PART ONE

STEPS FOR A SOUND BUSINESS CREDIT DECISION

INTRODUCTION

The first section of this book reviews some of the tools used by every credit professional to arrive at a sound business credit decision. This book uses the "A, B, C, D" method to prepare readers to make this type of decision not only for the case studies provided herein but also for those situations that cross readers' desks on a daily basis. Some of these concepts may appear basic to a seasoned pro, but the back-to-basics approach plus some more advanced concepts in these initial four chapters can prove useful to all. Even the seasoned pros need to return to the basics occasionally in order to avoid overlooking a danger sign that to a novice might appear blatant.

On many occasions when I taught two courses for the American Management Association (AMA), I was surprised by a question from a person who had only two or three months of credit experience. After 28 years in this field, I am proud to say that I do not know everything and never will. But what I do know is where to find the answers. Over the years I have established many ties and relationships with all types of individuals and organizations that can help me.

This book will provide not only my own insights but also the visions of those exceptional individuals who took my course. They came from all

over the country and from all different types of firms. This diversity helped to make the learning experience not only enjoyable but also very beneficial to all. I always opened my classes by saying that I would learn more from the session than any one student there as I would gain insight from all of those who attended the session. I usually finished this speech by saying that it is in the best interest of all who attend seminars paid for by their firms to take advantage of all the opportunities that their companies will provide. The firms are gaining a more knowledgeable employee and the student secures not only more knowledge and experience but also new contacts to use for the future.

The value of taking courses (and reading books) that improve skills and abilities is that you can never lose them and no one can take them from you. You are an asset to many firms. A table is also an asset. When a table is worn out, the company discards it. When you are of no use to the firm . . . well, you know what happens. Take advantage of all that your firm provides and obtain as many credentials, degrees, knowledge, skills, and most important contacts that you can. Although you may not need any of these tools today or tomorrow, one of these days . . .

1

A IS FOR ANALYSIS FOR CREATIVE CREDIT MANAGEMENT

INTRODUCTION

This chapter sets the groundwork for solid financial credit analysis. Specifically:

- What techniques are used for obtaining financial data while controlling the cost of acquiring it? How can the worth of the data obtained be evaluated?
- What is common-size analysis?
- What is trend analysis?
- How can you make sure that "apples" are compared to "apples" when equating ratios to industry averages?
- What is the benefit in determining the value of ratios in financial analysis?

This chapter covers techniques for obtaining financial data on customers while controlling the always-important aspect of cost. The chapter also determines the value of the data and how important it is in making a sound business credit decision. Tools such as vertical and horizontal

(trend) common-size analysis are discussed, and the text will leave readers with an appreciation of what these figures do and do not tell you about a customer. A clear understanding of what it means to compare "Apples to Apples" when comparing data will help readers appreciate the value of industry numbers. Finally, readers will gain an appreciation and understanding of the value of ratio analysis through a review on ratios that cover solvency, profitability, and efficiency and how these ratios work in tandem with each other to provide a clearer "picture" of the customer.

TECHNIQUES FOR GETTING FINANCIAL DATA WHILE CONTROLLING COSTS

To prepare readers for managing the case studies and those that are faced daily, we begin by looking at techniques for gaining financial data while controlling costs in obtaining it. The following sources can be used to make that all-important sound business credit decision. Their prices and value vary.

Customer. While being the ultimate free source of information, customers rarely provide all the data needed to help credit executives make that decision. If the customer is a publicly traded firm on any of the stock exchanges, easy access to data is available from its annual report or any of the reports that are submitted to the Securities and Exchange Commission (SEC). These include the 10K (detailed audited annual report) or a 10Q (limited detail unaudited quarterly report) and so on. If the customer is a privately held company, then the whim of the owners determines whether financial data can be obtained. The customer's need for your product will greatly enhance or detract from its willingness to provide this information.

Depending on the size of the firm, some customers will complete the credit application; larger firms will provide a fact sheet of basic information, usually their bank, possibly a trade reference or two, and their Duns number (Dun & Bradstreet reference number for their credit report). Credit executives can never obtain financial information on a division of a company; only sometimes will financial data on a subsidiary be provided. Typically the smaller the company, the more it needs the services of the credit executive's firm, and the more information the client will provide. Also proportionally, the larger a firm is, the more likely that its financial information will be audited.

