1 through 5			
7	Distributions			
8	Balance at end of tax year. Subtract line 7 from line 6			

(Rev. November 2018)

Department of the Treasury
Internal Revenue Service▶ **Attach to Form 1120, 1120-C, 1120-F, 1120S, or 1065.**
▶ **Go to www.irs.gov/Form1125A for the latest information.**

Name		Employer identification number	
Cam's Clothing, Inc.		63-1234567	
1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	Total. Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on Form 1120, page 1, line 2 or the appropriate line of your tax return. See instructions	8	
9a Check all methods used for valuing closing inventory:			
(i) <input type="checkbox"/> Cost			
(ii) <input type="checkbox"/> Lower of cost or market			
(iii) <input type="checkbox"/> Other (Specify method used and attach explanation.) ▶ _____			
b	Check if there was a writedown of subnormal goods	▶	<input type="checkbox"/>
c	Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970)	▶	<input type="checkbox"/>
d	If the LIFO inventory method was used for this tax year, enter amount of closing inventory computed under LIFO	9d	
e	If property is produced or acquired for resale, do the rules of section 263A apply to the entity? See instructions	<input type="checkbox"/> Yes	<input type="checkbox"/> No
f	Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation	<input type="checkbox"/> Yes	<input type="checkbox"/> No

**Schedule K-1
(Form 1120-S)**Department of the Treasury
Internal Revenue Service**2024**

For calendar year 2024, or tax year

beginning **07 / 01 / 2024**ending **06 / 30 / 2025****Shareholder's Share of Income, Deductions,
Credits, etc.**

See separate instructions.

Part I Information About the Corporation**A** Corporation's employer identification number
63-1234567**B** Corporation's name, address, city, state, and ZIP codeCam's Clothing, Inc,
1201 Main Street
Huntsville, AL 35801**C** IRS Center where corporation filed return
Kansas City**D** Corporation's total number of shares
Beginning of tax year **100**
End of tax year **100****Part II Information About the Shareholder****E** Shareholder's identifying number
123-45-6789**F1** Shareholder's name, address, city, state, and ZIP codeCameron Connor
1512 Locust Avenue
Huntsville, AL 35801**F2** If the shareholder is a disregarded entity, a trust, an estate, or a nominee or similar person, enter the individual or entity responsible for reporting:

TIN _____ Name _____

F3 What type of entity is this shareholder? _____**G** Current year allocation percentage **100 %****H** Shareholder's number of shares
Beginning of tax year **100**
End of tax year **100****I** Loans from shareholder
Beginning of tax year \$ _____
End of tax year \$ _____

For IRS Use Only

**Part III Shareholder's Share of Current Year Income,
Deductions, Credits, and Other Items**

1	Ordinary business income (loss)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Schedule K-3 is attached if checked <input type="checkbox"/>
6	Royalties	15	Alternative minimum tax (AMT) items
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)	16	Items affecting shareholder basis
10	Other income (loss)		
		17	Other information
11	Section 179 deduction		
12	Other deductions		
18	<input type="checkbox"/> More than one activity for at-risk purposes*		
19	<input type="checkbox"/> More than one activity for passive activity purposes*		

* See attached statement for additional information.

List of Codes

This list identifies the codes used on Schedule K-1 for all shareholders. For detailed reporting and filing information, see the specific line instructions, earlier, and the instructions for your income tax return.

Box 10. Other income (loss)

Code

<u>A</u>	Other portfolio income (loss)
<u>B</u>	Involuntary conversions
<u>C</u>	Section 1256 contracts and straddles
<u>D</u>	Mining exploration costs recapture
<u>E</u>	Section 951A(a) income inclusions
<u>F</u>	Inclusions of subpart F income
<u>G</u>	Section 951(a)(1)(B) inclusions
<u>H</u>	Reserved for future use
<u>I</u>	Gain (loss) from disposition of oil, gas, geothermal, or other mineral properties
<u>J</u>	Recoveries of tax benefit items
<u>K</u>	Gambling gains and losses
<u>L</u>	Reserved for future use
<u>M</u>	Gain eligible for section 1045 rollover (replacement stock purchased by the corporation)
<u>N</u>	Gain eligible for section 1045 rollover (replacement stock not purchased by the corporation)
<u>O</u>	Sale or exchange of QSB stock with section 1202 exclusion
<u>P – R</u>	Reserved for future use
<u>S</u>	Non-portfolio capital gain (loss)
<u>T – X</u>	Reserved for future use
<u>ZZ</u>	Other income (loss)

