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The ProSight Guide to Spreading Financial Statements

Spreading Financial Statement

"Spreading" is the process by which a bank transfers information from a borrower's financial statements into the bank's financial analysis spreadsheet program.

When the financial information is input correctly, the spreadsheet can generate meaningful financial reports to assist the bank in its analysis of the financial condition of the company. These reports include, but are not limited to:

- Common size balance sheet
- Common size income statement
- Financial Ratios
- Statement of Cash Flow
- Reconciliation of Net Worth

Additionally, ProSight member institutions all over the country annually submit those financial spreads ProSight to be compiled in ProSight's Annual Statement Studies® reports. ProSight's Annual Statement Studies® is the only source of comparative industry data that is sourced directly from the financial statements of business clients of ProSight's member institutions.

It provides the banking industry with reliable, accurate benchmarking figures including balance sheet and income statement line items, and financial ratios.

...and all that starts with a standard, uniform way of spreading of financial statements.

IMPORTANT: Bank spreads do not always conform to GAAP

Question 1: Isn't Spreading Financial Statements just a simple matter of transposing the borrower's financials into the bank's spreading program on the exact same lines?

No. While most of the information does get spread in accordance with GAAP, banks spreads deviate from GAAP in some key ways.

a. Current Assets that are restricted in any way are spread as Non-current Assets

b. Current Assets that won't actually convert to cash in the coming 12 months, or possibly ever, are spread as Non-current Assets.

c. Current Assets from related parties are spread as Non-current Assets.

d. Long Term Related Party Liabilities are spread as Current Liabilities.

Question 2: Does the quality of the financial statements factor into the Bank Financial Spreading Guidelines?

No. Regardless of whether you are spreading an unqualified audit or a company prepared statement, these Bank Financial Spreading Guidelines are going to deviate from those financials, i.e., deviate from GAAP, in the ways described in this guide.

Bank spreads reflect a more conservative view of the financials than GAAP, and whether it's a GAAP prepared audit or a GAAP prepared company prepared financial statement, the bank spreading principals remain the same. Refer to slide 4 for a more detailed explanation.

Why do Banks employ these deviation from GAAP?

Banks are **most** concerned with the borrower's ability to repay its debt. The presentation of financials in accordance with GAAP doesn't always match up with that goal. Banks employ a more **conservative** view of spreading financial statements than GAAP.

When evaluating a company's liquidity, a bank wants to have a better understanding of the **Current Assets** that can actually convert to cash to help support the subject debt, if needed.

Example #1:

Prepaid Expenses: GAAP prepared financial statements reflect Prepaid Expenses as a Current Asset. However, banks spread Prepaid Expenses as a Non-current Asset since this asset will never actually convert to cash. They will convert to the value of the expense that was prepaid, but that will not assist the borrower with cash to help service the subject debt. Similarly, in a liquidation scenario, those prepaids will often yield little to no value to reduce the debt.

Example #2:

Notes Receivable – Related Party (due within 12 months). Again, GAAP will reflect this item as a Current Asset. Banks, on the other hand, spread Notes Receivable – Related Party as Noncurrent Assets, recognizing that given the common relationship, whether the amount due actually gets paid on time, or at all, can be discretionary.

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<u>Take the following example:</u>

ABC Company is seeking a new banking relationship, and provides its financials to Bank A.

Bank A 'spreads' the financials but noticed in the footnotes that a sizable portion of the company's long-term debt is due to the company's owner, and spreads that debt as a Current Liability.

As one might imagine, the Current Ratio reflected in the Bank spreads was poor.

Spreading that related party long term debt as a current liability sent up a signal that was reflected in the low Current Ratio. The bank, in its analysis of the owner's personal financial condition included an assessment as to what reliance the owner had on payments of that debt in order to meet his own personal obligations.