Internet. One of the greatest sources of information (and occasionally disinformation) available today is the Internet. It provides access to

information from numerous firms, government agencies, colleges, news publications, libraries, and elsewhere. Search engines help users find the different web sites that will provide large quantities of data that can support research toward making a sound business credit decision. Some firms have web sites that include product information, financial data, history of the firm, and who owns or runs the firm.

All this can prove quite useful, but at times the amount of data and the time it takes to separate out the chaff from the wheat is overwhelming. A vast amount of these data is raw, unverified, or unaudited, which means that it must be taken with a grain of salt. Always be careful of what you read and the source that it comes from before accepting it as fact.

Brokerage firms. Brokerage firms are the place to go for information on publicly traded firms. They have prospectuses on all firms traded on the New York, American, and NASDAQ stock exchanges. Prospectuses provide not only financial data but also background information on the firm's makeup.

State government. Some state governments require that companies doing business in their state submit certain financial or business data in order to continue to conduct business there. None of the information is audited, and it tends to be very limited in nature. Some examples include balance sheet information, profit-and-loss statements, and intelligence only on the principles that run the firm. Since the information is unaudited, it should serve as nothing more than a good starting point to initiate your overall credit check.

Dun & Bradstreet/Experian. These two companies supply credit and other informational reports on firms across the United States (their strength) and across the world (less accurate and up to date). Both provide trade reference information as well as audited financial data on publicly traded firms; public records on companies that have judgments, suits, tax liens, bankruptcy filings, and date and state of incorporation (if applicable); and UCC-1 filings. Dun & Bradstreet also provides information on the principals of the firm, notes on any significant changes to a firm, analysis of the financial data, unaudited financial data, terms of sale, who and where they sell, and information on the location of the facility and its ownership. How good is this extra information supplied by D & B? It is unaudited and generally obtained directly from the customer itself. Does this mean that it is inaccurate or valueless? Like the unaudited information supplied to the state, it can serve as a good starting point to initiate your overall credit check.

International financial information is more difficult to obtain in countries other than the United States due to local customs, government regulations, and data availability. Thus, these reports tend to be less accurate or current. Most countries do not have access to the level of detail and the rigorous nature of a U.S. audit of financial information.

Securities and Exchange Commission (SEC). This wing of the federal government oversees firms that are publicly traded on the various stock exchanges. Firms that sell stock on these exchanges must supply certain audited and unaudited information on a regular and timely basis. These records and reports can be obtained directly from the SEC or through their web site Edgar.gov, and are free of charge. They can be downloaded to a computer for analysis.

EVALUATING THE WORTH OF THE DATA ACQUIRED

Once credit executives have the information, the next step is to evaluate its worth. If the data are audited, then an independent accountant's opinion will be stated, which confirms the validity of the information presented in the financial package. There are four levels of opinions for audited statements and other levels for unaudited statements.

1. **Unqualified:** This audit confirms that the financial data that was investigated totally conformed to generally accepted accounting principles (GAAP), which is the highest level of audit that can be performed on financial data. Rigorous testing of data is performed as outlined by the guidelines stated in GAAP. The firm that has completed the audit certifies that the data as presented meet all standards without exception according to those set by GAAP.
2. **Qualified:** This rating indicates that an independent accounting firm certifies that the audit performed met all GAAP standards with a notable exception. This exception can be for a variety of reasons and is noted because the way that the firm accounts for one aspect of its operation may not meet GAAP standards. This may or may not be significant in the eyes of the credit professional, but the facts relating to this failure to comply with GAAP should be investigated.
3. **Adverse:** The auditing firm confirms that the information audited does not conform to GAAP, which means that the value of the information

does not meet these requirements. An adverse opinion can mean, for example, that the firm is financially insolvent and may be out of business soon.