Box 12. Other deductions

<u>A</u>	Cash contributions (60%)
<u>B</u>	Cash contributions (30%)
<u>C</u>	Noncash contributions (50%)
<u>D</u>	Noncash contributions (30%)
<u>E</u>	Capital gain property to a 50% limit organization (30%)
<u>F</u>	Capital gain property (20%)
<u>G</u>	Contributions (100%)
<u>H</u>	Investment interest expense
<u>I</u>	Deductions—Royalty income
<u>J</u>	Section 59(e)(2) expenditures
<u>K</u>	Reserved for future use

<u>L</u>	Deductions—Portfolio income (other)
<u>M</u>	Preproductive period expenses
<u>N</u>	Reserved for future use
<u>O</u>	Reforestation expense deduction
<u>P – V</u>	Reserved for future use
<u>W</u>	Soil and water conservation
<u>X</u>	Film, television, and theatrical production expenditures
<u>Y</u>	Expenditures for removal of barriers
<u>Z</u>	Itemized deductions
<u>AA</u>	Contributions to a capital construction fund (CCF)
<u>AB</u>	Penalty on early withdrawal of savings
<u>AC</u>	Interest expense allocated to debt financed distributions
<u>AD – AJ</u>	Reserved for future use
<u>ZZ</u>	Other deductions

Box 13. Credits

<u>A</u>	Zero-emission nuclear power production credit
<u>B</u>	Production from advanced nuclear power facilities credit
<u>C</u>	Low-income housing credit (section 42(j)(5)) from post-2007 buildings
<u>D</u>	Low-income housing credit (other) from post-2007 buildings
<u>E</u>	Qualified rehabilitation expenditures (rental real estate)
<u>F</u>	Other rental real estate credits
<u>G</u>	Other rental credits
<u>H</u>	Undistributed capital gains credit
<u>I</u>	Biofuel producer credit
<u>J</u>	Work opportunity credit
<u>K</u>	Disabled access credit
<u>L</u>	Empowerment zone employment credit
<u>M</u>	Credit for increasing research activities
<u>N</u>	Credit for employer social security and Medicare taxes
<u>O</u>	Backup withholding
<u>P</u>	Unused investment credit from the qualifying advanced coal project credit or qualifying gasification project credit allocated from cooperatives
<u>Q</u>	Unused investment credit from the qualifying advanced energy project credit allocated from cooperatives
<u>R</u>	Unused investment credit from the advanced manufacturing investment credit allocated from cooperatives
<u>S</u>	Reserved for future use
<u>T</u>	Unused investment credit from the energy credit allocated from cooperatives
<u>U</u>	Unused investment credit from the rehabilitation credit allocated from cooperatives
<u>V</u>	Advanced manufacturing production credit
<u>W – X</u>	Reserved for future use
<u>Y</u>	Clean hydrogen production credit
<u>Z</u>	Orphan drug credit
<u>AA</u>	Enhanced oil recovery credit
<u>AB</u>	Renewable electricity production credit
<u>AC</u>	Biodiesel, renewable diesel, or sustainable aviation fuels credit
<u>AD</u>	New markets credit
<u>AE</u>	Credit for small employer pension plan startup costs
<u>AF</u>	Credit for small employer auto-enrollment
<u>AG</u>	Credit for military spouse participation
<u>AH</u>	Credit for employer-provided childcare facilities and services
<u>AI</u>	Low sulfur diesel fuel production credit
<u>AJ</u>	Qualified railroad track maintenance credit
<u>AK</u>	Credit for oil and gas production from marginal wells
<u>AL</u>	Distilled spirits credit
<u>AM</u>	Energy efficient home credit
<u>AN</u>	Alternative motor vehicle credit
<u>AO</u>	Alternative fuel vehicle refueling property credit
<u>AP</u>	Clean renewable energy bond credit
<u>AQ</u>	New clean renewable energy bond credit
<u>AR</u>	Qualified energy conservation bond credit
<u>AS</u>	Qualified zone academy bond credit
<u>AT</u>	Qualified school construction bond credit
<u>AU</u>	Build America bond credit