Depending on what Bank A found:

(a) a high reliance, in which case acceleration might be a possibility and a drain on ABC Company; or

(b) little to no reliance, in which case a covenant limiting payments on the debt to some formula or threshold could be negotiated

If the Bank has not identified the potential issue of the related party debt and treated it as conventional thirdparty debt, there is an increased risk that Borrower liquidity is unexpectedly used to pay a significant portion (or all) of that related party debt ahead of schedule. In that instance, the liquidity cushion will have been eroded, impacting the financial condition of the company.

Red Flags

When making your Statement Studies financial ratios comparisons, if your spreads are consistently significantly outperforming the ProSight averages, it might be worth re-visiting your spreading standards to ensure they're matching up with the ProSight spreading guidance. If you're regularly spreading financials in a manner different than other banks, you may be developing a false sense of security.

And what if the spreads consistently appear to be materially worse than the Statement Studies ratios ? It might not be just a simple case of weak financials. The results could be telling you that your borrower's reliance on line items that have a more questionable likelihood of converting to cash or a greater possibility of the acceleration of amounts due to related parties is higher than the industry.

If the latter turns out to be the case (high percentages of amounts due from related parties and/or higher percentages of amounts due to related parties), there are ways to structure around those risks –assuming the underlying company and the related parties are each financially healthy. In fact, getting that information on the related parties can even lead to new business opportunities.

Assets

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	Current	Non-current	Intangible	Notes
Account Receivables				
From Affiliates		X		A/Rs due from related parties are spread as non-current, recognizing that such A/Rs have a discretionary aspect to their repayment in addition to the normal risks associated with A/R collection. If the related party A/Rs are truly trade A/Rs, then spread as 'trade' so that accurate turnover ratios can be calculated, e.g., Sales/Receivables; A/R days on hand.
From Customers (trade)	X			
From Employees		X		
From Directors		X		
From Partners		X		
Brands			X	
Buildings		X		
Canadian Gov't Securities	X			
Capitalized Costs			X	
Cash				While CSVLI can easily be converted to cash, it is normally spread as non-current, as the Cash Surrender Value is not expected to be relied upon in the normal course of business.
In Bank	X			
In Sinking Fund		X		
On Hand	X			
Restricted		X		
Cash Value of Life Insurance (CSVLI		X		While CSVLI can easily be converted to cash, it is normally spread as non-current, as the Cash Surrender Value is not expected to be relied upon in the normal course of business.
Certificates of Deposits	X			
Claims for Tax Refunds	X			
Costs in Excess of Billings	X			
Deferred Charges			X	This category is referring to prepaid expenses that are long term in nature and amortized over a period of years. Examples include loan fees paid on a new 5-year commercial term loan or relocation costs.

Assets

	Current	Non-current	Intangible	Notes
Deposits				Deposits to be held for a period of time e.g., insurance, utility, property lease, etc. are not available as a repayment source, and are consequently spread as non-current
With factor	X			
With Insurance Company		X		
With Utility Company		X		
Equipment		X		
Fixtures		X		
Foreign Assets		X		
Furniture		X		
Goodwill			X	
Government (US) Securities	X			
Insurance Deposits		X		See above 'Deposits'
Inventory				
Finished Goods	X			
Raw Materials	X			
Work in Process	X			
Investments		X		Investments that are long-term in nature and not specified in other balance sheet line items.
Land		X		
Leasehold Improvements		X		
Listed Marketable Securities	X			
Loans to Affiliates		X		See 'Notes Receivable -due from related parties'
Machinery		X		Follow the same standards as for Notes Receivable.
Mortgages Receivables	X			
Municipal Bonds	X			

Liabilities

	Current	Non-current	Intangible	Notes
Account Payable				
For Inventory	X			
For Services	X			
To Directors	X			
To Partners	X			
To Related Concerns	X			
Accrued Expenses				
Commissions	X			
Interest	X			
Other Expenses	X			
Rent	X			
Salaries	X			
Taxes	X			
Wages	X			
Billing in Excess of Costs	X			
Capital (Partnership or Proprietorship)			X	
Capital Shock			X	
Capital Surplus			X	
Common Stock			X	
Contracts Payable	X			
Current Portion – Long Term Debt	X			
Deferred Income (or Credits)		X		
Deposits				
From Customers	X			
From Employees	X			
From Office	X			