4. **No Opinion:** When an account provides no opinion, it simply means that the level of the audit was insufficient to provide an opinion. GAAP has set standards regarding, the degree of investigation required to qualify for an accountant's opinion. Within this level there exist sublevels of "nonopinion." They are:
   - **Reviewed:** Some checks of the data have been made but they were of insufficient depth of audit to provide an opinion.
   - **Compiled:** No auditing was done. The company provided the accounting firm with enough information to create a balance sheet and income statement.
   - **No accountant's report:** No outside independent accounting firm reviewed the information.

Assuming no audited, unqualified opinion financial report was available, what data might be obtainable?

Complete annual report. Some privately held companies do have audited annual reports. This information is just as good as that supplied by any publicly traded company. Some private firms have statements that are reviewed or compiled by an outside accounting firm, and they will state that it does not comply with GAAP.

Annual balance sheet and income statement. Some firms will provide a year-end balance sheet and income statement. While this information is helpful, it is unaudited and lacks the notes necessary to clarify some numbers on the two reports. Without previous years to compare against, credit professionals cannot determine trends in the way that the firm is performing from just one year's numbers.

Quarterly balance sheet and income statement. A greater problem exists for the credit professional in using these reports, for they lack certain year-end adjustments without which the net income appears inflated. To get the best trend contrasts, comparisons should be made only from the same quarter previous year to same quarter present year. Quarter-to-quarter comparisons will show trends within the year but will not be a true comparison of like times.

One-month balance sheet and income statement. A one-month balance sheet provides a snapshot of the business on that day. The lack of something to compare it against and the fact that it is not audited decreases its value tremendously. A one-month income statement is merely an interim statement. Because it lacks final adjustments, it does not enable credit professionals to judge accurately how profitable the business is. Likewise, trend analysis cannot be performed on it.

Balance sheet only. This provides a snapshot picture but offers nothing to compare against and is unaudited.

Income statement only. This has the same problems as in the one-month income statement reviewed earlier.

Partial numbers only. Partial numbers have literally no value as they are taken out of context and tell precious little.

How good is the source of the financial information? Depending on who the source is will greatly vary the value the information will have. The following are the various levels of audit offered by various organizations:

- Customer: audited for public companies; audited to totally unaudited for private companies
- Internet: audited (public company from Edgar.gov, a brokerage firm, or the public company itself) to totally unaudited (company web site to news article)
- SEC/Brokerage Firm: audited annual, unaudited quarter numbers, public companies
- State Government: unaudited, varies could be balance sheet, income statement, and/or principals of company
- Dun & Bradstreet/Experian: audited (both) to totally unaudited (D & B only) to none at all

WHAT IS COMMON-SIZE ANALYSIS?

Common-size analysis was created to compare firms of different sizes against each other to determine how successful they are. It reduces a com-

pany's numbers down to the level of a percentage, which can be readily compared to a firm of a totally different size. It uses three different bases (denominators) as the divisor for computing these percentages.

1. In the case of assets, total assets is used as the denominator (i.e., cash/total assets as a percentage).
2. For liabilities or any part of the shareholder's equity (retained earnings, etc.), the denominator is the total of liabilities and shareholder's equity (i.e., accounts payable/total liabilities + shareholders' equity as a percentage).
3. For the income statement, net sales is used as the denominator (i.e., operating profit [loss]/net sales as a percentage).

Common-size analysis allows a company to compare its percentages for each item against the previous year's results. This will help when using trend analysis. Common-size analysis becomes much more focused when two or more firms that have the same Standard Industrial Classification Code (SICC) number are compared. This number is used to identify what type of business a particular company conducts. The level of comparison can be sharpened even more if the level of annual sales falls within a specific range and there are a particularly large number of members in the same code and same size range to compare against.

WHAT IS TREND ANALYSIS?

Trend analysis compares parts of the balance sheet, income statement, statement of cash flows, and ratios from the present year to those of previous years. It also can compare these same numbers against industry standards from those same years to see how they have improved or deteriorated not only against themselves but also against the industry as a whole.

This type of analysis is best when there is at least three to five years' worth of data to compare. This comparison can be of value when, by contrasting the present year against either the previous year or against industry norms, unusual items are discovered in the financial data. Such a discovery can be the difference between approving credit immediately (assuming all other work has been done and is satisfactory) and either asking more questions or quickly declining credit.