<u>AV</u>	Credit for employer differential wage payments
<u>AW</u>	Carbon oxide sequestration credit
<u>AX</u>	Carbon oxide sequestration credit recapture
<u>AY</u>	New clean vehicle credit
<u>AZ</u>	Qualified commercial clean vehicle credit
<u>BA</u>	Credit for small employer health insurance premiums
<u>BB</u>	Employer credit for paid family and medical leave
<u>BC</u>	Eligible credits from transferor(s) under section 6418
BD – BG	Reserved for future use
<u>ZZ</u>	Other credits

Box 15. Alternative minimum tax (AMT) items

<u>A</u>	Post-1986 depreciation adjustment
<u>B</u>	Adjusted gain or loss
<u>C</u>	Depletion (other than oil & gas)
<u>D</u>	Oil, gas, & geothermal—Gross income
<u>E</u>	Oil, gas, & geothermal—Deductions
<u>F</u>	Other AMT items

Box 16. Items affecting shareholder basis

<u>A</u>	Tax-exempt interest income
-----------------	----------------------------

<u>B</u>	Other tax-exempt income
<u>C</u>	Nondeductible expenses
<u>D</u>	Distributions
<u>E</u>	Repayment of loans from shareholders
<u>F</u>	Foreign taxes paid or accrued

Box 17. Other information

<u>A</u>	Investment income
<u>B</u>	Investment expenses
<u>C</u>	Qualified rehabilitation expenditures (other than rental real estate)
<u>D</u>	Basis of energy property
<u>E</u>	Recapture of low-income housing credit (section 42(j)(5))
<u>F</u>	Recapture of low-income housing credit (other)
<u>G</u>	Recapture of investment credit
<u>H</u>	Recapture of other credits
<u>I</u>	Look-back interest—Completed long-term contracts
<u>J</u>	Look-back interest—Income forecast method
<u>K</u>	Dispositions of property with section 179 deductions
<u>L</u>	Recapture of section 179 deduction
<u>M</u>	Section 453(l)(3) information
<u>N</u>	Section 453A(c) information
<u>O</u>	Section 1260(b) information

<u>P</u>	Interest allocable to production expenditures
<u>Q</u>	Capital construction fund (CCF) nonqualified withdrawals
<u>R</u>	Depletion information—Oil and gas
S – T	Reserved for future use
<u>U</u>	Net investment income
<u>V</u>	Section 199A information
W – Z	Reserved for future use
<u>AA</u>	Excess taxable income
<u>AB</u>	Excess business interest income
<u>AC</u>	Gross receipts for section 448(c)
AD – AI	Reserved for future use
<u>AJ</u>	Excess business loss limitation
AK – AM	Reserved for future use
<u>AN</u>	Farming and fishing income
<u>AO</u>	Reserved for future use
<u>AP</u>	Inversion gain
AQ – AR	Reserved for future use
<u>AS</u>	Qualifying advanced coal project property and qualifying gasification project property
<u>AT</u>	Qualifying advanced energy project property
<u>AU</u>	Advanced manufacturing investment property
<u>AV</u>	Reserved for future use
<u>AW</u>	Reportable transactions
AX – BD	Reserved for future use
<u>ZZ</u>	Other information

III. Section Three: Building a Tax Return (cont.)***Formatting and Other Notes***

Where to find the cash/accrual check boxes for the common business entities

- Sole proprietorships, Form 1040, Schedule C, _____
- Partnerships and most LLCs, Form 1065, _____
- S corporations, Form 1120S, Schedule B (p. 2), row 1
- C Corporations, Form 1120, _____

For businesses that have a fiscal year end (FYE) other than December 31, the year for tax forms depends on the date that the fiscal year begins.

