AN INTRODUCTION TO
The RMA Guide to Spreading Financial Statements

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The RMA Guide to Spreading Financial Statements, created by RMA’s Accounting Committee, has recently been made available on the RMA website. The guide is intended as an industry document that will help promote greater consistency in the spreading of bank financial statements.

The guidelines provided in the publication match the spreading practices at most banks. Many of those spreads make up the financial information contained in the RMA Annual Statement Studies®, used by many banks when performing credit analyses of potential borrowers.

Spreading Financial Statements
“Spreading” is the process by which an analyst transfers information from a borrower’s financial statements to the bank’s financial analysis spreadsheet program.

When the financial information is entered correctly, the spreadsheet can generate meaningful financial reports that help banks analyze a company’s financial condition.

These reports include, but are not limited to, the following:
• Common-size balance sheet.
• Common-size income statement.
• Financial ratios.
• Statement of cash flows.
• Reconciliation of net worth.

RMA member institutions from all over the country submit their financial spreads for inclusion in RMA’s Annual Statement Studies. This compilation of comparative industry data is sourced directly from the financial statements of RMA members’ business clients. Following these spreading guidelines will result in providing the banking industry with the most reliable and accurate benchmarking figures, including balance sheet and income statement line items, and financial ratios.

Bank Spreads Don’t Always Conform to GAAP
Spreading financial statements is not just a matter of transposing the borrower’s financials into the bank’s spreading program on the exact same lines. Although most of the data does get spread in accordance with GAAP, banks’ spreads deviate from GAAP in some key ways:
• Current assets that are restricted in any way are spread as noncurrent assets.
• Current assets that won’t actually convert to cash in the coming 12 months, or possibly ever, are spread as noncurrent assets.
Current assets from related parties are spread as noncurrent assets.

Long-term related-party liabilities are spread as current liabilities.

**Why Do Bank Spreads Deviate from GAAP?**

Banks are most concerned with their borrowers’ ability to repay their debts. But 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 does.

For example, when evaluating a company’s liquidity, a bank wants to have a better sense of which current assets can actually convert to cash to help support the subject debt if needed.

GAAP-prepared financial statements reflect prepaid expenses as a current asset. Banks, however, spread prepaid expenses as a noncurrent asset because the reality is that those prepaids will never actually convert to cash. They will convert to the value of whatever expense was prepaid, but that will not assist the borrower with cash to help service debt. Similarly, in a liquidation, those prepaids will bring little to no value in reducing debt.

Another example is Notes Receivable—Related Party (due within 12 months). Again, GAAP will reflect this item as a current asset. Banks, on the other hand, spread it as a noncurrent asset, recognizing that, given the common relationship, whether the amounts due actually get paid on time (or at all) can be discretionary.

**Financial Statement Quality**

The quality of the financial statements does not factor into the financial spreading guidelines. Regardless of whether you are spreading a GAAP-prepared unqualified audit or a GAAP company-prepared statement, the spreading guidelines will deviate from those financials—that is, deviate from GAAP—in the ways described in the guide. Bank spreads reflect a more conservative view of the financials than GAAP does. The quality of the financials provided does not change that. The spreading principles remain the same.

**An Example**

Seeking a new banking relationship, ABC Company provides its financials to Bank A.

Bank A spreads the financials, but notices in the footnotes that a sizable portion of the company’s long-term debt is due to the company’s owner. It spreads that debt as a current liability.
As one might imagine, the current ratio reflected in the bank’s 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. In its analysis of the owner's personal financial condition, the bank included an assessment of how much reliance the owner had on payments of that debt in order to meet his personal obligations.

The assessment would depend on what Bank A found: either a high reliance, in which case acceleration might be a possibility and a drain on ABC Company; or little to no reliance, in which case a covenant limiting or preventing payments on the debt could be negotiated.

Clearly, if the bank had not identified the potential issue of the related-party debt and had treated it as conventional third-party debt, it may one day have received a financial statement from ABC Company showing a sizable loss in liquidity—liquidity that had been used to pay off or pay down the related party ahead of schedule and significantly changing the company's financial condition.

**Red Flags**

When comparing your borrower’s financial statement information against the financial ratios in Statement Studies, be mindful of the following issues.

If the spreads you’re reviewing are consistently outperforming the RMA averages by a wide margin, it might be worth revisiting your spreading standards to ensure they’re matching up with the RMA guidance. If you’re regularly spreading financials in a manner different from other banks, you may be creating a false sense of security.

And what if your spreads are consistently appearing materially worse than the industry ratios? It might not be just a 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 accelerating amounts due to related parties, is higher than the industry average.

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 both financially healthy. In fact, getting that information on the related parties can even lead to new business opportunities.

**Conclusion**

Credit analysis follows a three-step process by which a bank evaluates a potential commercial borrower:

1. Obtain a quality level of financial information commensurate with the transaction’s size and risk.
2. Spread that information uniformly, in accordance with RMA guidance.

3. Use RMA’s Annual Statement Studies to assess the results of those spreads relative to the borrower’s peer companies.

Spreading financial statements in accordance with RMA guidance allows for accurate comparisons between the company that you’ve spread and the ratios in the RMA Statement Studies. It also signals potential issues that should be addressed in the underwriting and structuring of a loan.

But financial statement spreading should not become a mechanical exercise performed on autopilot. Every spread must be well thought out. The accountant’s footnotes must be read, schedules must be reviewed, questions may have to be asked, and a logical thought process, one 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 that the credit approver is aware of the change.

When financial statements are not spread in accordance with RMA guidelines, credit approvers are not provided with all the information they need to make the most informed credit decision. RMA’s spreading guidelines bring to light risks that might have been overlooked. Once identified, those potential risks can then be factored into credit decisioning and loan structuring, leading to a sounder credit portfolio.

*The views and opinions expressed in this article are solely those of the author.*

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To access The RMA Guide to Spreading Financial Statements, go to the RMA website (rmahq.org) and click on the Knowledge Center tab under Publications and Resources.