Liabilities & Net Worth

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	Current	Non-current	Intangible	Notes
Dividends Payable	X			
Income Taxes Payable	X			
Loans Payable				
Minority Interest		X		
Mortgages Payable				Unless the related party mortgages are specifically subordinated to your bank, mortgages payable to related entities should be spread entirely as a Current Liability. Absent the subordination, if financial problems do occur, the related parties have advance knowledge of the issue and may elect to accelerate repayment of the related party debt ahead of other obligations.
To an Unrelated Part – Amts due within 1 year	X			
To Related Party – Amts due within 1 year	X			
Notes Payable				See 'Mortgages Payable' for treatment of unrelated party and related party debt. The same rationale applies.
To Banks	X			
To Individuals	X			
To Partners	X			
To Related Entities	X			
To Stockholders	X			
Overdrafts	X			
Paud-in-Surplus			X	
Preferred Stock			X	
Provision for Income Taxes	X			
Reserves for:				Reserves may be spread as Current or Non-Current, depending on whether the expectation is for the liability to be paid within the coming 12 mn or not.
Contingencies	X			
Self-Insurance		X		
Taxes	X			
Subordinate Debt		X		
Surplus Account			X	
Terms Loans				See Notes Payables and Mortgages Payable
Unearned Income		X		

Income Statement Spreading Tips

Remember that certain expenses may appear in various parts of the Income Statement and need to be identified and then spread on the appropriate line.

For example:

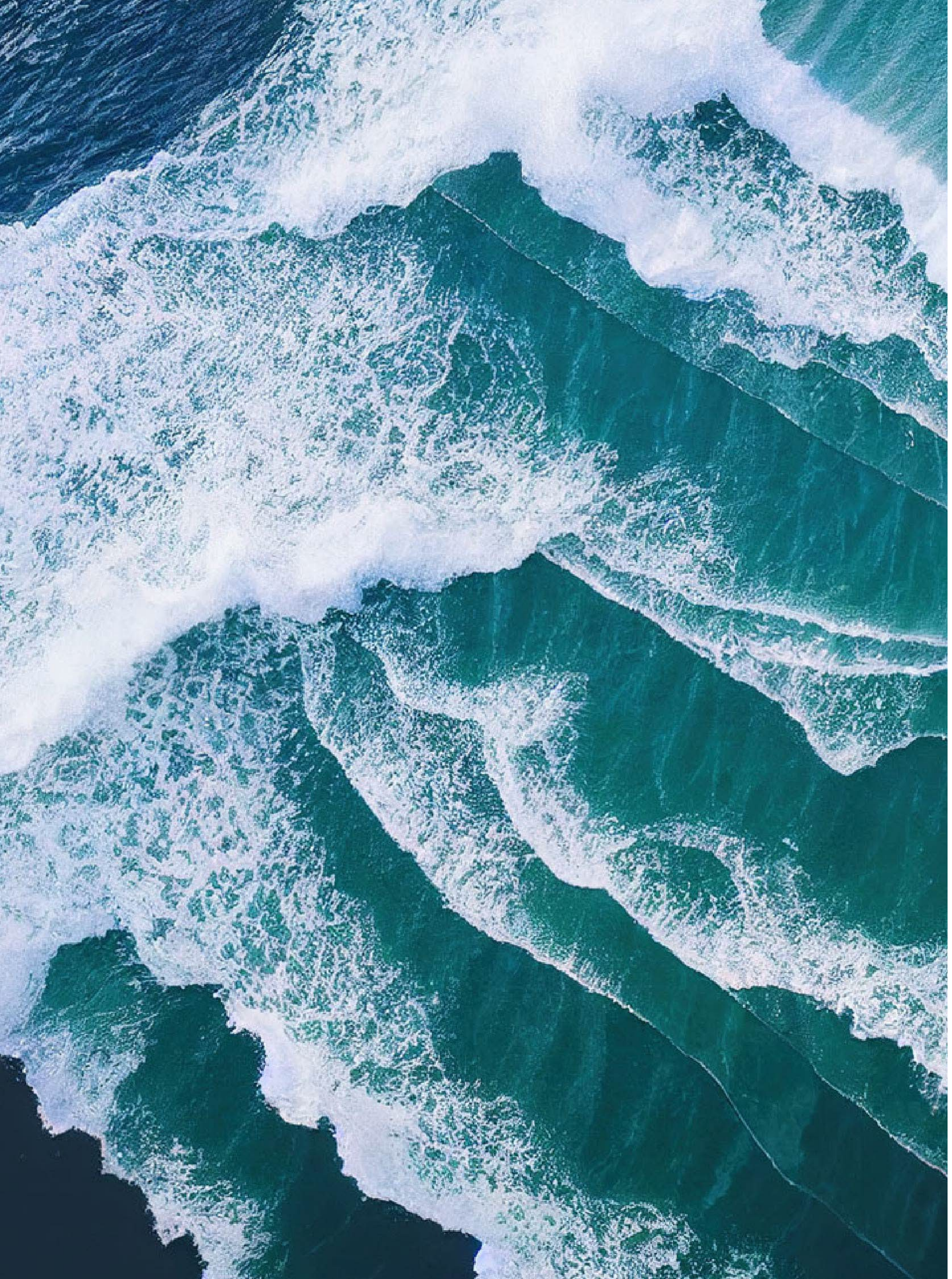
Accounting standards for homebuilders allow them to include interest expense for homes that have been sold in Cost of Goods Sold. If you have not identified and broken that amount out of COGS and included that figure in with Interest Expense, you will be grossly understating Interest Expense for the company. Naturally, this will materially affect ratios such as EBIT/Interest Coverage.