On the income statement, conventional financial statements show “other income” near the bottom of the income statement, after operating expenses.

Tax returns show “other income” within the top section, just below gross profit and before operating expenses.

Similarly, interest expense and other expenses are shown in conventional financial statements after operating expenses, while tax returns include interest expense and other expense within operating expenses.

No other major formatting changes, other than tax returns breaking out “compensation of officers” that is not typically done in a conventional financial statements.

Other than formatting changes, many of the account labels or titles any not be consistent from one format to the other; be flexible and do not take row labels literally, that is, “other” is the same as “miscellaneous.”

In this exercise, we are estimating that depreciation for Cam’s Clothing likely will be higher for income tax purposes [\$1,200] than a basic straight-line approach for internal financial statements in our t-accounts [\$800].

For example, modified accelerated cost recovery system (MACRS), mid-year dating and other tax return rules generally allow businesses to depreciate assets at a higher rate early in the useful life, then decreasing later in the useful of the asset.

Note that line 14 (and similar lines in other BTRs) is not necessarily the total amount of depreciation being claimed – some can be deducted in cost of goods sold, see “tip” below.

Tip: Additional depreciation expense may be found in Form 1125-A Cost of Goods Sold; it will be part of “other costs” on line 5, and you will need the attachment/detail.

As of 2021, in most situations, 100% of meals expense is deductible, but there are exclusions.

Through 2020, one-half of meals and entertainment was deductible in most situations.

For Cam in FY 2023, only \$300 of meals expense was deductible, therefore, it can deduct only \$300 of the \$400 in meals costs incurred during the fiscal year.

So far, of the \$4,000 in miscellaneous expenses, \$200 will be shown as interest expense on a separate BTR line, with \$3,700 left after excluding \$100 of meals expense.

There are not many other expense categories with BTR exclusions.

Most of the business income (loss) items that pass through to the owners are lumped together as ordinary business income (loss), for IRS purposes. However, items that need to enter special personal tax forms/schedules are broken out into Schedule K rows 1-13, such as: charitable contributions to Schedule A, interest and dividend income to Schedule B, and capital gains (losses) to Schedule D

On the balance sheet, conventional financial statements show “land” as a component of fixed assets, along with buildings, machinery and equipment, furniture and fixtures, vehicles, etc. – even though land usually is not depreciated.

Tax returns show “land” as a separate row on Schedule L, apart from the remaining “depreciable” and “depletable” assets.

In general, fixed assets (other than land) are depreciated,
natural resources owned are depleted
intangible assets are amortized (different from loan principal amortization), and
sometimes re-valued annually to be written up or written down during that year

All are *non-cash expenses* on the income statement, and should be added back to ordinary income to determine cash flow

Conventional financial statements usually break out short-term notes payable (often an operating line of credit for bank customers) from current maturities of long-term debt (CMLTD) [sometimes called current portion of long-term debt (CPLTD). Remember to be flexible with row labels.]

CMLTD is the principal to be paid in the next 12 months on amortizing long-term debt (see the Reference Guide).

BTRs combine them in the row called “mortgages, notes, bonds payable in less than 1 year”

