The RMA Guide to Spreading Financial Statements

SPREADING FINANCIAL STATEMENTS

"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 Flows.
- Reconciliation of Net Worth.

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

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

Answer: 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 DEVIATIONS 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 Non-current Assets, recognizing that given the common relationship, whether the amount due actually gets paid on time, or at all, can be discretionary.

IMPLICATIONS

Take the following example:

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 third party 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 RMA averages, it might be worth re-visiting your spreading standards to ensure they're matching up with the RMA 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.

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Assets

	Current	Non-Current	Intangible	Notes
Accounts Receivable				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 Affiliates		X		
From Customers (trade)	X			
From Directors		X		
From Employees		X		
From Partners		X		
Brands			X	
Buildings		X		
Canadian Gov't Securities	X			
Capitalized Costs			X	
Cash				Cash in a Sinking Fund and Cash that is designated as Restricted, is not liquid and is not immediately available for use by the company, consequently it is spread as non-current.
In Bank	X			
In Sinking Fund		X		
On Hand	X			
Restricted		X		
Cash Value of Life Insurance		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 Deposit	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.

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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 (U.S.) Securities	X			
Insurance Deposits		X		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.
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		
Mortgages Receivable	X	X		Follow the same standards as for Notes Receivable.
Municipal Bonds	X			

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Assets

	Current	Non-Current	Intangible	Notes
Notes Receivable				* For Third-Party N/R, the portion of N/Rs that are due within 12 mos. would be spread as 'Current', while the remaining balance would be spread as 'Non-current'. * For N/R due from related parties, the entire amount is spread as 'Non-current' due to the discretionary aspect to repayment.
Due from third parties	X	X		
Due from related parties		X		
Patents			X	
Prepaid Items				Prepaids are spread as non-current, recognizing that they are not liquid, i.e., are not available as a source of repayment.
Insurance		X		
Rent		X		
Suppliers		X		
Taxes		X		
Real Estate		X		
Research & Development			X	
Ships		X		
Trademarks			X	
Trucks		X		
Unlisted Securities		X		
Vessels		X		
Water Rights (Riparian Rights)			X	

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Liabilities & Net Worth

	Current	Non-Current	Net Worth	Notes
Accounts 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			
Billings in Excess of Costs	X			
Capital (Partnership or Proprietorship)			X	
Capital Stock			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 Officers	X			
Dividends Payable	X			
Income Taxes Payable	X			

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Liabilities & Net Worth

	Current	Non-Current	Net Worth	Notes
Loans Payable (see Notes Payable and Mortgages 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 party - Amts. due within One Year	X			
To an unrelated party - Amts. due after One Year		X		
To a related party - Amts. due within One Year	X			
To a related party - Amts. due after One 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			
Paid-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 mos. or not.
Contingencies	X			
Self-Insurance		X		
Taxes	X			
Subordinated Debt		X		
Surplus Account			X	
Term Loans (see Notes Payable and Mortgages Payable)				See "Mortgages Payable" for treatment of unrelated party and related party debt. The same rationale applies.
Unearned Income		X		

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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", pp. 58-60.

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.

SUMMARY

Spreading financial statements to RMA banking industry guidance:

- is necessary to make accurate comparisons between the company that you've spread and RMA Statement Studies Ratios.
- signals potential issues that should be addressed in the underwriting and structuring of a loan.
- 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.

The credit analysis process starts with: (a) obtaining a quality level of financial information commensurate with the transaction size and risk; (b) the uniform spreading of that information to RMA guidance; and (c) an assessment of the results of those spreads relative to peer companies through use of the Annual RMA 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 RMA spreading guidelines, Credit Approvers are not provided with all the information they need to make the best informed credit decision. The RMA 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.