Depreciation and amortization can be found in various segments of the business. Make sure you are capturing all the depreciation and amortization expenses when spreading the Income Statement.

To the extent you are able to identify Officers' Compensation and break-out that figure in the Income Statement Spreads, that information is tremendously helpful in identifying to what extent Salaries may include a discretionary component.

See RMA Journal, November 2004, "Getting Behind the Numbers, Part 4 -Profitability, It's Not Just the Bottom Line."

This is not an all-encompassing list, but it may help prompt the thought process when spreading the Income Statement. As with the Balance Sheet, spreading the Income Statement is not simply a mechanical process. It requires thinking through the implications about how certain line items are spread and how that affects the financial ratios generated.



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Summary

- Spreading financial statements to ProSight banking industry guidance:
  1. Is necessary to make accurate comparisons between the company that you've spread and ProSight Statement Studies Ratios.
  2. Signals potential issues that should be addressed in the underwriting and structuring of a loan.
  3. Should not be a mechanical exercise on "autopilot", every financial statement that is spread must be thought out. The accountant's footnotes must be read, schedules must be reviewed, questions may have to be asked, and a logical thought process compatible with the banking industry's approach to spreading should be followed. If an exception is made, the rationale should be well supported and explained so the Credit Approver is aware of the change.

Summary

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- The credit analysis process starts with:
  1. Obtaining a quality level of financial information commensurate with the transaction size and risk
  2. The uniform spreading of that information to ProSight guidance
  3. An assessment of the results of those spreads relative to peer companies through use of the Annual ProSight Statement Studies.
- Together, these three actions form the basis that help a bank conduct its financial analysis of a potential Commercial Borrower.
- When financial statements are not spread in accordance with ProSight spreading guidelines, Credit Approvers are not provided with all the information they need to make the best, informed credit decision. The ProSight Guidelines surface what might have been otherwise overlooked risks. Once identified, those potential risks can then be factored into credit decisioning and loan structuring and lead to more sound credit portfolio.

Thank You

For more information about the Campaign:
www.prosightfa.org/statement-studies-submissions

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