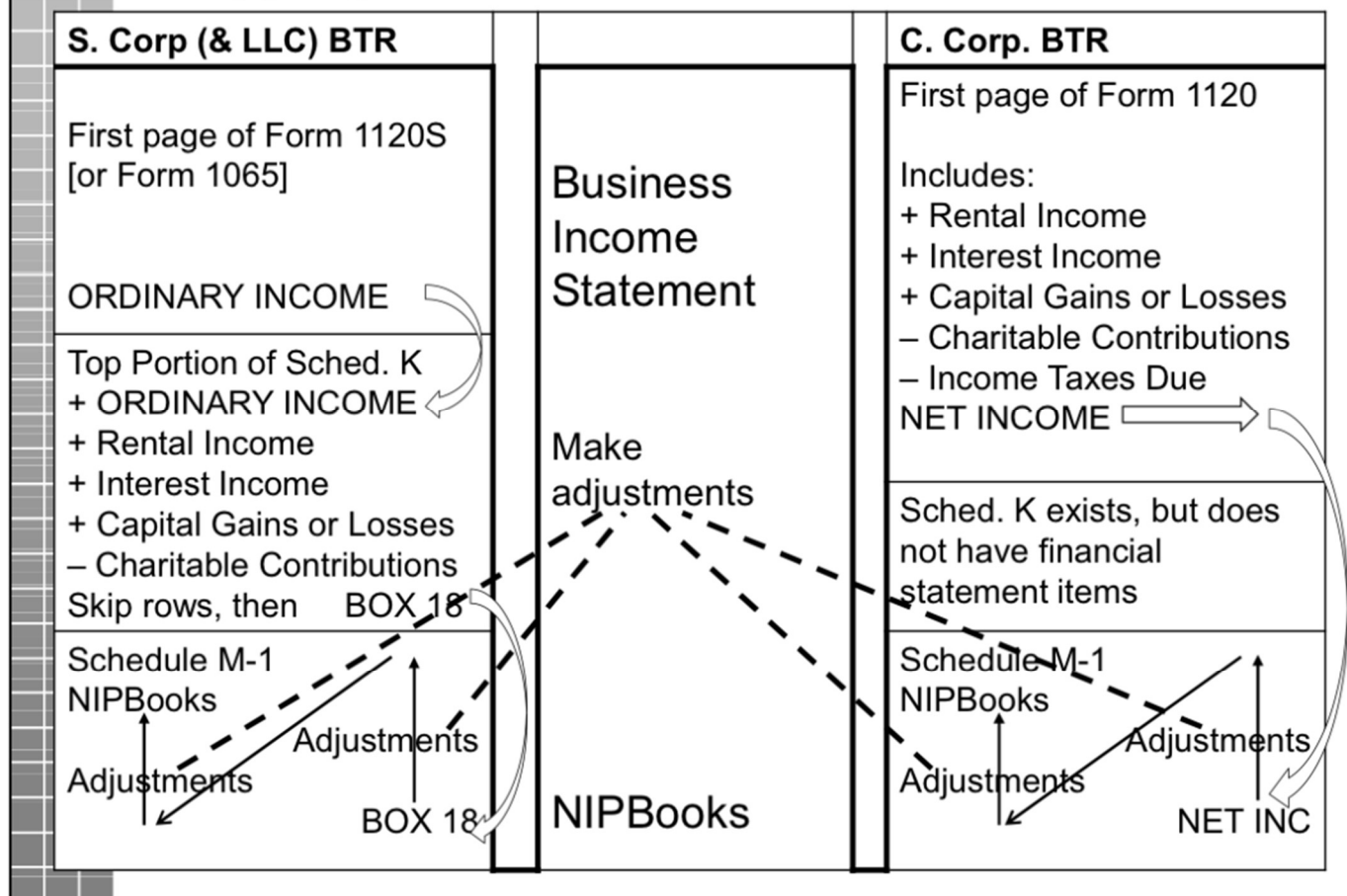
So, when working from a BTR, it helps to break these short-term items apart, to be consistent, and this will require further information from your borrower.

Also, BTRs and most accountant prepared BFSs usually show a long-term loan as *short-term if it matures in the next 12 months from the BFS or BTR date*. If it is a loan with a regular, bullet or balloon maturity that is expected to be renewed, it should be shown as long-term debt in the analysis. For example, think of a real estate loan where there is a long-term amortization (15 years?) but it matures in three or five years (maybe called a bullet or balloon) primarily for re-pricing purposes. If the loan is expected to be renewed, then it should continue to be shown as long-term when the financial statement or tax return date is within one year of the renewal date.