RATIO ANALYSIS AND THE MOST IMPORTANT RATIOS

Ratio analysis compares certain parts of the balance sheet with the total balance sheet, the balance sheet with the income statement, or a certain part of the income statement with the total income statement in a mathematical formula that can be used to compare against previous years or industry standards. Formulas can be calculated in number of days, number of times that something is turned over, comparison to a $1.00, or as a percentage. These ratios usually fall into three types of categories:

1. *Solvency* is the level at which a firm can meet its obligations.
2. *Efficiency* is how effective a firm is at turning over its debts and assets.
3. *Profitability* reflects level of income a firm generates from its daily operations.

Certain ratios are more important to some organizations than others. Ratios used by those firms that extend long-term credit or brokerage firms are totally different than the ratios used by a trade creditor. Some examples of ratios important to trade creditor are:

Quick ratio. This ratio is computed by taking cash, marketable securities, and accounts receivables and dividing them by current liabilities. This provides a dollar amount of current assets compared to $1.00 of current liabilities. The ratio defines the degree to which a company's current liabilities are covered by the most liquid current assets. It was thought in past days that a quick ratio of $1.00 to $1.00 was great. However, this can be misleading, depending on the outcome of the days sales outstanding ratio and what is normal for that particular industry.

Days sales outstanding. DSO is computed by taking the accounts receivable and dividing it by the net sales number times 365 days. This provides an average number of days it takes for a customer to collect receivables. When comparing this number to industry standards, it can be seen if the receivables appear to be collected slowly or if longer terms are being offered. If the customer's industry rarely has variable terms, then it is likely a sizable portion of its receivables may be either delinquent or nonperforming.

Using this ratio in conjunction with the quick ratio will help credit professionals make a better determination of a customer's liquidity. Trend analysis on both of these ratios will reflect the overall liquidity status over

the last few years. These two ratios are extremely important to the short-term trade creditor. If a firm does not have solid receivables turnover, it will not have the necessary liquidity to meet its trade debt.

Accounts payable turnover. This ratio is calculated by taking accounts payable and dividing it by the cost of sales times 365 days. This ratio presents the average days that a customer takes to pay its trade suppliers. Why is this important to a trade creditor? The higher this number, the longer the trade creditor will have to wait for payment. While a company that has managed its cash flow well can be defined as one that gets its payment before it has to pay its creditors, that situation can make for some very unhappy trade vendors and credit professionals.

Inventory turnover. This ratio is calculated by taking inventory and dividing it by the cost of sales times 365 days. Why is this important to the trade creditor? This is easy; this is the creditor's inventory. This is the average days that the customer takes to turn its inventory once. The longer the inventory sits, the less the chance that it will ever move. Low inventory turnover also decreases the trade creditor's ability to sell new additional product to a customer. While a slightly higher than industry average is not bad, a number that is vastly higher than industry average is dangerous, as it could mean that the inventory is being sold at "fire sale" prices. In such a circumstance, the customer will not have the funds necessary to meet its obligations, as the funds received will most likely be used to cover costs.

Debt to tangible net worth. This ratio is computed by dividing the total liabilities by tangible net worth (net worth minus intangible assets). It indicates a firm's ability to leverage itself while still meeting its obligations. It shows how much the owners and creditors have invested in the firm. The higher the number, the higher the potential danger to all creditors, for if the owners have little invested in the firm, there is far less incentive to do much to salvage the firm.

In the case of a leveraged buyout, the owner(s) typically have only one percent invested in the firm. In the past, bankruptcy courts were littered by these types of firms.

Gross profit margin. This ratio is computed by taking gross profit and dividing it by the net sales of a firm. This is an example of common-size analysis. The value of this ratio can be shown only when it is compared to

the industry standard. Is a company profitable? The answer depends on how it did in the previous years as well as how it is doing against its competition. This ratio also tells how much a firm can afford to lose on a sale before the profits of that sale are completely eaten away.

Return on investment. This ratio is computed by taking profit before taxes, dividends, and interest, and dividing them by the tangible net worth. It reflects the efficiency of management's performance by stripping away all other nonoperations and cost-of-sale items from net sales and shows just how much management has made through its efforts. If management ends up costing the firm profits through poor leadership, that situation will be reflected in these numbers when compared with industry standards.