Financial Accounting Standards Board (FASB) slowly modifying GAAP to match International Reporting Standards (IFRS)

- IFRS is a very different accounting system and the dominant approach used by most countries
- Most large, international firms use both IFRS and GAAP, and would prefer to operate under one system
- In 2008 the Securities and Exchange Commission mandated changing to IFRS for U.S. public firms in 2013; however this was dropped during the “great recession”
- Now the Financial Accounting Standards Board (FASB) is taking a piecemeal approach and slowing modifying U.S. GAAP
- In a similar fashion, the U.S. considered a total change to the metric system of measurements (used by most other countries) in the 1960s, but total conversion was never mandated, while many measurements are now metric (medicines, foods and fluids, nuts and bolts) and slowly expanding
- Two examples of GAAP to IFRS conversion steps are shown on page 32 (in Reference Guide)

Mapping Tax Return to BFS



IV. Section Four: Case Work Using the Reference Guide

A. CASE – ANDERSON STEEL – PART 1

Individually, take a few minutes to read page 27 (first page of the six-page **Reference Guide**) with more about statement “spreading” and some tips and traps. Note that the case data on pages 37-38 already are in the format of the first part of statement spreading. That is, four years of reviewed financial statements have been combined into a consistent format to allow orderly computation of ratios and to help you spot various trends in the balance sheet and income statement line items.

B. CASE – ANDERSON STEEL – PART 2 – Case Data pages 35-40

In small groups, complete the ratio worksheet below for the latest year of financial data. Note that Year 1 is not the first year of this business. The four years of financial data were numbered for convenience. While economic issues certainly affect the financial performance of a business, this exercise is intended to focus the analysis on the numbers and how the ratios work and what they mean, irrespective of the economy, etc.

Please refer frequently, as needed, to the remaining pages of the **Reference Guide** for assistance – it will answer most of the questions you may have. It covers the formulas for the ratios and defines most of the financial statement items you will encounter, such as current maturities of long-term debt.

The order of the ratios and measures in the chart below do not match order/sequence of the **Reference Guide** contents.

Anderson Steel-Ratios	Year 1	Year 2	Year 3	Year 4
Sales Growth (%)	22.1%	165.0%	19.3%	
Gross Profit Margin (%)	27.4%	29.9%	28.0%	
Operating Expense/Sales (%)	21.6%	21.9%	22.7%	
Net Profit Margin (%)	3.8%	4.0%	3.2%	
Current Ratio (x)	1.4x	1.4x	1.6x	
Quick Ratio (x)	0.9x	0.8x	0.8x	
Working Capital (\$)	\$ 305	\$ 471	\$985	
Debt/Tangible Net Worth (x)	4.3x	2.8x	3.3x	
Accounts Rec. Turnover (d)	97d	52d	65d	
Inventory Turnover (d)	73d	54d	82d	
Accounts Payable Turnover (d)	83d	49d	81d	
Sales/Assets (x)	1.9x	3.2x	2.1x	
EBITDA (\$)	\$ 220	\$ 659	\$583	
Gross Cash Flow Coverage (x)	0.7x	1.5x	2.0x	
Interest Coverage (x)	3.9x	8.2x	4.2x	
Fixed Charge Coverage (x)	0.8x	2.1x	2.0x	

C. CASE – ANDERSON STEEL – PART 3

As a large group, we'll discuss the results from computing the financial ratios for Anderson Steel and develop comments about key trends and issues in the areas listed below. If you are aware of desired levels for the various ratios and any benchmarks often discussed at your bank, please share with the class.

1. Sales growth

2. Gross profit margin

3. Operating expenses/sales

4. Net margin

5. Liquidity (current & quick ratios, working capital)

6. Leverage (debt/TNW)
7. Efficiency ratios
8. Conventional coverage ratios (EBITDA, gross cash flow coverage, interest coverage and fixed charge coverage)
9. Overall or general analytical conclusions
10. Some analytical tips and pointers from this discussion

- Develop a prioritized list of follow-up questions instead of one-at-a-time questions to customer
 - Two immediate things to resolve: (1) detail where detail is needed, (2) AR and AP dating terms
- Avoid analyst cop-out, similar to “The lender or customer has not told me/us.”
- Avoid blunt customer questions, such as “Why did gross margin go down?”
- Many senior level bankers have at least one unusual way to calculate an item or ratio
- Note the peaks and valleys (high points and low points)
- It’s okay to calculate some items two ways
 - You usually reach the same conclusion either way (one-time items?) so don’t agonize over it and waste valuable time
- Base effect when previous year item small but growing
- Unpack ratio components to explain trend
- Sometimes there’s no clear trend
- In narrative, play tour guide and develop themes
 - Every package tells a story, it’s not just a bunch of numbers

V. APPENDIX (Time Permitting): Using Industry and Comparative Data

- A. Most common source of comparative data is **RMA Annual Statement Studies Financial Ratio Benchmarks** book, available with most automated programs in a comparative printout
 1. Newer companion **Industry Default Probabilities and Cash Flow Measures**
 2. Based on submissions from hundreds of banks, with output grouped
 - a. By North American Industry Classification System (NAICS) code
 - b. By asset size ranges or entire NAICS sample and by revenue size ranges or entire NAICS sample
 3. Customer can be placed in a quartile for just about any ratio (top 1/4th, second highest 1/4th, etc.)
 4. Issues
 - a. Quartile rankings are difficult to discuss in your loan memo narrative (no “average” to compare to)
 - b. Numerous size categories allow manipulation (what looks better, the comparison to the appropriate asset size or revenue size), since there is not one, definitive set of numbers to use
 - c. Most banks do not get statements from stronger businesses that do not borrow money – sample is automatically skewed to weaker firms
 - d. Think about LIFO vs. FIFO, consolidated financials with multiple industries or the prevalence of smaller firms to lease significant assets (such as a building) from the owners – this skews the data, unless there is a clear “norm” in the industry
 - e. Most banks have data integrity problems on their loan systems, particularly with the seemingly-simple SIC/NAIC code – there is a similar, inherent error factor with SIC/NAIC codes on spreads
 - f. The most recent year of comparative data is usually over 12 months old before available, due to the time it takes to collect the samples, publish data, etc.
 5. While the RMA data is often best available, be careful to use it objectively and fairly, and recognize that it is only a comparison of limited value to the overall analysis
- B. Aggressively use the Internet to find industry data, examples . . .

Industry and trade associations, plus governmental entities, colleges and universities, can provide industry information, plus data based on basic financial ratios, but more often cover statistics or ratios that are somewhat unique to their own industry. The following are examples:

1. The website for the National Association of Motorcoach Operators (www.namo-coaches.org) provides unique data and statistics, such as the industry having about 4,000 companies, with 90 percent operating fewer than 25 buses. About 50 percent of the active job positions in the industry are with firms with fewer than 50 total employees. The association also tracks items such as annual revenue per bus, etc. This is information that goes far beyond current ratios and leverage ratios and is equally important to understanding a commercial borrower.
2. Governmental entities, such as the U.S. Department of Agriculture, provide extensive information on crop yields and pricing. Most major commodities also have a dedicated industry group. For example, the National Cotton Council of America (www.cotton.org) provides data on production, production history and yield from the county and state level in the U.S., to worldwide data. It also provides technical resources that would be ideal for a business banker attempting to learn the industry such as, the following:
 - Bale packaging (standards, specifications, and updates)
 - Biotechnology (reports and studies on biotechnology, plus links to other resources)
 - Cottonseed (information on cottonseed and cottonseed products)
 - Flow-shipment (warehouse reporting information, shipping standards, rack sample study and related reports)
 - Pest management (info on boll weevils, cotton nematodes, and cotton seedling diseases)
3. Colleges and universities also can be a source of information, sometimes in cooperation with an industry group. Since 1980, the Recreational Vehicle Industry Association (RVIA) has commissioned the University of Michigan Survey Research Center to update various industry statistics every four years. The most recent study cited a 15 percent increase over the four years in numbers of RV owners, now reaching one in twelve households in the U.S.
4. SEC filings by larger, public firms in the same industry: In a lending situation that involved a large manufacturer of private label dog food, the lender found a PowerPoint presentation with data about worldwide and U.S. household expenditures for pets – everything from veterinary services to food (branded vs. private label), plus competition in the industry, at the website of Purina’s parent company Nestle, AG.