HOW RATIOS CAN BE USED TO PREDICT FUTURE PERFORMANCE

By mapping the changes that have occurred over the stretch of data available, a prediction can be made. (Note: Predictions are only as good as the data used. The greater the number of years of data available, the better the prediction.) The data must be devoid of any large, unusual, or nonrecurring items. Any known (or unknown) major changes that have occurred recently or will occur to a company or its industry or a change due to a major legal ruling (i.e., a major acquisition, a bankruptcy filing, a spin-off of a major product line, etc.) will make future forecasting less accurate or totally inaccurate.

Apples with Apples Comparison

Obviously, the worth of any evaluation depends on the validity of the ratio comparison. How do you make sure that "apples" are compared to "apples" when equating ratios to industry averages? The use of the same formulas as are used to compute the ratios of the industry standards is the first step. The matching of ratios of companies in the same SIC code and in a similar narrow dollar sales range also will keep this comparison valid.

An attempt to discern "commonality" in how industry members value inventory and compute depreciation versus the customer's methods (this will be reflected in the annual report's notes section) will aid in making these comparisons more factual. The last and one of the most important

tasks involves checking the annual report's notes for unusual or one-time occurrences that affect the company's results. Doing so prevents miscalculations in determining true annual net income, especially when comparing income from the previous year to the present year. It also provides an accurate picture as to a company's "real" income from operations.

Benefits of Ratio Analysis

Ratios provide a means of comparing a firm's performance to that of an industry. Without this, there is literally no way to tell how the customer is achieving its goal to be the best in the industry. Ratios provide a means of comparing a firm's performance to that of its industry. This can help a firm to prove that it is on the right track as an operation that is successfully run.

Ratios view a company in light of solvency, efficiency, and profitability. These three areas are the most critical to a firm's survival. Ratios can provide a method to tie all the parts of a balance sheet and income statement together. Since parts of both kinds of data are used at times to calculate these ratios, and since they can be tied together by some additional ratios, they provide the "binding" that locks these two reports together.

One such example of a ratio that binds these two reports together is the DuPont method. It takes the total asset turnover (sales/assets) and ties it to the net profit margin ([net income/net sales] income statement) to give the return on investment (net income/assets). It then takes and multiplies the return on investment times the financial leverage ([assets/equity] [balance sheet]) to arrive at the return on equity (net income/equity). The DuPont method shows how efficiencies can be developed in both sides of a financial statement when they are reflected by the trend movement over a five-year period in the return on equity.

Ratios can show trends in all the parts of a balance sheet and income statement and can tie the results together and focus on the weakest link in the chain. The advantage of using ratios is that exceptional items or areas where the numbers are unusual will tend to stand out when compared against the industry numbers.

Ratios also can help to identify some tricks companies use to make their numbers look good, such as:

- Recording revenue too soon: This makes a firm appear more profitable than it really is.

- Recording bogus revenue: This can make a company appear profitable when it may or may not be profitable and can be a form of fraud.
- Boosting profits with one-time gains: This can make a customer appear more profitable than it is.
- Shifting current expenses to a later period: By doing this, a firm makes itself appear to be more profitable than it really is.
- Failing to record or disclose all liabilities: This is an attempt by a firm to appear financially sound when it may or may not be solvent and can be a form of fraud.
- Shifting current income to a later period: Playing games with profit using the "saving of income for a rainy day" method of accounting deceives shareholders into believing that income is consistently improving.
- Shifting expenses into the current period: This likewise uses the "saving of income for a rainy day" accounting technique and deceives shareholders into believing that income is consistently improving.

CONCLUSION

Using the four main forms of financial analysis—common, ratio, trend, and comparison to industry standards—provides the ability to determine the financial strength or weakness of a firm. It furnishes insights into how well a firm is being managed and can give a "look" into the future using past trends as a guide. These analyses are by no means the only sources of information that credit professionals have at their disposal for arriving at a sound business credit decision. Many other factors within and outside of the firm can and will influence the final decision. These factors are reviewed in Chapters 2 and 3.